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TAXATION

OF

FOREIGN AND NATIONAL ENTERPRISES

(Volume III)

STUDIES OF THE TAX SYSTEMS AND THE METHODS OF ALLOCATION OF THE PROFITS OF ENTERPRISES OPERATING IN MORE THAN ONE COUNTRY

BRITISH INDIA, CANADA, JAPAN, MEXICO, NETHERLANDS EAST INDIES, UNION OF SOUTH AFRICA, STATES OF MASSACHUSETTS, OF NEW YORK AND OF WISCONSIN.

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PREFACE

This volume contains a study of the system of the taxation of income in nine non-European States n the point of view of enterprises doing business in more than one country. Together with a ilar volume dealing with the legislation of a certain number of European countries [1], it is the ult of an enquiry of which the first findings were published in a volume entitled " Taxation Foreign and National Enterprises in France, Germany, Spain, the United Kingdom and the ited States of America ".

This enquiry, which was undertaken thanks to a grant from the Rockefeller Foundation, had its principal object the study of the methods actually employed for the allocation or portionment of the income of enterprises having establishments in countries other than that of ir fiscal domicile. Its purpose was to provide the Fiscal Committee with the data necessary formulating a draft convention for the avoidance of the double taxation of business income.

These data were submitted to the Fiscal Committee at its fourth session in June 1933, together th a study by Mr. Mitchell B. CARROLL, director of the enquiry, entitled " Report on the Methods allocating Taxable Income " [2], which consists, on the one hand, of a general survey of the methods allocation practised in the different countries, and, on the other, of the practical conclusions nding to indicate which system of allocation would appear most suitable for general adoption. his documentation was completed by a study by Professor Ralph C. JONES, on the accounting pects of the allocation of the income of industrial enterprises [3].

On this basis, the Fiscal Committee has framed a draft Convention which it adopted on June th, 1933, and which is principally intended to serve as a model for bilateral and even multilateral nventions.

A prerequisite for an examination of the methods for allocating business income as well as the ethod of taxing the different items of income is a knowledge of the system of direct taxation in ach of the countries under review. Each report contained in the two volumes now being published, s well as those which appeared in the 1932 volume, is divided into three sections :

1. A survey of the income-tax system.

2. A survey of the methods of taxing the various items of income (interest, dividends, royalties from patents and other intangible property, income from real property, salaries and wages, business income) according to whether they belong to foreign or national enterprises, or whether they arise from foreign or national sources.

3. Finally, a last section in which is examined, first, the provisions applicable to the taxpayer's books and accounts ; secondly, the use of the different methods of allocation (separate accounting, fractional apportionment, empirical methods), and thirdly, the manner in which gross profit, interest, general overhead and net profit are apportioned between the branch and the real centre of management. This section is completed by a study of concrete cases ; an examination is made of the manner in which the rules set forth in the preceding paragraphs are applied to the different kinds of enterprises, such as industrial and commercial enterprises, banks, insurance companies, railways, electricity and gas companies, telephone companies and mines.

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[1] *Taxation of Foreign and National Enterprises* — Volume II : Austria, Belgium, Czechoslovakia, Free City of Danzig, Greece, Hungary, Italy, Latvia, Luxemburg, Netherlands, Roumania and Switzerland. (L.o.N. document C.425.M.217.1933.II.A.)

[2] Volume IV of this collection (L.o.N. document C.425*(b)*.M.217*(b)*.1933.II.A).

[3] Volume V of this collection (L.o.N. document C.425*(c)*.M.217*(c)*.1933.II.A).

The outline indicated above has been followed in each of the studies undertaken in the course of the enquiry, and for this reason it should be easy to compare the various tax systems point by point. It also makes it possible to complete, when necessary, the material synthesised in Mr. Carroll's study and to ascertain to what extent the adoption of the rules advocated by the Fiscal Committee would confirm or modify the practices now followed in allocating profits.

The studies contained in this volume have been prepared either by the members of the Fiscal Committee or, under their direction, by officials in the Fiscal Administrations of the different countries. The names of the authors are to be found on the title-page of each study.

BRITISH INDIA

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PART I. — GENERAL DESCRIPTION OF INCOME-TAX SYSTEM[1]

1. For the purpose of this survey India must be taken as consisting of two parts — viz., British India and the Indian States. Except for a few areas directly administered by the Central Government, British India is divided into provinces administered by Governors. The Central Government and the Provincial Governments have their own separate resources. Under the Constitution, the head of revenue "Taxes on Income" — which includes both income- and super-tax, and, when it was in existence, excess profits duty — is a central item of revenue. These taxes are administered by the Commissioners of Income-Tax in each province, subject to the supervision of the Central Board of Revenue, which works under the control of the Governor-General in Council, and is the highest administrative authority in regard to income tax. It makes the statutory rules and issues executive instructions on various matters of detailed procedure and administration generally (Income-tax Act of 1922).

2. A small part of income-tax revenue proper is given, however, to Provincial Governments as representing their shares in the growth of such revenue since the Montagu-Chelmsford reforms. Certain local authorities in British India levy income-taxes, called by different names in different localities, but these taxes are on such a small scale that they can be ignored.

3. The Indian States — *i.e.*, protected and feudatory States — have their own fiscal resources, over which, for all practical purposes, the Government of India has no control, and in which, in any case, it does not participate. For the purpose of income-tax administration, each of these States is practically a foreign State in relation to British India. The several Indian States which levy income-tax have their own separate laws regulating the tax. Generally speaking, most of these laws are modelled on the British-Indian law, though the rates of tax are lower than in British India. This survey will confine itself to the law and practice of income-tax administration in British India.

4. In 1929-30, the taxes on income yielded about 11 per cent of the tax and Customs revenues of British India and about 7 per cent of the total revenues. [2]

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[1] Legislation in force on April 30th, 1933.

[2] The table below shows in rupees the importance, for the fiscal year 1929-30, of taxes on income in the British-Indian fiscal system :

Principal heads of revenue	Central Rupees	Provincial Rupees	Total Rupees
Customs	51,27,66,229	—	51,27,66,229
Taxes on income	16,70,60,821	35,73,975	17,06,34,796
Salt	6,76,46,354	—	6,76,46,354
Opium	3,04,09,788	—	3,04,09,788
Other heads	2,25,60,177	74,37,48,405	76,63,08,582
	80,04,43,369	74,73,22,380	1,54,77,65,749
Receipts from railways, irrigation, interest, etc.			72,48,82,649
Total revenue	1,32,68,52,091	94,57,96,307	2,27,26,48,398

5. The law relating to income-tax[1] is contained in two groups of statutes, the rates of taxation being regulated by the annual Finance Acts, and everything else — viz., machinery, basis of liability, computation, procedure and administration being regulated by the Indian Income-Tax Act (XI of 1922), [2] as amended from time to time, and the Government Trading-Taxation Act (III of 1926).

6. The tax is composed of the income-tax, which falls directly or indirectly on individuals, a super-tax on individuals and certain associations and a super-tax on companies. The income-tax has progressive rates, but is imposed sometimes at its maximum rate, as when levied on the income of companies or withheld from interest on securities ; or sometimes at an estimated rate, as when deducted from salaries. The shareholder receiving dividends does not pay income-tax again on them, but they are included in his total income for the purpose of determining the rate applicable thereto. Tax withheld from interest and salaries is credited against the individual's tax on total income. If the rate levied at source (as in the case of dividends) or collected at source exceeds the rate applicable to the total income of an individual, he may obtain a refund of the difference. The super-tax is imposed at progressive rates on successive slices of income exceeding an exempted minimum. The income-tax and super-tax form, in effect, a single tax on the total income of the individual. Nevertheless, for the purpose of computing taxable income, the various items are classed in different categories — namely, (1) salaries ; (2) interest on securities ; (3) property ; (4) business ; (5) professional earnings, and (6) other sources.

The company super-tax [3] is levied at a flat rate on the total income of the company, less an exempted minimum of Rs. 50,000. It is a tax on the company itself and may therefore not be credited against the tax on the shareholder.

7. The tax is levied : *(a)* for each year (from April 1st to the following March 31st) ; *(b)* at the rates prescribed by the Finance Act for that year ; *(c)* on every individual, firm, company, Hindu undivided family, or other association of individuals ; *(d)* on the income, profits and gains of the previous year accruing, arising or received in British India, or deemed under the Act so to accrue, arise or be received (Sections 3 and 4).

The tax, it will be noted, is levied in arrear — *i.e.*, on the ascertained income of the previous year, which is both the basis and measure of liability. Subject to certain exceptions governing peculiar cases like discontinuance of business, the position, broadly speaking, is that, if there is no income in a given year falling within the Act, there is no liability to tax in the next year, while, if there is such income, the liability remains for the next year, even though there may be no income in that year.

The tax in each year, though levied on the basis and measure of the previous year's income, is a liability to the Crown for the year in which tax is levied, and has therefore to be levied at the rates prescribed for that year by the Finance Act of that year. [4]

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[1] This expression is used in this study as referring generally to super-tax also, unless differentiated from it in the context

[2] References to "sections" are to those of the Indian Income-Tax Act of 1922, as amended, unless stated to the contrary. References to "rules" are to those in the *Income-Tax Manual*, fourth edition, 1931, Part II References to *Income-Tax Manual*, paragraph .... are to paragraphs in the same manual, Part III, entitled "Notes and Instructions regarding the Income-Tax Law and Rules". The word "paragraph" refers to paragraphs in this survey.

[3] The reason for introducing the company super-tax was that, when the super-tax was first levied in India in 1917 at graduated rates on income in excess of Rs. 50,000, the rates were imposed on companies in respect of their undistributed profits, and the distributed profits were taxed in the hands of the shareholder as a part of his income. The commercial community criticised this arrangement, because it discouraged the accumulation of undistributed profits and encouraged the distribution of profits beyond the limits of prudence and safety. Consequently, in 1920, the tax on companies was modified, so as to be levied on the entire profits less Rs 50,000 at a rate of one anna in the rupee instead of on a graduated basis The shareholder was not credited with the tax paid by the company, and the super-tax on companies became all but in name a corporation-profits tax *(Sundaram*, third edition, page 13).

[4] In *re* Behari Lal Mullick, 2 I.T.C. 328.

8. " Previous year " is defined at some length in the Act and means, broadly speaking, the last closed accounting year of the taxpayer before March 31st, or, if accounts are not kept or closed, the last financial year of the Government ending March 31st. In order to prevent evasion of tax by manipulation of the accounting period from time to time, the law forbids changes in the accounting period of a taxpayer except with the consent of the income-tax officer (Section 2 (11)).

1 TAXPAYERS.

9. The different classes of persons liable to tax are : (1) individuals, (2) partnerships, (3) companies, (4) Hindu undivided families, and (5) other associations of individuals (Section 3). By the Government Trading-Taxation Act, Governments of His Majesty's Dominions (which, by special definition, include territories under His Majesty's protection and those " mandated " to His Majesty's Dominions) are liable to tax on the income from their trading operations and property in British India in the same manner as a company.

10. From the preceding general description of the income-tax (paragraphs 5 to 8), it is evident that the British India income-tax is levied primarily on the basis of the principles of origin and receipt. Income is taxable if, actually or presumptively, it arises, accrues or is received in British India. Domicile plays no part in determining tax liability, and nationality is not considered except in regard to allowing certain refunds only to British subjects or subjects of Indian States (paragraph 55), and recouping from residents the tax on profits diverted to non-residents not being British subjects or companies (paragraph 97). The residence of the taxpayer is taken into account in several provisions under which income is deemed to arise or accrue or to be received in British India, but those provisions are subsidiary to the general rule of liability stated above, and will be described in detail under the heading of taxable income (paragraphs 27 *et seq.*). Broadly speaking, an enterprise conducted by a resident taxpayer will be taxable on all income arising, accruing, or received for the first time in British India, and also on profits arising or accruing abroad which are brought into India within three years. Other foreign income is not taxable as a general rule, unless received for the first time in British India, which in practice rarely occurs. An enterprise conducted by a non-resident is taxable on income arising, accruing or received for the first time in British India. All income derived by a non-resident from a business connection in British India is deemed to arise or accrue there, and all income derived from the sale in British India of goods which have been manufactured or purchased abroad is deemed to arise, accrue and be received there (see paragraphs 28 to 34).

(a) *Individuals.*

11. Individuals are taxed at graduated rates (see Annex, and Schedules to Finance Act every year). The rate of income-tax rises by steps, and tax is levied at a single rate for the whole taxable income, the rate being determined by the " total income ". Marginal relief is allowed at the points where the steps arise, the tax being restricted to the amount payable on the highest income in the lower range plus the excess of the income over this maximum. Super-tax, which is also graduated, is levied on the slab plan, progressively rising rates being applied to successive slices of income. The only marginal relief required, and given, in the case of super-tax is at the points at which changes in the rate of income-tax coincide with changes in the rate of super-tax (Section 17 and notification under Section 60).

12. The manner in which individuals are taxed at source and the extent to which tax is collected at source will be explained later (paragraph 51) ; but in the meantime it may be observed that married persons are not taxed together as one person, merely because they are married. No distinction is made between earned and unearned incomes. No allowance or abatement is given either for the taxpayer himself or his family. The only allowances of a personal nature are in respect of certain

provident fund contributions and insurance (see paragraph 42). The same rate of income-tax is applied to the whole taxable income, and not, as in certain other countries, at reduced rates for a certain initial part of the income and at the full rate thereafter.

(b) *Partnerships.*

13. For the purpose of the Income-Tax Act, partnerships or firms [1] are of two kinds — viz., registered and unregistered. A registered firm is a firm " constituted under an instrument of partnership specifying the individual shares of the partners ", of which certain particulars (notably in regard to the names of the partners and the importance of their shares) prescribed by statutory rules have been registered by the income-tax officer. (Sections 2 (14) and 2 (6 A) and Rules 2 to 6). The " prescribing " is done by the Central Board of Revenue by the issue of rules having statutory force. A firm which is not registered is an unregistered firm.

14. A registered firm pays no super-tax but pays income-tax at the maximum rate on its profits (see Annex, and Schedules to Finance Act every year). The partners do not have to pay any further income-tax on the shares of profits due to them, but have to pay super-tax on such profits if personally liable, with reference to their " total income " (Sections 14 and 58). They can also get refund of income-tax on their shares of profits, if they are eligible, on the basis of their " total income ", which includes their shares of profits of the firm which have been taxed in the hands of the firm (Sections 14 and 48).

15. The law assumes that the shares of profits are actually received by the partners in the same year (paragraph 55, *Income-Tax Manual).* If for any reason the firm has not been assessed, the shares of the partners will be merely added on to their other income, and tax levied on the whole in their hands. It will be noted that taxing the registered firm is really " machinery " and, that the scheme of the law is to tax the individual on the basis of his total income.

16. An unregistered firm pays both income-tax and super-tax at graduated rates exactly like an individual (see Annex, and Schedules to Finance Act every year). No further tax is payable by the partners in respect of their shares of profits which, however, are added to total income — *i.e.*, for the purpose of determining the rate of tax payable on the rest of the income (but not for the purpose of super-tax) (Sections 14, 16 and 55). No refund of tax can be claimed by the partners. If for any reason the firm has not been assessed *(e.g.*, if its profits are below the taxable limit), the shares of the partners will be added on to their income, and tax levied on such total. This applies both to income-tax and super-tax.

17. It will be seen that, while the partner of a registered firm ultimately suffers tax on the whole of his income at the rate appropriate to his total income, a partner in an unregistered firm may be suffering on a part of his income — namely, his share of the firm's profits — tax at a rate higher or lower than the rate applicable to his total income.

18. There is no obligation on firms to register, and registration is subject to renewal every year. The reason for not compelling all firms to register is to relieve partners in petty businesses from the trouble of applying for refund on the profits taxed at source. This one-sided option allowed with the above-mentioned object was, however, abused by certain rich persons who divided their business, nominally, between a number of different partnerships and registered only those which it suited them to register and only when it suited them to register. Power was taken in 1930 to tax, in

[1] The terms " partnership " and " firm " have the same meanings in the Income-Tax Act as they have in the Indian Contract Act, 1872. " Partnership is the relation which subsists between persons who have agreed to combine their property, labour or skill in some business, and to share the profits thereof between them. Persons who have entered into partnership with one another are called collectively a firm " (Section 239 of the Indian Contract Act). It may be mentioned, in passing, that the general law relating to partnerships is at present being amended and consolidated.

certain circumstances, such " one-man concerns " directly on the partners — *i.e.*, practically to treat the firms as registered (Section 23A).

19. If a registered firm defaults in submitting its return of income or its accounts or producing evidence in support of its return when called upon to do so, its registration is automatically cancelled (Section 23 (4)).

(c) *Companies.*

20. A company under the Income-Tax Act is a company formed under the Indian Companies Act, or under a Royal Charter, or Letters Patent, or an Act of Parliament, or an Act of the Legislature of a British possession. It includes foreign associations doing business in British India, whether incorporated in British India or not, which the Central Board of Revenue may declare to be companies *e. g.*, American corporations and French *sociétés anonymes* (Section 2 (6)). A company is taxed at the maximum rate of income-tax on the whole of its taxable income, whether distributed or not. It also pays the company super-tax (see paragraph 6) at a flat rate on the excess of its total income above a free limit of Rs. 50,000 (see Annex, and Schedules to Finance Act every year). No income tax is payable by the shareholder in respect of his dividend if the company has been assessed (Section 14). On the other hand, he can obtain refund of income-tax if his total income, which will include the dividend plus maximum income tax on it, entitles him to such refund because of being subject to a lower rate (Sections 16 and 48). No registered firm or company holding shares in a company can get a refund of income-tax, since its own appropriate rate would also be the maximum. Refunds, therefore, can be obtained only by other kinds of shareholders. The dividends are included in the total income of the shareholder for the purpose of the graduated super-tax or the company super-tax.

21. As the company super-tax is on the income of the company itself, and is therefore regarded as a corporation tax, the shareholder cannot claim a refund in respect thereof, nor can he set off this tax against the super-tax to which he may himself be liable if his total income exceeds the exempted minimum (Section 58). A holding company must pay super-tax. Although a holding company does not pay income-tax on dividends received from a taxed company, it must pay super-tax on dividends already subjected to the super-tax levied on the distributing company. Though really a corporation tax, the company super-tax is not allowed as a deduction from taxable income for the purposes of income-tax (Section 10).

22. The levy of super-tax on companies at a flat rate, while super-tax is levied at graduated rates on individuals, has led to the evasion of tax by certain individuals through the formation of " one-man " companies. In order to prevent such evasion, the law was amended in 1930 so as to empower the revenue officers to ignore such companies and tax their profits directly in the hands of the shareholders (Section 23A).

(d) *Hindu Undivided Families.*[1]

23. The Hindu undivided family is a separate unit — a juristic person — for various purposes under the civil law of the country. The Income-Tax Act, therefore, treats such a family as a separate unit of taxation, represented in its dealings with the Revenue Department by its manager.

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[1] Such a family is a co-parcenary arising out of certain definite degrees of relationship (including adoption) and cannot be created by contract. Such a family can own property, and can buy and sell it and carry on trade ; and, in fact, can do almost everything which an individual can do. The family is usually administered by the eldest male member. The law relating to the Hindu undivided family is governed by various sacred books of the Hindus, commentaries on and digests of these books, custom, and, since the advent of British rule, rulings of courts.

24. The Hindu undivided family is taxed exactly like an individual at graduated rates, but the allowance on account of super-tax is larger than in the case of an individual (see Annex, and Schedules to Finance Act every year). The members pay no tax (neither income-tax nor super-tax) on their share of income received from the family ; and such shares are not included in their total income — *i.e.*, in fixing the rate of tax payable on the rest of their income. In this last respect the difference between partners of unregistered firms and members of Hindu undivided families should be noted. In the case of these families, the income of the family is completely ignored in assessing the extra-family income of the members, and such extra-family income is completely ignored in assessing the family (Section 14). No question of refund as a consequence of taxation at source arises in this case.

(e) *Other Associations.*

25. This residuary head includes institutions like unincorporated clubs, co-operative societies and chambers of commerce — in fact, all associations not previously mentioned, but excluding a foreign State. Such associations and their members are taxed exactly on the same basis as unregistered firms and their partners, subject to one difference — viz., while partners of unregistered firms cannot be super-taxed on their shares of the firm's profits if the firm has been taxed, a member of an association which is not a firm can be so taxed a second time. This, however, was unintended (a mere error in drafting) and the practice is not so to tax a second time (Sections 14, 16 and 48).

26. It will be seen from the foregoing statement that the broad scheme of the Act is ultimately to tax individuals on their incomes, but this object is defeated to some extent by the existence of unregistered firms, Hindu undivided families and certain nondescript associations of individuals. The scheme is further altered by the taxation of undistributed profits of companies (though in the long run even this tax is suffered by individuals) and the company super-tax (which, however, is really a corporation tax and not meant to be a tax on individuals).

2. TAXABLE INCOME.

27. Subject to certain exemptions given either by the Act or by the Governor-General in Council, under the powers given to him by the Act, the Act applies to :

(a) All income accruing, arising or received in British India ; and

(b) All income deemed by the Act so to accrue, arise or be received (Section 4 (1)).

The following kinds of income are deemed to be liable under *(b)* above :

(1) Profits and gains from a business accruing or arising abroad to a resident of British India if brought within three years [1] of the close of the year of origin (Section 4 (2)) ;

(2) Salaries paid outside British India but within India (in protected and feudatory States) to a British subject or any servant of His Majesty by the Government or a local authority (Section 7) ;

(3) Professional fees paid in any part of India to a person ordinarily resident in British India (Section 11) ;

(4) Profits and gains accruing or arising to a non-resident — whether directly or indirectly — through or from any business connection or property in British India (Section 42).

[1] The reason for the three-year limitation is that, if the income remains abroad for more than that length of time, it is presumed to become capital which is not taxable. To obtain this exemption, the burden is upon the taxpayer to prove that the money brought into India arose or accrued abroad more than three years before it was brought into the country, or, if it were brought within the country in less than three years after it accrued, that it is capital. There is a legal presumption that, if a taxpayer has profits to remit, he will remit them before he remits capital.

28. The British Indian income-tax bases liability primarily upon the fact of origin or receipt in British India, and the fact of residence or non-residence is of importance, from the viewpoint of international commerce, in only two cases. By " origin in British India " is meant the fact that income arises or accrues in British India, or is deemed to arise or accrue in British India in accordance with certain provisions of the Act. By virtue of the principle of receipt, certain income, which actually has its origin outside British India, may become liable to tax by the fact that it is received for the first time in British India. Inconsistencies arise because of the application of the doctrine of receipt in addition to the doctrine of origin, but no attempt is made in the Act to reconcile them.[1]

29. The cases in which the principle of residence is of importance are, first, that mentioned above (paragraph 27) in *(b)* (1), where a resident brings foreign income into British India within three years (Section 4 (2) of the Act) ; and, secondly, that in *(b)* (4) where profits are deemed to accrue or arise to a non-resident through or from a business connection or property in British India (Section 42 (1) of the Act). The former provision is intended to bring within the Act profits arising abroad but remitted to British India rather promptly, yet save residents from the taxation of foreign profits which may be considered to have become capital. As there is little chance of the foreign income of a non-resident being received for the first time in India, a similar provision for non-residents is unnecessary.

30. The provision regarding profits and gains accruing or arising through a business connection or property in British India [2] applies only in the case of a non-resident. Consequently, although a non-resident has been held taxable on an income deemed to arise in British India through making purchases there for export to foreign countries,[3] a resident firm doing precisely the same thing has been held non-taxable, because Section 42 (1) does not specifically include residents.[4] In practice, however, the resident is likely to be taxed because of receiving the profit in British India or bringing it into that country in three years.

31. In a recent amendment (Section 42 (3)) [5] covering importation and sale of merchandise in British India, the question of residence is carefully avoided, and liability is made to depend entirely upon the statutory presumption of the income arising, accruing or being received in British India.

32. The principal cases arising under Section 42 (1), those of the Rogers Pyatt Shellac Company and Steel Bros. & Co., Ltd. (mentioned above in paragraph 30), involved the export from India, by a non-resident, of goods manufactured or purchased in India, and in the latter case the Burma

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[1] In 1931, a bill was brought before the Legislature which sought to amend the law to correspond with the law in the United Kingdom, but it was rejected. According to this bill, the tax would be levied on the following basis :

(a) On residents : (1) if domiciled, on all the income, wherever accruing or arising and whether brought into British India or not ; (2) if not domiciled, on the income accruing or arising in British India plus such foreign income as is brought into British India ;

(b) On non-residents — irrespective of domicile — on the income accruing or arising in British India

Consequently, if the bill had been passed, the principle of receipt would have been abandoned.

An individual would be resident in British India in any year if (1) he remained there for six months or longer, not necessarily in one period ; or (2) even if he remained for a shorter period, if residence in British India were part of the regular order of his life.

A Hindu undivided family, company, firm or other association of individuals would be resident in British India, unless the central control and management of its affairs were situated wholly outside British India.

The domicile of a Hindu undivided family would be that of its manager, and that of any other association would be the same as its residence.

[2] For a detailed discussion of the application of Section 42 (1) to business done through agents, see paragraph 87, *Income-Tax Manual*, fourth edition, 1931 (quoted in paragraph 80 of this survey).

[3] Rogers Pyatt Shellac Company *v.* Secretary of State for India, 1 I.T.C., 363; and Steel Bros. & Co., Ltd. *v.* The Commissioner of Income-Tax, Burma, 2 I.T.C. 119.

[4] Jiwan Das *v.* Commissioner of Income-Tax, Punjab, 4 I.T.C. 40.

[5] Inserted by the Income-Tax (Amendment) Act, 1928 (III of 1928).

High Court held that a reasonable commission should be allowed to the London establishment making the sale and deducted from the profits taxable in India. The latter decision gave occasion for the adoption of Section 42 (3), which precludes the allocation of such a notional commission to a foreign factory or purchasing establishment, whether the enterprise belongs to a non-resident or to a resident.

33. Section 42 (3) states that, where any profits or gains have accrued or arisen to any person directly or indirectly from the sale in British India by him or by any agency or branch on his behalf of any merchandise exported to British India by him or any agency or branch on his behalf from any place outside British India, such profits or gains shall be deemed to have accrued and arisen and to have been received in British India, and no allowance shall be made under subsection (2) of Section 10 in respect of any buying or other commission whatsoever not actually paid, or of any other amounts not actually spent, for the purpose of earning such profits or gains. Consequently, this provision precludes the deduction from the total profit of any manufacturing profit or purchasing profit, which, in fact or in law, accrues in the country of manufacture or purchase.

34. It is significant that, whereas Section 42 (1), which has been applied primarily in connection with the export business, states that the income from a non-resident's business connection in British India shall be deemed to arise or accrue there, Section 42 (3) goes further and states that the income, derived by any person from the importation and sale in India of merchandise, shall be deemed, not only to accrue and arise there, but also to have been received there. Thus, whether payment is, in fact, received within or without British India, the profits or gains shall be deemed to be received there and shall be taxed there.

35. *Meaning of Income.* — The word " income " has been used in this report loosely to cover " income, profits and gains " ; but the Act, generally speaking, uses " income " with reference to salaries and interest on securities and the taxable value of house property; the term " profits and gains " with reference to business and professions ; and the term " income, profits and gains " with reference to " other sources " *(i.e.,* the residuary head of income). This distinction, however, is not of much importance for the main purpose of this survey ; nor have the words been clearly defined in the Act.

36. *Meaning of " Accrue " or " Arise ".* — The law does not define " accrue " or " arise ". Judicial pronouncements have been inconsistent, sometimes interpreting the words as referring to the origin or source of income and sometimes to the place of receivability. Most of the rulings have dealt with the time of accrual rather than the place. In general, the courts and the income-tax department have followed the English decisions in determining where a source of income is situated ; for example, in the case of the most important source of income — namely, trade — the main, but not the exclusive, criterion is the place where the contracts are concluded. In respect of most of the taxable items of income there is, in practice, little difficulty in determining whether or not the income arises from sources in British India ; for example, in the case of salaries, interest on securities, property and professional earnings. In the case of the business of a resident, it is immaterial if the source is foreign, so long as the profits are received for the first time in British India or are brought into British India within three years of the year of origin.

37. Where a person, whether resident or non-resident, carries on the business of purchasing or manufacturing abroad and selling in India, by statutory prescription the whole of the income is deemed to arise or accrue or to be received in British India. Similarly, by virtue of the statutory prescription concerning non-residents with a business connection or property in British India, all profits or gains accruing or arising to such persons, whether directly or indirectly, through or from such business connection or property, is deemed to be income accruing or arising within British India. Thus, a non-resident, whether purchasing or manufacturing in British India, becomes taxable on the whole of his profits derived from the sale abroad from such purchased or manufactured goods, because the statute says they shall be deemed to be income accruing or arising within British India. In the

case of a non-resident, therefore, the question as to place of accrual is settled by statute. Whether the cycle of operations (including purchase, manufacture or processing and sale) begins or ends in British India, the whole of the income received, whether the receipt, in fact, takes place within or without British India, is deemed by statute to accrue in British India. In practice, however, the provision regarding a non-resident with a business connection in India may be tempered, for example, by allowing a notional sales commission to the selling establishment abroad, as in the case of the Commissioner of Income Tax, Burma, *v.* Steel Bros. & Co., Ltd., [1] or by assuming the British Indian profit to be what a local manufacturer would make on a f.o.b. shipment to a foreign country. As a resident is likely to receive his income in India or bring into India within three years that arising abroad, the question of accrual is relatively unimportant.

38. *Meaning of " Residence ".* — The law does not define " residence ", and English rulings as to the meaning of this word — viz., place of habitation in the case of individuals, and the seat of direction and control in the case of corporations — are followed in British India.

39. *Meaning of " Total Income ".* — " Total income " is that which determines the rate of tax payable by a person. The term means " the total amount of income, profits and gains from all sources to which the Act applies and computed as provided in Section 16 ". This section brings into the computation certain items exempted under other sections, such as interest on tax-free securities issued by the Indian Government and dividends received from companies or shares of profits of firms whose profits have been taxed. The amount of tax paid by the company in respect of the dividend must be added to the dividend included in the income of the shareholder. The rate determined by " total income " is applied to the taxable income to determine the amount of tax directly payable. The difference between " total income " and " taxable income " represents either what has been taxed at source or anactual exemption from tax. The significance of " total income " must be grasped in order to understand what follows regarding the method of taxation of the various classes of taxpayers (Sections 14, 15 and 16).

Exemptions.

40. The exemptions given by the Act cover income of charitable (including education and medical relief) and religious institutions, local authorities, investments of certain provident funds, commuted capital sums of pensions, capital sums received in payment of insurance policies, compensation for death or injuries, accumulated balances paid from certain provident funds, allowances, benefits and perquisites specifically granted to meet expenses wholly and necessarily incurred in the performance of duties of an office, casual and non-recurring receipts not arising out of a business, profession or vocation and not by way of addition to the remuneration of an employee, and agricultural income (Section 4 (3)).

By notification under Section 60, the Governor-General in Council has exempted various classes of income of which the more important are the interest on post office savings deposits and cash certificates, diplomatic and consular salaries, pensions and leave salary paid abroad (but in the British Empire) to employees serving in British India,certain disability and wound pensions, certain perquisites and allowances given in the Army.

3. Assessment of Tax.

Returns.

41. The tax on the total income of the assessee is determined by the income-tax officer [2] on the basis of a return. The principal officer of every company shall submit on or before June 15th of

[1] 2 I.T.C. 119.

[2] The income-tax officer is the official who deals with the taxpayer in the first instance. Above him in rank are the Assistant Commissioner and the Commissioner of Income-Tax of the province.

each year a return of the total income of the company during the previous year. The date of delivery may be extended by the income-tax officer.

In the case of any person other than a company whose total income is, in the income-tax officer's opinion, of such an amount as to render such person liable to income-tax, the income-tax officer shall serve a notice upon him, requiring him to furnish within a specified period of not less than thirty days a return in a prescribed form declaring the total income of the previous year (Section 22). Account is taken in this return of any tax withheld at source on salaries, interest on securities, dividends, etc.

Every employer, whether the Government, a local authority, a company or other public body or association, and every private employer shall submit before April 30th of each year a written return showing the name and address of every person receiving on the previous March 31st, or during the year preceding that date, any salary and the amount thereof, as well as the amount deducted in respect of income-tax from the income of such person.

Deductions and Abatements.

42. The deductions allowable in respect of each category of income, which together form " total income " are described below in the paragraphs under " Classification of Incomes ". No allowances from total income are given for a minimum of existence, for wife, children or dependents, or for earned income. The only allowance of a personal nature is that given on account of contributions to certain provident and family pension funds (either Government or quasi-Government institutions or funds of private employers specially recognised by Government and conforming to certain restrictions imposed by Government) and on account of insurance premiums (Sections 7 and 15). The insurance may be on the life of the taxpayer or on that of his wife (even though married persons are not taxed together) ; and, in the case of a Hindu undivided family, it may be on the life of any male member or on that of his wife. The total allowance on account of insurance premiums and contributions to provident and similar funds is restricted to one-sixth of a person's " total income " (Section 15). The allowance, though exempted from tax, is taken into account in the total income -- *i.e.*, in fixing the rate to be applied to the taxed part of the income (Section 16). The allowance on account of insurance premiums and provident fund contributions is given only for the purpose of income-tax and does not apply to super-tax (Section 58).

Classification of Incomes.

43. For the purposes of computation, income is divided into six classes, as stated below assessments are not made separately under each class, but on the income in all the classes together after deduction of losses, etc.

44. *Salaries.* — This category includes all salaries paid to employees, except to servants of foreign Governments, whether on a monthly or any other basis. The person responsible for paying the salary has to deduct tax (income-tax only) at an estimated rate and remit the tax to the Government treasury. Failure to deduct tax subjects the person to certain penalties. The amount deducted at source is held at the credit of the employee against the assessment to be made on him (ordinarily) in the next financial year ; assessment, as already stated, being made on the income of the " previous year ". The only allowance made under this head of income is in respect of insurance premiums and certain provident fund deductions — subject, however, to a limit of one-sixth of " total income " (see paragraph 39). The rental value of free quarters is taxable whether or not the employee can convert it into money — *i.e.*, irrespective of his right to sublet Other perquisites are not taxable unless capable of conversion into money.

45. *Interest on Securities.* — This category includes the securities of the Government and local authorities and companies.

The person paying the interest has to deduct tax (income-tax only) at the maximum rate and remit it to the Treasury ; he does not, however, submit an information return of the payees. The tax may be claimed as a credit by the receiver of interest against the assessment to be made on him (ordinarily) in the next financial year, the excess credit being either set off against the tax due under other heads from the person or refunded if necessary. In order to avoid inconvenience both to the Income-Tax Department and to small assessees, arising out of the deduction of tax at the maximum rate in the first instance and then refunding or adjusting this tax afterwards, it has been arranged, by executive orders, that income-tax officers should issue certificates to holders of securities, on the production of which, the person paying the interest would deduct tax at the rate likely to be eventually borne by the owner of the securities.

Tax-free securities are free of income-tax only and are liable to super-tax in respect of the interest. Also, the exempted interest is taken into account in computing " total income " —*i.e.*, in fixing the rate of income-tax payable on other income (Sections 8 and 58).

No deductions of any kind can be claimed from interest on securities under the law, but by executive orders allowance is given on account of interest on borrowed capital if securities are bought with such capital (paragraph 26, *Income-Tax Manual*, fourth edition, 1931).

46. *Property, i.e.*, buildings and lands appurtenant thereto. — The tax is levied on a notional income — viz., the annual letting value (subject to a maximum limit of 10 per cent of the owner's " total income " if he resides on the property), less the following allowances ; (1) repairs (at one-sixth of the annual value irrespective of the actual cost) ; (2) insurance premiums ; (3) interest on mortgages and charges ; (4) ground rent ; (5) land revenue ; (6) rent-collection charges subject to a maximum of 6 per cent of the annual value ; (7) vacancies, according to circumstances. There is an overriding proviso which restricts the aggregate allowances to the annual value of the property. In other words, no loss can be claimed under property for the purpose of set-off against income under other heads, though losses under other heads may be set off against income from property (Section 9).

47. *Business.* — This term is defined as including " any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture ".

Profits and gains under this head are computed in accordance with the assessee's own method of accounting, if it clearly reflects his profits and if he regularly employs a definite method ; otherwise, at the discretion of the income-tax officer with reference to the circumstances of the case.

The following deductions are allowed (Section 10) — viz. :

(1) Rent and repairs of the business premises ;

(2) Interest on capital borrowed for the business, if the interest does not depend on the earning of profits ;

(3) Insurance premiums against risk of damage or destruction of buildings, machinery, plant, furniture, stocks or stores, used for the purposes of the business ;

(4) Cost of current repairs to such buildings, machinery, plant or furniture ;

(5) Depreciation (to the extent of a prescribed percentage on the original cost) of such buildings, machinery, plant or furniture, being the property of the assessee ;

(6) Loss on obsolescence — *i. e.*, depreciated value minus scrap value or sale proceeds ;

(7) Loss of working animals ;

(8) Land revenue, local rates and municipal taxes in respect of the business premises, but not if the taxes are based on the profits, *i.e.*, are in the nature of income-tax ;

(9) Bonuses and commissions to employees if they are reasonable, even if dependent on profits ;

(10) All expenditure, not being capital expenditure, incurred solely for the purpose of earning the profits or gains ;

(11) Bad debts, provided they are written off when legally irrecoverable.

The only non-allowable deductions are those prohibited under (2), (8) and (10) above. No deduction is allowed for reserves of any kind, except in the case of insurance companies to cover liability for unexpired risks.

48. *Professional Earnings.* — This category includes profits or gains of any profession or vocation followed by the assessee. The only allowance under this head is for expenditure (not being in the nature of capital expenditure) incurred solely for the purpose of the profession or vocation. Personal expenditure is disallowed. Professional fees received outside British India but within India by a person ordinarily resident in British India are taxable. The assessee's method of accounting is accepted if clear and regular ; otherwise, the income-tax officer estimates at his discretion (Section 11).

49. *Other Sources.* — This category includes " income, profits and gains of every kind and from every source to which this Act applies (if not included under any of the preceding heads) ". The allowable deductions include expenditure incurred solely for the purpose of earning such income, profits and gains, with the exception of capital expenditure and the personal expenses of the assessee (Section 12).

Set-off permissible.

50. Set-off is allowed between the different heads of income before the aggregate income of a person from all the heads together is determined. Thus a firm can set off a business loss against its income from securities and the annual value of its property. If the assessee is a registered firm and the business loss sustained cannot wholly be set off against its other income, the partners can set off their shares of any loss made by it against their other incomes. The legal rights of partners in unregistered firms in similar circumstances are obscure, but executive instructions of Government allow such partners to be treated on practically the same footing as partners of registered firms (Section 13 and paragraph 72, *Income-Tax Manual).*

4. Collection of Tax.

Collection at the Source.

51. Tax is deducted at source ordinarily only in two classes of cases — viz., salaries and interest on securities. On the former, the collection is made at an estimated rate, and on the latter at the maximum rate, unless (under an extra-legal arrangement) the income-tax officer authorises collection at an estimated rate. In all these cases, the tax collected is held at the credit of the person against his assessment normally made on the basis of his return of total income in the next financial year ; and, when that assessment is made, the excess credit is either adjusted or refunded (Section 18).

Super-tax is not collected at source except in the case of non-residents who receive dividends from companies in British India and in the case of certain sums paid out of certain " recognised provident funds " (Sections 19 and 58).

52. All sums deducted are paid within a prescribed time (usually a month) by the person making the deduction to the credit of the Government of India, or as the Central Board of Revenue directs. In the case of interest payments, every person deducting tax must furnish to the person to whom the interest is paid a certificate to the effect that income-tax has been deducted, and specifying the amount deducted, the rate at which deduction has been made, and other prescribed particulars.

A foreign enterprise may obtain from the fiscal authorities a certificate as to the amount of tax paid for a given year whether collected at source or after assessment.

53. *Information at Source concerning Dividends.* — Although dividends are not subject to income-tax by deduction at source, the principal officer of every company shall, on or before

June 15th in each year, furnish to the income-tax authorities an information return of the names and addresses, as entered in the register of shareholders maintained by the company, of the shareholders to whom dividends in excess of a prescribed amount have been distributed during the preceding year, and also the amount so distributed to each shareholder. Furthermore, at the time of distributing dividends, the principal officer of every company is required to furnish to every person receiving a dividend a certificate to the effect that the company has paid, or will pay, income-tax on the profits which are being distributed (Sections 19 A and 20).

Taxation at the Source.

54. Firms and companies and certain nondescript associations of individuals are utilised as machinery for taxation at source (as distinguished from collection at source). What happens in such cases is that the partner or shareholder or member is let off from tax a second time if the firm or company or association has been taxed. The exact position in each case has already been explained in more detail (paragraphs 13 *et seq. supra).*

Small Incomes Relief.

55. Refund of tax, either collected at source or in respect of income taxed at source, is allowed to partners of registered firms, shareholders of companies and persons receiving salaries and interest on securities. The refund is equal to the amount by which the rate of tax collected or levied at source exceeds the rate applicable to the total income of the person (including, of course, the income on which refund is allowed). No refund is allowed to non-residents who are not British subjects or subjects of an Indian State. In the case of those who are such subjects, refund is allowed on the basis of their " world income " -- *i.e.*, assuming a personal rate of tax in British India corresponding to their world income and not their British-Indian income (Section 48).

56. Since super-tax is ordinarily neither taxed nor collected at source, there are no provisions for refund of such tax except in connection with double taxation relief.

Double Income-Tax Relief.

57. Arrangements for relief from double income-tax have been concluded between : *(a)* British India and the United Kingdom ; and *(b)* British India and most of the Indian States which levy income-tax.

58. Under *(a)*, relief is given in the first instance by the United Kingdom, limited to the Indian rate of tax or to half the United Kingdom rate of tax, whichever is the lesser. If the full Indian rate of tax has not been refunded by the United Kingdom, the taxpayer is entitled to further relief in British India at a rate equal to the difference between the Indian rate of tax and the rate of relief obtained in the United Kingdom but limited to half the Indian rate of tax (Section 49).

The company super-tax, though of the nature of a corporation tax is treated as super-tax, so far as relief to the company is concerned. Further, income-tax paid by a company or registered firm is treated as paid on behalf of the shareholder or partner.

59. *(b)* These arrangements between British India and most of the Indian States which impose income-taxes differ from that with the United Kingdom in the following details :

(1) The refund made by British India is limited to half the State rate of tax, subject to a maximum of half the British-Indian rate of tax.

(2) The relief given by one Government does not depend on that given by the other.

(3) The States usually refund half their own rates of tax (Notifications under Section 60).

60. Both under *(a)* and under *(b)*, relief in British India is regulated on the doubly charged part of the income as computed in accordance with British-Indian law, without regarding the computation under the laws of the other State. Relief is granted on the basis of a comparison of rates only in the two countries without reference to the amounts of tax paid in the two countries. As a consequence, certain anomalies arise, which, however, were foreseen when the plan was sketched by the Royal Commission in the United Kingdom on Income Tax.

61. Claims for refund of tax, whether small incomes relief or double income-tax relief, have to be made, ordinarily within one year from the last day of the year (calendar year) in which the tax was recovered, or before the last day of the financial year (April 1st to following March 31st) commencing after the expiry of the previous year (see paragraph 8) in which the income arose on which the tax was recovered, whichever period may expire later (Section 50).

5. Procedure in Assessment and Appeals.

62. The assessment is made, in the case of a business, by the income-tax officer of the area where the principal place of business is situated, and in all other cases by the income-tax officer of the area in which the assessee resides. The income-tax officer examines the return, and if he does not accept it, must give the assessee an opportunity of substantiating it, either in person or by a representative, with the aid of such evidence as he can produce (Section 23). Furthermore, the income-tax officer can, at any stage of the proceedings before the actual assessment, call for the accounts and documents of the assessee, but not for accounts more than three years old (Section 22). The income-tax officer has also the powers of a civil court to summon witnesses, issue commissions, administer oaths, etc. (Section 37). On making the assessment, the income-tax officer serves on the assessee a notice of demand (Section 29). This demand is payable in full, in the absence of any stipulation to the contrary, on the first day of the second month following the service of notice (Section 45).

63. If a taxpayer fails to file a return, or, having filed one, fails to furnish requested evidence in support of it, or fails to produce requested accounts or documents, he will be assessed at the discretion of the income-tax officer, and no appeal can be made against such assessments (Sections 23 and 30). Within a month of such assessment (or rather service of notice of demand) the taxpayer may move the income-tax officer to reopen it and make a fresh assessment on the evidence produced (with a right of appeal), provided he can satisfy the income-tax officer that the default was due to " sufficient cause ". If the income-tax officer declines to reopen the assessment, the taxpayer can appeal to the next higher authority on the question of reopening the assessment, but not on the merits of the assessment. If the appeal succeeds, the income-tax officer will make a fresh assessment (Sections 27 and 30).

64. Assessment and collection (other than collection at source) are made by income-tax officers, the assistance of certain other Government departments being invoked when coercive processes are resorted to for the purpose of collecting tax (Sections 19 and 46). Appeals against their assessments and refusals to reopen assessments are disposed of by Assistant Commissioners of Income-Tax (Section 31). A further appeal lies to the Commissioner, if the Assistant Commissioner has in the course of the appeal either increased the assessment or levied a penalty (Section 32). Otherwise, the assessee has two alternative remedies — viz., *(a)* to move the Commissioner in revision, his orders being final (Section 33), or *(b)* to ask the Commissioner to refer to the High Court questions of law arising out of the appellate order of the Assistant Commissioner (Section 66). The Commissioner is in all cases the final arbiter on questions of fact. If the Commissioner holds that no question of law arises, the assessee can move the High Court of the province direct, asking it to order the

Commissioner to make a reference. Against the orders of the High Court on a reference, both the Crown and the assessees can appeal to the Privy Council if there is a substantial question of law, and the High Court certifies that the case is fit for appeal (Section 66A). No civil suit can lie against an assessment (Section 67).

65. All the authorities referred to above are Government officials ; and the services of non-officials are utilised only on certain Boards of Referees specially appointed to deal with the assessments of " one-man " companies and firms and associations evading tax (Section 33A).

PART II. — TAXATION OF FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

1. Definition and General Principles.

66. Although liability to tax is based on the origin or receipt of income in British India, rather than on the place of residence of the taxpayer (see paragraph 28), it will be assumed for the purpose of this survey that a " foreign " enterprise means an enterprise belonging to a person — whether a corporation or an individual or a partnership — not resident in British India. There is no definition of " residence " in the British Indian Income-Tax Law. The word has been generally construed as interpreted by the courts in the United Kingdom — viz., the place of residence in the case of a partnership or company is the place of direction and control, and in the case of an individual his place of habitation.

67. A non-resident enterprise is liable to tax (income-tax and super-tax) on : *(a)* all income accruing, arising or received, or deemed to accrue, arise or be received in British India ; *(b)* all income accruing or arising without British India directly or indirectly through or from business connection or property in British India. It is not liable on income made and received abroad and subsequently brought into British India. For all these purposes it is immaterial whether the enterprise belongs to a corporation or to a partnership or to an individual (Sections 4 and 42).

68. The liability to tax is unaffected by the fact whether the foreign enterprise has or has not an establishment in British India or whether the establishment receives the income or not. The machinery of taxation is, of course, affected by the existence or non-existence of an establishment within the country. If there is an establishment in the country, no difficulty arises in regard to assessment and collection. If there is no establishment, any resident person employed by or on behalf of the non-resident or having any business connection with the non-resident or through whom the non-resident is in receipt of income can be assessed as the agent of the non-resident after he has been given an opportunity to show cause to the contrary by the income-tax officer (Section 43). In practice, however, the Government has issued executive instructions asking income-tax officers not to assess the local " agents " (the term being employed in the loose commercial sense) unless the connection between the principal and agent is so close as to make the local establishment an agency (the term being employed in the strict legal sense) of the non-resident. In other words, if the non-resident is trading *with* British India -- and not *in* British India — he is let off. If he trades *in* British India, he is bound to have an establishment there or at least a regular agency, and not merely a casual agent (paragraph 87, *Income-Tax Manual).*

69. If a foreign company has several establishments in British India, it will ordinarily be taxed at its principal establishment there. Incidentally, a foreign company is taxed as an association of individuals until it is recognised to be a company by the Central Board of Revenue.

70. While it is necessary for the revenue authorities to proceed with the recovery of tax from a resident within a limited period, tax due from a non-resident may be recovered *at any time* from his assets in British India.

2. Taxation of Certain Kinds of Income.

(a) *Dividends.*

71. Companies operating in British India are taxed on their profits — including undistributed profits — at the maximum rate of income-tax, and also pay company super-tax (corporation tax) if liable. A shareholder, whether resident or not, cannot be asked to pay British-Indian income-tax again on these dividends. On the other hand, he can claim a refund of tax if his personal rate of income-tax is lower than the maximum. No refund can be claimed by a company or a registered firm in any circumstances, as such assessees are themselves liable to pay tax at the maximum rate. It is only other classes of shareholders — viz, individuals, Hindu undivided families, unregistered firms and nondescript associations — that can claim a refund. If the shareholder is a non-resident, the refund is subject to the following restrictions : *(a)* no refund can be allowed to persons who are not British subjects or subjects of Indian States ; *(b)* even to those who are given refunds, the personal rate of tax is based on the world income and not merely the British-Indian income, whereas in the case of residents, irrespective of their nationality, the rate is based on the British-Indian income (see paragraphs 20 *et seq.* and 55 in Part I).

72. No refund can be claimed by a shareholder on account of company super-tax. On the other hand he is liable to pay super-tax if his total taxable income exceeds the exempted minimum. If he is a non-resident, the income-tax officer can ask the principal officer of the company paying the dividends to deduct super-tax from the dividends at such rates as the income-tax officer may fix, taking into account the shareholder's total income taxable under the Indian Act. This power, however, is not, in practice, resorted to when the non-resident has an agent in British India to whom the dividends are paid and through whom he can be assessed in the ordinary way. In any case, if a principal officer of a company has reason to believe that a shareholder who receives a dividend large enough to come within the super-tax brackets is resident in British India and has no notice from the income-tax officer to deduct super-tax from the shareholder's dividend, he is under obligation to deduct super-tax at the rate applicable to that amount of income. Where the shareholder is a foreign company, the British India company is requested to deduct company super-tax if the dividend exceeds Rs. 50,000. All these deductions at source are automatically credited to the taxpayer's account and held there against the regular assessment, if any, to be made (ordinarily) in the next financial year (Sections 48, 55, 57 and 58).

(b) *Interest.*

73. (1) *From interest on securities — i.e.,* from British-Indian Government securities and debentures and other securities for money issued by or on behalf of a local authority or company — income-tax is deductible at time of payment ; and refund of tax, if due, will be regulated as under paragraph 71 regarding dividends (Sections 8, 18 and 48). Super-tax cannot be deducted at source, and has to be assessed on the agent in British India who receives the interest. In respect of rupee-paper of the Government of India enfaced for payment of interest in the United Kingdom, there is no machinery for assessing super-tax if the person has no other taxable sources in British India on which an assessment can be made.

(2) *On interest from any other source,* whether annual or non-annual, and whether the loans are secured or unsecured, the non-resident can be taxed only if he is taxed through an agent who receives

the interest in British India or who has business connection with him or is employed by or on behalf of him or through whom the non-resident is in receipt of income. The assessment will include super-tax as well as income-tax. Irrespective of whether the recipient of the interest is taxed, the interest will be allowed as a deduction from the taxable profits of the debtor, if the interest is paid for the purpose of earning the profits under taxation (also in the case of property — *i.e.*, houses and lands appurtenant thereto, if the interest is on a mortgage or charge). As a matter of Government policy in regard to the encouragement of banking, banks are usually not compelled to disclose to the Income-Tax Department the identity of their depositors and lenders, even though the interest paid to these is allowed as a deduction from taxable profits. In all other cases, attempts are made to trace the payees and tax them — at least, through their agents.

(c) *Directors' Percentages.*

74. Whether the directors of a company operating in British India live abroad or in British India a part of the fees paid to them (corresponding to the British-Indian income of the company) would be allowed as a deduction from the taxable profits of the company. Fees paid to directors are of the nature of salaries, and it is the duty of the principal officer of the company to deduct tax (income-tax only) at the time of payment and make it over to the Treasury. But, in practice, in cases of companies with head offices and directors abroad, the allowance made in British India is merely a rough estimated figure on account of head-office expenses, which would indirectly include an undefined share of directors' fees. It would be difficult to isolate this particular item, and no attempt is made to recover tax on such directors' fees unless the directors have other income in British India on which an assessment is made.

Even if the fees are dependent on the making of profits and are expressed as a percentage of the profits, the fees can be allowed as a deduction from the taxable profits of the company (Section 10 (2) (viii) *(a)*).

(d) *Royalties for Use of Patents, Copyrights, Trade-Marks, Secret Processes and Formulæ and Similar Income.*

75. In all these cases the resident who pays out the royalties would be allowed to deduct them from his taxable profits ; and the non-resident would be subject to income-tax and super-tax on the royalties either through an agent who is in receipt of the royalties on the non-resident's behalf or through an *ad hoc* agent appointed by the income-tax officer from among those through whom the non-resident receives the royalties or with whom he has business connection, or who are employed by him or on his behalf in British India (Sections 40, 42 and 43).

(e) *Rents from Real Estate, Mining Royalties and Similar Income.*

76. The position is the same as under paragraph 75 above, except that agricultural income is not taxable.

Agricultural income means :

" *(a)* Any rent or revenue derived from land which is used for agricultural purposes, and is either assessed to land revenue in British India or subject to a local rate assessed and collected by an officer of Government as such ;

" *(b)* Any income derived from such land by : *(i)* agriculture ; or *(ii)* the performance by a cultivator or receiver of rent in kind of any process ordinarily employed by a cultivator or receiver of rent in kind to render the produce raised or received by him fit to be taken to market ; or *(iii)* the sale by a cultivator or receiver of rent in kind of the produce raised or

received by him, in respect of which no process has been performed other than a process of the nature described in sub-clause *(ii)*;

" *(c)* Any income derived from any building owned and occupied by the receiver of the rent or revenue of any such land, or occupied by the cultivator, or the receiver of rent in kind, of any land with respect to which, or the produce of which, any operation mentioned in sub-clauses *(ii)* and *(iii)* of clause *(b)* is carried on ; Provided that the building is on or in the immediate vicinity of the land, and is a building which the receiver of rent or revenue or the cultivator or the receiver of the rent in kind by reason of his connection with the land requires as a dwelling-house, or as a storehouse or other outbuilding " (Section 2 (1)).

(f) *Gain derived from the Purchase and Sale of Real Estate, Securities and Personal Property.*

77. The gains in question would not be subject to income-tax and super-tax unless the purchases and sales were in the nature of business ; otherwise, if the transactions were casual and not part of the assessee's trade, they would constitute mere appreciation of capital and be therefore exempt.

If the gains are taxable, the only way of assessing them is either through a local agent in receipt of the profits or through an *ad hoc* agent appointed for the purpose by the income-tax officer (Sections 40, 42 and 43).

(g) *Salaries, Wages, Commissions and Other Remuneration for Services.*

78. It is the duty of the principal officer of a company or other person responsible for the payment of salaries, etc., to deduct income-tax (not super-tax) at the time of payment of the salaries, etc., and to remit the tax to the Treasury. Super-tax is paid directly by the assessee. Cases of non-residents receiving remuneration abroad for services rendered in British India (income " accruing or arising " in British India) are not common, but such persons are liable in respect of the salary earned for services in British India, whatever the length of stay. If the services were performed abroad and the receipt also was outside British India, the payee cannot be taxed merely on the ground that the payment is made ultimately out of a source in British India. The law on the subject is obscure, and the question is of little importance.

(h) *Income from a Trust.*

79. If a business is conducted by the British India trustee or trustees on behalf of the beneficiary, the assessment is made on the trustee ; or, if there are several trustees, they would be treated as an association of individuals. The beneficiaries are dealt with as though they were partners in an unregistered firm — that is, they are not again taxed on what they receive from the trust, and they cannot get refund of tax, but the trust income is added on to other income to fix the rate of tax on the other income. Also, no super-tax is levied on the income received from the trust if the trust has borne super-tax.

If both the trustee and the beneficiaries are companies, no difficulty arises, and the position is just like that of one or more companies holding shares in other companies -- that is, income-tax is levied on the profits of the " held " company at the maximum rate and no further income-tax is paid by the other companies on their shares of the dividend. Also, each of the companies has to pay company super-tax (corporation tax) on the same profits.

If the trust is for the benefit of an infant, idiot or insane person, or is administered by the Court of Wards or by the Administrator-General or by the Official Trustee, the assessment is made on the trustee on behalf of the beneficiary, and refund allowed to the trustee on the beneficiary's

behalf if the trustee holds the entire property of the beneficiary. Otherwise, the beneficiary is assessed on his whole income ; but tax on the part of the income received by the trustee is recovered from the trustee, who is also given a proportionate refund if such refund is admissible to the beneficiary, having regard to his total income.

In all other cases — whether the income is accumulated or distributed — the trustee is ignored and the beneficiary taxed direct and given a refund if eligible.

In general, a trust is regarded merely as a conduit of income rather than as a separate source of income, and the various items of income received through a trust are taxed in accordance with the corresponding provisions previously described.

In all cases, the trustee, in his capacity as trustee and in his individual capacity, is treated as two different persons. The income of a trust cannot be added on to the trustee's personal income or to the income of other trusts administered by him.

The law makes no distinction between foreign and national trusts, or, rather, between resident and non-resident trusts, other than what it makes between residents and non-residents generally. Whether an alleged trust is in law a trust or not might be affected by the nationality of the trust, but such cases have not arisen in practice.

(i) *Income from carrying on a Business or Industry.*

80. The following instructions in the *Income-Tax Manual,* which are not binding, indicate the attitude of the Central Board of Revenue in regard to doing business in British India through a branch or agency (paragraph 87, *Income-Tax Manual) :*

" There is no precise definition in the Act which can be used as a test for determining in every particular instance whether a non-resident is or is not carrying on business in British India and how the amount of taxable profits is to be arrived at . . . Instances are given below of the method to be adopted in dealing with typical cases :

" (1) *Indian branches of non-resident firms* are liable to assessment under the Act. In order to secure an accurate assessment in such cases, Sections 22 (4) and 37 enable an income-tax officer to require the production of the balance-sheet and profit-and-loss account of the firm as a whole, in addition to that of the Indian branch, and also to require the submission of a detailed statement of all the profits credited to the personal account of the head office on account of transactions carried out on its behalf. In some instances, however, the form adopted for the accounts and balance-sheets of the head office or the Indian branch does not enable the share of profits properly due to the Indian branch to be accurately gauged, while there are certain firms which keep no accounts at all either at their head office abroad or at their branch office in India. Rule 33 gives income-tax officers wide powers to determine how the profits of the Indian branch shall in these circumstances be calculated . . . In the case of shipping companies in particular, the most suitable method of assessing the Indian branch is usually to calculate tax on the same proportion of the total profits of the company as the Indian receipts of the company (meaning thereby the sums received either in India or elsewhere on account of goods shipped or passengers carried from India) bear to its total receipts. In the special case of the Indian branches of non-resident insurance companies (life, marine, fire, accident, burglary, fidelity, guarantee, etc.), it will probably be found both feasible and equitable to adopt the provisions of Rule 35 and assess these branches on the proportion of the total profits of the companies corresponding to the proportion which their Indian premium income bears to their total premium income.

" (2) *Indian firms allied to non-Indian firms of which they are not, technically, either branches or agencies* often succeeded in the past in escaping their proper taxation by a manipulation of accounts with the parent non-resident companies. To cite an example, a foreign firm dealing in aniline dyes was registered as a separate limited liability company in India with a capital

of Rs. 20,000. The shares were never placed on the market in India, but, with the exception of small holdings by managers in India, were all held abroad. The registered capital was nominal in comparison with the value of the stock-in-trade, and the parent company abroad sold to the subsidiary Indian company at a price leaving a margin just sufficient to cover the expenses of the subsidiary company, or causing an actual loss to be shown. Section 42 (2) of the Act is designed to prevent a subsidiary Indian firm or company from benefiting by such a manipulation, and enables an income-tax officer to assess it on the profits which may reasonably be deemed to have been derived from its Indian business ; while, where any difficulty is experienced in arriving at a basis for assessment, assessment on a percentage of turnover, or other suitable method, can be adopted under Rule 34 . . .

" (3) *Indian agents of non-resident firms of which they are not technically either branches or subsidiary firms* are liable for the payment, on account of their principals, of the tax on their principal's Indian profits under the provisions of Sections 42 (1) and 43 of the Act. It will be observed that these provisions permit the levy of the tax on a non-resident's business, not only where he has established a regular *agency* in India, but also where he conducts his business regularly through a particular *agent* or casually through various *agents*. In this case, it is not necessary that anything of the nature of a regular *agency* should exist in order to make the profits of a non-resident chargeable in the name of an agent. They are so chargeable, even when the only connection between the non-resident and the person acting as his agent is that that person is ordinarily and regularly employed as an agent by the non-resident. The Government of India do not, however, desire, that, in practice, the liability to assessment should be enforced, except where something definitely of the nature of an agency exists, and, in particular, no attempt should be made to tax the profits of a *consignment business pure and simple*,[1] merely because the non-resident consignor habitually uses a particular resident as his agent.

" In all cases, it will be a question of fact whether the connection between the non-resident and the resident is such that an agency can be held to exist. " Agency " for the purposes of this section should be interpreted to mean a regular, not casual, agent, and one whose relation to the non-resident principal is such that the principal may reasonably be held to be trading *in* the country and not merely *with* the country. If, for example, there is no privity of contract between a foreign principal and a resident who purchases the foreign principal's products through another resident, or if the resident vendor has to bear any bad debts arising out of such transactions, the resident vendor is not to be treated as the agent of the non-resident. Even if a non-resident does not bear bad debts, he will be considered to be trading in the country (if there is privity of contract) if the agent receives a *del credere* [2] commission — *i.e.*, an additional commission in consideration of guaranteeing the non-resident against bad debts or if the rate of commission is so unusually high as evidently to be intended to include a *del credere* commission though none is specially mentioned. It is doubtful whether it is practicable to formulate, for the guidance of income-tax officers, any more definite principles than those stated above ; but the following examples may serve to indicate the lines on which decisions should be reached :

> " *(a)* B, a distiller in Glasgow, has agreed to sell to no one in India except A, his agent, provided that A gives B all or an agreed proportion of his trade. A purchases from B and sells to the trade at his own rates, and all bad debts are A's. No attempt should be made to tax B on his profits. His position, in spite of his supplementary agreement with A, is merely that of a seller to an Indian consignee, who takes the risks or profits of the trade in India.

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[1] There is no definition of " consignment business pure and simple ", but it is unimportant, as the test of liability, in practice, is whether or not the non-resident has in India an " agency " as is described herein.

[2] For reason for taxing a foreign enterprise doing business through *del credere* agent, see Weiss, Biheller & Brooks, Ltd., *v* Farmer (1918), 8 T. C. 406

" *(b)* A, an Indian resident and a large supplier of mill stores, has a monopoly for the sale in India of the belting of a non-resident B. A is paid commission by B on all orders he sends either for his own stock or risk or execution of orders obtained. He does not confine his purchase of belting to B. He stands all loss from bad debts and fixes the price to be asked for the goods. Here, again, the position of B is merely that of a seller to an Indian consignee, and no attempt should be made to tax B's profits.

" *(c)* A is the Indian agent for hardware and sundries of B, a British manufacturer. A receives salary and commission from B, and bad debts fall on B. Here, there is a regular agency, and B's Indian profits should be taxed through A.

" *(d)* A is the Indian agent for B, a firm in an Indian State, who consigns goods for sale in Bombay or China through A. The business is purely a consignment business, and B's profits on his Indian trade should not be taxed.

" In all these cases, A's remuneration or profits as agent are liable to the tax.

" (4) *Casual agents for non-resident firms to whom goods are from time to time consigned* have been dealt with in (3) above, and no attempt should be made to tax the profits of a non-resident through the agent on this class of business.

" Attention is invited to the ruling of the Madras High Court (case of Bhanjee Ranjee & Co.)[1] in which it has been held that a person who is not resident in British India but to whom income arises or accrues through business connection in British India is assessable to income-tax under Sections 4 and 42 (1) of the Act, whether he is a British subject or a foreigner, and that the provision in the latter section that such income shall be taxable in the name of the agent of any such person does not mean that it is not chargeable unless assessed in the name of an agent. It will be clear from Section 42 (3) that the entire profits of a branch or agency of a foreign firm importing goods into, and selling them in, British India are liable to tax in British India irrespective of where the profits accrued or arose, and whether received in British India or not. Thus, if a foreign manufacturer has a branch or agency in British India and sells his products through it in British India, he is liable to tax on his manufacturing profits as well as on the merchanting profits, while a foreign head office is not allowed to charge a notional commission to its branch or agency in British India on goods exported to the branch or agency and sold by it in British India.

" If it is desired to assess a non-resident who has no resident agent through whom such assessment can be made, and whose entire income also cannot be taxed at source or indirectly, a notice under Section 22 (2) should be served upon him as early as possible in the year by registered post (acknowledgment due), allowing plenty of time for the return to be made. If he then fails to make a return, or to comply with subsequent notices calling for accounts, etc. (in which also ample time should be allowed for compliance), an assessment can be made under Section 23 (4). When serving such notices on a non-resident, he should be invited in a covering letter to appoint an agent to represent him for income-tax purposes in India.

" A person whom the income-tax officer has decided, after due notice and hearing under Section 43, to treat as the agent of a non-resident, is not entitled to appeal to the Assistant Commissioner against the income-tax officer's order until an assessment has been made. But it is open to such person to petition the Commissioner of Income-Tax against the income-tax officer's order before an assessment has been made ; and Commissioners of Income-Tax are authorised to dispose of such petitions under Section 33 of the Act."

81. From the above instructions the following conclusions may be drawn :

(1) *Commission Agent or Broker.* — This point is covered by the above instructions. Broadly speaking, liability would not arise if no regular agency could be construed to exist under the circumstances of the case, and if a " consignment business pure and simple " is involved.

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[1] 1 I.T.C. 147.

(2) *A Local Dealer or Distributor* (with an exclusive right to handle a line of goods but buying and reselling on his own account). — Normally, the non-resident will not be taxed, since he presumably sells from abroad to the local dealer outright and has no interest in the transactions, once the property has passed to the local dealer. But cases of this kind are sometimes difficult to deal with, since the line of distinction between trading *in* and trading *with* a country often wears very thin.

(3) *Travelling Salesman.* — If the travelling salesman has no power to conclude a contract, he will not be taxed as the agent of the non-resident principal, who will be merely trading *with* the country and not *in* the country. In any case, the salesman will be taxed on his own salary or commission.

(4) *Agent with Power of Attorney.* — Presumably the agent concludes contracts on behalf of his non-resident principal ; if so, the agent will be taxed on the principal's behalf.

(5) *Agent selling out of Stock belonging to the Foreign Enterprise.* — Clearly this is a case of the non-resident trading in British India ; the local agent will be taxed on behalf of the non-resident.

(6) *A Permanent Establishment.* — The non-resident will be taxed, since he is evidently trading *in* the country.

B. NATIONAL ENTERPRISES.

1. Definition and General Principles.

82. As already stated, this survey assumes the term " national enterprise " to refer to a *resident* enterprise. It is immaterial for the purposes of this survey whether the resident is an individual, partnership or a company. It is, of course, possible for one or more partners to be resident and for the partnership to be non-resident and *vice versa* (see paragraph 66).

83. A resident is taxable on his foreign income only in the following cases :

(a) If the income is from a profession or vocation and received in India *(i.e.*, in an Indian State) and if the person is ordinarily resident in British India (Section 11) ;

(b) If the profits are from business (trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture) and if the profits are brought into British India within three years of the close of the year of origin. If the profits, though accruing or arising out of British India, are received in the first instance in British India itself, the profits are taxable then and there (Section 4 (2)) ;

(c) In regard to income other than income from a business abroad ; if it is first received outside British India, it cannot be " received " again in British India for tax purposes. If receipt took place the first time in British India, the income would be taxable unless the taxpayer could show it had become capital. The authorities would presume that the remittance is from income if the taxpayer has sufficient income of foreign origin to cover the remittance. In general, however, income arising abroad will be received abroad actually or constructively, and will therefore not be taxable in actual practice.

2. Taxation of Certain Kinds of Income.

84. In view of the general principles of liability just stated, it is necessary to give a more detailed discussion only in regard to income from business abroad.

Only that portion of the earnings from a trade or business carried on abroad can be deemed to be taxable profits and gains which is actually brought into British India within three years

of origin. Before the enactment of this clause, Section 4 (2) of the Act, it had been held that profits which had arisen or accrued to a British India resident from a business outside British India, but which had subsequently been transmitted to British India, was not his income assessable under the Act, as a person could not receive his income twice over, and the receipt in British India of such amount must be presumed to be that of capital. [1]

The Legislature considered that this state of the law was unsatisfactory and amended the Act by enacting that, if profits on such business, earned in a foreign territory, are brought into British India within three years from the end of the year in which they accrued or arose, the amount so brought in should be liable to assessment. The practical effect of this provision is to lay down that all the profits of a foreign business brought into British India shall be deemed to be assessable income, if they are brought within three years of the end of the year in which they are earned, but they will be treated as capital (and therefore immune of assessment) if they are so brought after the expiry of that period. By fixing this arbitrary limit of three years, the Legislature has, on the one hand, provided against evasion of the law by the assessee bringing in his foreign income at intervals and urging that it was not received in British India in the year in which it was earned and had thus become his capital ; and, on the other hand, recognised the principle that if foreign profits are not brought into British India within a reasonable period *(i.e.*, three years from the end of the year in which they were earned), they should be treated as having become his savings or capital and not liable to assessment if brought in after the expiry of that period. In determining the " profits " of such foreign business, the deductions permissible under Section 10 (2), including interest on capital borrowed in India for use in connection with the foreign business, may be taken, provided the amount so set off does not exceed the amount brought into British India and taxed in the accounting year. This is true, even if all the profits of the business earned in the accounting year and the three preceding years [2] have not been brought into British India.

85. *Checking Accounts.* — Since the taxpayer is a resident, there is no difficulty in collecting the tax, but there is difficulty in checking the accounts. The accounts of foreign branches are usually not called for (though the Crown has the power to do so), as the production of such accounts might often cause inconvenience to the taxpayer. In many cases, the local head office keeps synchronous records of the transactions of the foreign branches on the basis of accounts received periodically, and a scrutiny of these accounts is generally sufficient. If the income-tax officer requires further evidence, he puts the taxpayer to proof, and the taxpayer has to produce either the accounts of the branches or copies thereof certified by a consul or a magistrate. So much depends on the nature of each account, the past record of the taxpayer and the judgment of the income-tax officer that it is not possible to set out with any precision how the accounts are checked.

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[1] Sundar Das *v.* Collector of Gujrat, 1 I.T.C. 189.

[2] Harkishan Lal *v.* The Commissioner of Income Tax, Punjab, 4 I.T.C 431, at page 437.

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

I GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

(a) Book-keeping and Accounting Requirements.

86. Income from salaries and interest on securities is computed on receipt — *i.e.*, cash basis — and not on an " accrual " basis. Income from property is computed on a notional basis with reference to the annual letting value. Income from other heads — namely, business, professional earnings and other sources is computed " in accordance with the method of accounting regularly employed by the assessee : provided that, if no method of accounting has been regularly employed, or if the method employed is such that profits and gains cannot properly be deducted therefrom, then the computation shall be made upon such basis and in such manner as the income-tax officer may determine " (Sections 8 to 13).

87. The onus is always on the taxpayer to prove his income. So, if his accounts do not reflect his true profits in British India, and if the income-tax officer has perforce to make an estimate of such profit, the assessee cannot, obviously, object to the estimate. There is no obligation on the assessee either to keep accounts or to keep them in a particular form. If he does not keep them or keep them clearly and regularly, he has to submit to the estimate by the income-tax officer, even if it is arbitrary.

88. The accounting practice in certain classes of export trade has been the subject of special instructions issued by the Commissioner of Income-Tax at Madras in 1922, as follows :

> " It is the practice of firms exporting hides and other goods to foreign countries to draw advances against the value of a consignment at the time of shipment. Some time afterwards, often in a subsequent year, when the goods have reached their destination and the firm to which they were consigned has taken delivery of them, or has disposed of them on behalf of the exporter, the latter receives what are called ' accounts sales ', showing the final result of the whole transaction, which may be that a further sum, called a ' surplus ' is due to the exporter, or that the latter had to refund the whole or part of the advance drawn, which refund is called a ' short-fall '.
>
> " The advances and surpluses or short-falls often come into the accounts of two years, as just stated. The question is how the profits of any year should be calculated. This will depend on the manner in which the firm in question keeps its accounts.
>
> " One method is to credit nothing to profit and debit nothing to loss, as the case may be, in respect of a particular consignment till the transaction is closed, the accounts sales have been received and the final result is ascertained. Until then, the expenditure and receipts are

kept in a suspense account, or a separate account is kept for each consignment or ' venture ', and the final result when such an account is closed is carried to profit and loss. If accounts are consistently, properly and completely maintained on this basis and there is no reason to doubt their genuineness, the results shown by them should be accepted.

" Otherwise, and in the great majority of cases, another method has to be adopted, which is to treat the entire advance as income of the year in which it is received, and, if it is less than the cost price, to treat the difference between cost price and the advance as closing stock. Of course, in all cases the cost price is also debited to purchases. The net result is, therefore, that, where there is an excess of advance over cost, the excess is taken as profit in the year in which it is received ; while, if the advance equals or is less than the cost price, nothing is taken as profit or loss, since the debit and credit balance one another. Of course, the surplus or short-fall are treated as profit or loss of the year in which they actually come into the accounts."

(b) Methods of Allocation.

89. The basic principles of allocation in the British India Income-Tax Act are found in Section 4 (1), which declares taxable all income, profits or gains accruing or arising or received in British India, or deemed under the provisions of the Act to accrue or arise or to be received in British India, and also in Section 42 (1) and (3), which describes certain items of income that are deemed to be chargeable income. In other words, the British India income-tax is essentially (barring a few exceptions) a territorial tax which is levied on all income which actually or presumptively accrues or arises or is received in British India, according to the provisions of the Act.

90. With regard to one of the most important types of international business which gives rise to questions of double taxation, that of the importation and sale in British India of goods manufactured or purchased abroad, whether the business is carried on by a resident or non-resident enterprise, the whole of the profits or gains shall be deemed to have accrued or arisen and to have been received in British India. This is true whether the sale is effected in British India by the taxpayer himself or by any agency or branch on his behalf, and whether the shipment into British India is made by himself or by any agency or branch on his behalf, from any place outside British India. Furthermore, no deduction is allowed of any buying or other commission whatsoever not actually paid, or any other amounts not actually spent for the purpose of earning such profits or gains (Section 42 (3)).

91. Similarly, when a non-resident derives profits or gains directly or indirectly through or from any business connection or property in British India — for example, from the manufacture or purchase of goods in British India and their sale abroad — all such profits or gains are deemed to be income accruing or arising within British India, and are chargeable to income-tax in the name of the agent of any such person (Section 42 (1)).

92. In short, under the statute, the whole of the profit is allocable to British India, whether the establishment in British India of a non-resident enterprise sells goods which have been manufactured or purchased abroad, or, on the contrary, manufactures or purchases goods which are sold abroad. In taxing the latter category of transactions, the authorities, in practice, sometimes exclude from the assessment the part of the profit attributable to sale abroad (see paragraphs 113 to 119).

93. In the case of a resident, the whole of the profit derived from the importation and sale in British India of goods, whether manufactured or purchased abroad, is allocable to British India, under Section 42 (3) as described above. Section 42 (1) does not apply to a resident, and it has been held that a resident is not taxable when he purchases goods in India and sells them abroad (see paragraph 30) ; but, in general, income derived by a resident from the manufacture or purchase

of goods in India and their sale abroad will be allocable to British India because of being received there. Even if the profits or gains arise or accrue abroad when the sale takes place, they will be allocable to British India if brought there within three years (Section 4 (2)).

1. *Method of Separate Accounting.*

94. The tax authorities will assess the local branch of a foreign enterprise on the basis of its separate accounts, provided they reflect the allocation of profits as described above. For example, the accounts of the branch should show the entire net profit derived from the sale in India of goods purchased or manufactured abroad. The branch will be asked to produce evidence of the following nature in corroboration of the entries in its accounts : a certificate from the auditors of the parent office or company that the prices charged to the branch or subsidiary company are true costs of purchase or production and do not include any element of profit ; if such a certificate cannot be easily had, the authorities may accept an affidavit certificate from the head office or the parent company and, in some cases, from the manager of the local branch. No difficulty is likely to arise in regard to interest charges except in the case of banks and similar institutions. Rates of interest which are unduly high or unduly low would, of course, attract attention. In regard to management charges, patent royalties and the like, the income-tax officer would use his discretion as to the evidence required. If he did not feel satisfied with the evidence, he would resort to the fractional method or to the percentage of turnover method described below.

2 and 3. *Empirical Methods : Method of Fractional Apportionment.*

95. When it is difficult, in practice, to determine the income allocable to British India on the basis of the principles described above and in accordance with the separate accounts of the branch, the income-tax officer may have recourse to the percentage of turnover method, the method of fractional apportionment, or the method of estimating income as provided in Rule 33.

96. Rule 33 runs :

> " In any case in which the income-tax officer is of opinion that the actual amount of the income, profits and gains accruing or arising to any person residing out of British India, whether directly or indirectly through or from any business connection in British India, cannot be ascertained, the amount of such income, profits or gains for the purposes of assessment to income-tax may be calculated on such percentage of the turnover so accruing or arising as the income-tax officer may consider to be reasonable, or an amount which bears the same proportion to the total profits of the business of such person (such profits being computed in accordance with the provisions of the Indian Income-Tax Act) as the receipts so accruing or arising bear to total receipts of the business, or in such other manner as the income-tax officer may deem suitable. "

97. Furthermore, under Section 42 (2), if a non-resident, not being a British subject or a company or firm constituted within His Majesty's Dominions or a branch thereof, carries on business with a resident and if, owing to the close connection between the two and to the substantial control exercised by the non-resident over the resident, the course of business is so arranged that the resident realises therefrom either no profits or less than the ordinary profits which might be expected to arise, the income-tax officer can assess the resident on the basis of estimated profits. In such cases, the resident is assessed as a principal and not as agent.

98. In applying the percentage of turnover method, the income-tax officer usually ascertains the average ratio of net profit to turnover of similar enterprises, and, where there are no similar enterprises, he usually endeavours to take a percentage which fairly represents the importance of the activities of the establishment in India, with due regard to the provisions of Section 42.

99. The fractional method contemplated by Rule 33 consists in apportioning the total net profit of the enterprise (computed in accordance with the Indian Act) in the ratio of receipts in India to total receipts. In the case of an enterprise manufacturing or purchasing abroad and selling in India, the effect of this method is to carry out Section 42 (3) ; in other words, the total net profit pertaining to the merchandise sold in India is allocated there. The fact that the profit is deemed to be received in India, even though payment is actually effected abroad, assures the allocation to India of all profits realised through the sale there. In practice, cases arise where it is possible to separate the items of expenditure relating to the branch, while it is not possible to ascertain the gross profit relating to the branch. In such cases, the gross profit is apportioned in the ratio of receipts, and from the amount of gross profit thus allocated to the branch the items of expenditure are deducted in order to determine the net profit. In such cases, the authorities exercise the reserve power mentioned at the end of Rule 33.

100. When the fractional method is adopted, the means of checking the parent accounts are either the printed and published accounts of the concern as a whole (in the case of companies, accounts have to be published in most countries) or certified copies of the accounts of the parent concern or auditor's certificates. The particular evidence relied on in a given case depends, on the one hand, on the discretion of the income-tax officer, and, on the other, the reputation and past record of the taxpayer and the nature of the transactions shown in the accounts.

101. Very frequently, in practice, the income-tax officer and the taxpayer reach an agreement as to the method by which the profits will be computed or estimated. Previous to reaching the agreement, the nature of the transaction is scrutinised and consideration is given to the general level of profits in similar transactions carried on by other enterprises. Questions of fact such as the reasonableness of a percentage applied to turnover, if not settled by agreement between the taxpayer and the income-tax officer, are referred to the Assistant Commissioner, and, finally, if necessary, to the Commissioner of the Province. Questions of law may be carried to the same officials, and, finally, referred to the High Court (see paragraph 64). Consequently, the factual questions of allocation are, as a rule, settled by discussion and agreement between the authorities and the taxpayer.

4. *Requirements for Selection of Methods and Value of the Various Methods.*

102. The income-tax officer may employ whichever method he considers most satisfactory for the computation of the net income. The method of separate accounting is considered the best if the accounts truly reflect the British-Indian income ; but it is not usually sufficient, as the transactions of the head office and branches are generally so closely interlocked that it is difficult to isolate the British-Indian income. Furthermore, the transactions between the head office and branches require very close scrutiny, which entails the examination of the head office accounts. The percentage of turnover method and the method of fractional apportionment are those most commonly employed, and, of the two, the fractional method is usually preferred both by the Crown and the taxpayers as being less arbitrary and giving a closer estimate of the true profits.

103. The use of the fractional method is ordinarily limited to cases where the chain of transactions is completed in British India — for example, where goods have been manufactured or purchased abroad and sold in India. It is not considered possible to apply this method where the chain of transactions merely begins in British India, such as where goods are purchased there and exported for sale abroad ; in such instances, it is customary to apply a percentage to the receipts from the sale of goods exported which is intended roughly to represent the profit which the foreign enterprise makes by operating itself instead of buying through agents or brokers.

104. The method of arbitrarily estimating income is a reserve power to be used at the discretion of the income-tax officer, and this method is seldom applied by itself. For example, it is resorted to when the use of the fractional method without further adjustment would give manifestly unfair results.

(c) Apportionment between Branch and Parent Enterprise.

1. *Apportionment of Gross Profits of Local Branch to Parent Enterprise.*

105. The question of apportioning any part of the gross profit of the local branch to the real centre of management abroad cannot arise under the British-Indian law. The income to be taxed is the income accruing or deemed to accrue, etc., in British India, and it is immaterial at what place the operations are controlled. Therefore, when profits are computed on the basis of separate accounting, no part of the British-Indian profit will be allocated to the head office merely on the ground that the management is located abroad. If the fractional or percentage of turnover method is adopted, then, also, no allowance will be given on the mere ground that the control of the business is from abroad.

2. *Apportionment of Expenses of Real Centre of Management to Branch.*

Interest Charges.

106. Interest charges payable on a general debt would be apportioned between head office and branches and not solely ascribed to the centre of management. The basis of distribution would be that of turnover *e.g.*, the volume of loans given by each branch in the case of a bank. In British India, of course, all the branches located there would be taxed as one ; and there would be no need to allocate the charges between them. If the interest could be correlated with a particular profit-earning transaction or group of transactions, it would be allocated accordingly.

General Overhead.

107. In principle, a reasonable part of the head office expenses would be deducted from the profits of the Indian branch. If the method of fractional apportionment is adopted with reference to gross profits and it is necessary to work out the deductible expenditure corresponding to the British-Indian share of the gross profits, the general overhead of the head office is apportioned, usually on a turnover basis, unless a closer estimate can be made on other available data (see, however, paragraph 110).

3. *Apportionment of Net Profits.*

108. Once the net profit of the British-Indian business has been arrived at — by whatever method — the foreign part of the business is completely ignored. That is, if the British-Indian business has made a profit, the enterprise cannot claim a set-off against loss elsewhere ; and, if it has made a loss, it cannot be taxed on the ground that the foreign business earned profits.

(d) Apportionment between Parent Enterprise and Subsidiaries.

109. In general, a company organised under the law of British India but controlled through stock ownership by a foreign company will be regarded as a distinct legal entity, and it will be taxed separately on the basis of its own accounts, provided they reflect the profit that would be earned

by an independent enterprise. A great deal would, however, depend on the facts of each case ; thus, in a case where an American manufacturing company sold its products to a subsidiary company registered in Bombay, which in turn marketed the products in a district of British India, the Privy Council held that, apart from the liability of the Bombay company, the parent company was liable to (1) income-tax and super-tax under Section 42 (1) upon profits derived from selling goods to the Bombay company, and (2) to super-tax under Section 42 (1) upon dividends received from the Bombay company. [1]

The reason given for this liability was that the Bombay company was formed for the express purpose of acquiring from the American company, and carrying on in a particular area, the American company's business of selling its manufactures. Although no contractual obligation existed by which the Bombay company was compelled to purchase any of the products of the American company, the flow of business between the two was secured by the fact that the ultimate and complete control of the Bombay company was vested in the foreign company which owned virtually all its shares. The opinion stated that it is not a question whether the Bombay company is in law the agent of the foreign company, but whether the facts of the case are such that the Bombay company can properly be deemed to be such agent under Section 43. Their Lordships were of the opinion that such a business connection existed under Section 43 and also under Section 42 (1). As the necessary business connection was established, their Lordships concluded that the profits and gains in question accrued or arose to the American company " directly or indirectly through or from a business connection in British India ", and were accordingly taxable. The assessment made in the name of the Bombay subsidiary, as agent for the foreign company, included, on the same grounds, income-tax and super-tax and super-tax on profits derived from selling to two other subsidiary British-Indian companies and also super-tax on dividends received from them.

If the accounts of a subsidiary company are not satisfactory, it may be taxed under Section 42 (2), provided it is not a British or Dominion company (see paragraph 97), or under Rule 33 as having a business connection with its non-resident parent company. If the subsidiary is a sham or a simulacrum, it would be open to the income-tax officer, even if the company were a British or Dominion company, to assess it on its true nature as a branch of the parent company and not as a separate company.

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

(a) INDUSTRIAL AND COMMERCIAL ENTERPRISES.

1. *Selling Establishments.*

Local Establishments selling in National Markets.

110. If a foreign enterprise — *i.e.*, non-resident, sells goods in British India, whether through an agency or a branch, under Section 42 (3) the profits and gains shall be deemed to have accrued and arisen and to have been received in British India, and no allowance shall be made for any buying or other commission not actually paid or of any other amounts not actually spent for the purpose of earning the profits. The prohibition is only against the deduction of notional commissions — *i.e.*, against the allocation of gross profits between the place of sale (British India) and the place of purchase (abroad). If the buying commission can be proved to have been spent, it will be allowed.

111. Where the foreign enterprise sells in British India goods which it has manufactured abroad, the profit taxed is the whole net profit — *i.e.*, both manufacturing and merchanting. In such cases it is to be seen by the income-tax officer that the selling-price charged by the head office to the selling

[1] Commissioner of Income-Tax, Bombay, *v.* the Remington Typewriter Company (Bombay) Limited ; Bombay High Court, 3 I.T.C. 166 ; Privy Council (1930), 5 I.T C. 177

branch is the true cost of production and does not take into account any element of profit. When information of this kind is not submitted, in practice the Calcutta authorities sometimes arrive at the assessment in the following manner : they first fix a percentage of turnover to represent the sale profit here, and then a percentage to represent the manufacturing profit abroad, and add the two together. The resulting percentage is applied to the gross receipts from sales in India. The percentage of turnover method is usually resorted to by the authorities in preference to examining and arbitrarily adjusting the price at which goods are invoiced to the branch in British India.

The question of making an allowance for a foreign manufacturing profit was considered in a judgment rendered February 5th, 1932, by the High Court of Judicature at Fort William, Bengal, concerning assessments upon the Port Said Salt Association, Ltd. The assessee had its headquarters in Egypt, where it manufactured salt and exported that product for sale in British India and other parts of the world. Although not contesting liability under Section 42 of the Act of 1922, the assessee raised before the Commissioner, and he referred to the court, the following question :

> " Is an assessee, assessed under Section 42 in respect of a business in which the manufacture of a commodity takes place in a foreign country and the sale thereof takes place in British India, entitled, in computing profits and gains of such business, to make a deduction representing the proportion of profits earned by manufacture in the country of origin ; or is he bound, in computing such profits and gains, to do so on the assumption that the whole of these are earned in the country of sale ? "

The court upheld the Commissioner in disallowing any such deduction in the following language:

> " By Section 4, the tax is charged upon profits ' accruing or arising or received ' in British India, and if any profit is, or must be deemed to be, of this character it will not be saved by the circumstance that work was done and money spent abroad in order to obtain it. Naturally, the cost to the assessees, wherever incurred, of producing the article, transporting it and selling it must be deducted from the price obtained before the balance can be called a profit. Again, upon a valuation of stock in hand, the Egyptian business might be well entitled to treat it as an asset for more than the bare cost of production. But profit, though it may be anticipated by valuation or otherwise, is not realised before price, and, when the article is sold, the whole profit is realised for the first time. Support for the assessees' argument cannot be derived from anything in Section 10 of the Act, the principle of which is to permit of allowances for actual expenditure and loss actually incurred for the purpose of earning the profits. The phrase ' earning and profits ' occurs in clause IX of subsection 2 of Section 10, but the section contains no hint that part of the profits will be exempted, although they arise or are received in British India, because they have been ' earned ' elsewhere.
>
> " The purpose of Section 42 in its first subsection is to enact that all profits accruing to a person through or from any business connection or property in British India shall be deemed to come within the class of profits taxed by Section 4. The third subsection shows that profits arising from the sale of merchandise exported to British India are within the class that has been made taxable under Section 4. To permit of the assessees' contention, both subsections must be drafted very differently, and Rule 33, which appears to have been applied to the present case, authorises a method of computation by taking the proportion of ' receipts so accruing or arising ' to the total receipts — a computation which would be radically changed if the claim of the assessees is admitted. An international convention to limit the rapacity of nations towards the nationals of others might listen to the argument of the assessees with great respect, but we cannot make room for it in the Indian Act.
>
> " The question referred to us must be answered as to the first part in the negative. The second part need not be answered, as it assumes that profits to be taxable must be ' earned ' in British India, which is to beg the question. The assessees must pay the costs."

Local Establishments selling abroad.

112. Where a foreign enterprise has a branch in British India which makes sales in a third State, if the contracts for sales in the third State were concluded in British India, the income would accrue or arise in British India and be taxable there. In any case, wherever such contracts are concluded, if the profits are received for the first time in British India, they would still be taxable. Profits made abroad and realised there would not be taxable when subsequently brought into British India, if the taxpayer is not a resident of British India.

2. Manufacturing Establishments.

113. If a foreign enterprise manufactures goods at a factory in British India and sells them abroad, under Section 42 (1), read in connection with Section 4 (1), all the profits arising from such business connection are deemed to arise or accrue in British India, and are therefore taxable. In practice, however, the foreign company is sometimes taxed on that part of the profit which is attributable to the manufacturing operations in British India. This part may be estimated either with reference to the profits made by manufacturers similarly circumstanced who sell outright for export from British India, or, if this is not possible on an arbitrary basis, which is usually a certain percentage, fixed by agreement between the income-tax officer and the assessee, of the profits realised from the sales abroad. In other cases, the whole of the profit is taxable except for the allowance of a foreign sales commission if actually incurred. It is assumed that all goods shipped abroad are sold at a profit unless the taxpayer proves the contrary.

114. The question of the liability to tax in British India in the case of a non-resident enterprise which manufactures in British India has been thoroughly considered in two cases : that of Rogers Pyatt Shellac Co. *v.* Secretary of State (1924) [1] and that of the Commissioner of Income Tax, Burma, *v.* Messrs. Steel Bros. & Co., Ltd. (1925).[2] In the former, an American corporation was held taxable, because it operated a factory in the United Provinces, the products of which were exported and sold abroad, and also because it purchased, at a branch office in Calcutta, gum, shellac and other products for export and sale abroad. The basis of determining the profit was not before the court, but one of the judges indicated that the profits or gains attributable to a business connection in British India might be calculated by fixing a reasonable percentage of turnover, or by one of the other methods indicated in Rule 33 previously described (see paragraphs 96 to 100).

115. Similarly, in the case of Steel Bros. & Co., Ltd., a non-resident company, with headquarters in London, worked up rice, cotton and other products in India, which were sold abroad, and also purchased certain products and sold them abroad without transformation. The court held that, in so far as liability to income-tax was concerned, no distinction could be drawn between profits on products which had undergone some process of conversion or working up by the taxpayer in India and profits on products purchased by the taxpayer in India and exported in the same form. Although Section 42 (1), read in conjunction with Section 4 (1), provides that all income derived from such business connection in British India shall be deemed to have accrued or arisen there, the court held that there should be excluded from assessment a reasonable agent's commission on the sale of the produce in London. Such commission is allowed if incurred, or in some cases if no other sales expenses *(e.g.*, share of cost of London office) are claimed.

3. Processing Establishments.

116. Processing at an establishment in British India by a non-resident enterprise constitutes a " business connection " and gives rise to liability under the provisions of Section 42 (1) described in the previous paragraph. For example, a non-resident enterprise operating in British India,

[1] 1 I.T.C. 363
[2] 2 I.T.C.119.

buying raw material from an Indian State and processing it in British India, and then exporting it abroad for sale or for further processing, would, in practice, be taxed on that part of the profit which could be attributable to the processing in British India. This profit would probably be computed by resorting to the percentage of turnover method.

4. *Buying Establishments.*

117. A non-resident who has no establishment in British India but buys through commission agents or brokers is not taxable, but he is taxable if he has an establishment or anything in the nature of a regular agency. In such a case, the non-resident is regarded as deriving income from a " business connection " in British India, and all the profit is therefore deemed to arise or accrue there under Section 42 (1). In practice, however, some allowance is granted in respect of the sales profit actually accruing abroad, or an attempt is made to estimate the profit attributable to purchasing in British India

The principal reasons given for taxing non-residents with purchasing establishments are :

(1) It is considered that a part of the eventual profit is due to skill in purchasing, and

(2) It is felt that non-residents who profit from purchasing and exporting British India products should bear some tax.

The cultivator or receiver of rent in kind who sells raw produce *(e.g.*, tea, cotton, paddy), or the landowner who sells timber grown on his own land to the non-resident, pays no tax on such " agricultural income ", provided the land itself is subject to local taxes (see paragraph 76).

118. Cases involving purchasing establishments in India - namely, those of the Rogers Pyatt Shellac Co., and Steel Bros. & Co., Ltd., have been mentioned above in connection with manufacturing profits.

In the former case, it was suggested by the Court that the profit might be fixed by applying Rule 33. The latter decision held taxable all the profit, less a reasonable sales commission allocable to the London sales office of the enterprise. Thus, no distinction is made as to whether the goods sold abroad have been merely purchased in Burma or manufactured in Burma. The only deduction beside actual expenses is the commission that would have been paid to an agent to sell the goods, and this commission may vary with the nature of the goods -- *e.g.*, the commission for selling rice often differs from that charged for selling other products.

In another instance, a non-resident firm purchased pearls in Bombay and cured them there as well. It was estimated that the profit attributable to these activities was from 3 to 5 per cent of the purchase price. If accounts showing total net profit were submitted, the tax commissioner would assume one-fourth or one-third to be Indian profit.

119. Where an attempt is made to tax only the purchasing profit, as the estimation thereof is very difficult, the usual practice is for the income-tax officer to come to an understanding with the taxpayer concerning a percentage to be applied to receipts from sales abroad. This percentage is usuall applied to receipts from sales during the preceding financial year rather than to receipts from particular shipments. It is presumed that the purchased goods which are exported are sold at a profit, but no assessment would be made in respect of goods unsold or sold at a loss, provided the taxpayer shows that such is the case.

5. *Research or Statistical Establishments, Display Rooms, etc.*

120. Only one case can be readily traced with a distant similarity to those suggested by this heading. The importers of a certain commodity from a particular country had a common propagandist organisation to push up sales. The organisation did not, naturally, make any profit ;

and the extra profits that could be attributed to the activities of the organisation were automatically taxed in the hands of the various importers, who were taxable in this country, either because they had an establishment or because they had agencies (business connection). Importers who sold through the post were placed in the same position as the others who advertised, but the fact that they contributed to the funds of the common propagandist organisation could not make them taxable in British India.

(b) Banking Enterprises.

121. These enterprises present difficulties, especially in allocating the profits arising out of financing international trade, because the transactions are almost inextricably intertwined. In certain cases, the local branch works merely on credits provided by the head office, and there are very little assets in this country beyond these credits. Further, if the profits were to be allocated with reference to assets, evasion would be simple if the allocation were made with reference to the position on a particular date — *e.g.*, the closing date of the accounting year, since manipulation of assets would be easy, while any computation with reference to the varying position from day to day would lead to enormous work without any commensurate advantage.

122. In many instances, the local branches of foreign banks are taxed on the basis of their separate accounts. Where no such accounts exist, the more common plan is to work out an *ad hoc* account of the local branch, basing it on the gross profit worked out for the local branch in the ratio of its receipts to total receipts and separating the items of expenditure for the local branch. The local items allowed would be proved local losses, salaries and other costs of the local establishment, a *pro rata* share of the general management charges at the head office and interest on general indebtedness. This proportion is usually fixed in the ratio of receipts.

123. Inasmuch as only profits accruing or received in British India are taxable, only expenses incurred for the purpose of earning such profits are deductible. No deduction is allowed for interest on capital or reserves which is allocable to the branch in India. Interest on deposits and borrowings is deductible only to the extent that such deposits are required to make loans in British India and to provide for other assets in British India necessary for the banking business, like cash in hand and buildings. The interest charged *pro forma* on the transactions between the head office and the branches will be scrutinised with reference to market rates from day to day.

124. Profits from the discounting of international bills are not allocated between the two ends in any definite manner, and the accounts of the banks are generally accepted without challenge, in so far as there is nothing suspicious. Where both the ends of the bill are in British India, there is, of course, no difficulty.

(c) Insurance Enterprises.

125. Under Rule 35, the total net income of the Indian branches of non-resident insurance companies (life, marine, fire, accident, burglary, fidelity guarantee, etc.), in the absence of more reliable data, may be deemed to be the proportion of the total net income, profits and gains of the companies (computed according to the British India Act) corresponding to the proportion which their Indian premium income bears to their total premium income.

126. Certain non-resident life-insurance companies make separate actuarial valuations for their British-Indian business, and, when these valuations are available, the assessment is based on them. Incidentally, the assessment on British-Indian life insurance companies is based on the actuarial valuation and not, as in certain other countries, on the investment income less management expenses (Rule 25). The profits from other insurance business — not ascertained actuarially —

are estimated on the ordinary commercial basis, but provision for depreciation of securities (or actual depreciation) is treated as deductible expenditure, appreciation being treated as profits. Reserves to meet outstanding liabilities or unexpired risks are also treated as deductible expenditure.

(d) Transport Enterprises.

Ocean Transport.

127. As regards ocean transport, the following instructions have been issued in the *Income-Tax Manual* (Rule 88) :

" If a company furnishes annual accounts for the whole of its business, Indian and foreign, the second method provided by Rule 33 should be applied. Depreciation has only to be considered in calculating the world profits. These are to be calculated according to the Indian Income-Tax Act. Profits calculated according to the United Kingdom Act will, therefore, require some adjustments. Deductions permitted in the United Kingdom but not permitted in India will have to be added back, and deductions permissible in India but not permissible in the United Kingdom will have to be allowed. If any company, however, prefers to claim the depreciation allowed by the United Kingdom income-tax authorities, the Commissioners of Income-Tax may adopt that figure. Otherwise, depreciation will have to be calculated according to the Indian rules. What follows applies to the calculation of depreciation according to the Indian rules. For this purpose, a complete depreciation record has to be maintained for the entire fleet. Depreciation begins to run from the first year in which the company is ' assessed ' in India — that is, the first year in which its profits (or loss) were determined for the purpose of deciding whether it was liable to Indian income-tax. Unabsorbed depreciation — *i.e.*, any balance of depreciation which cannot be allowed in any year owing to the profits not sufficing to cover the full amount permissible under the Indian rules — will be carried forward and allowed, as far as possible, in calculating the world profits according to the Indian method in the following year and, if necessary, in subsequent years. What has been said above about depreciation applies equally to obsolescence.

" The proportion ' Indian Receipts ÷ Total Receipts ' is applied to the world profits calculated according to the Indian method (if there are any such profits), and the result is the Indian income liable to tax. No further deduction is permissible from the amount thus arrived at on account of depreciation (unabsorbed or otherwise) or anything else. The due proportion of all allowances permissible is automatically set off against the Indian profits by the above method.

" This method is equally applicable whether a company works out the profits for each voyage or follows any other method of accounting, provided that it prepares complete annual accounts for the whole business, Indian and foreign, and furnishes the accounts of gross receipts, Indian and foreign.

" Some lines do not furnish complete annual accounts for their world business. They keep complete separate annual accounts for their Indian trade — that is, for all ' round voyages ' to and from Indian ports. The proper course is then to apply the method just described, treating the profits of the Indian trade and the gross receipts of the Indian trade as though they were the ' world profits ' and the ' world receipts ', respectively. In fact, the business other than the Indian trade is ignored.

" A difficulty sometimes arises in such cases owing to the fact that the ships employed in the Indian trade are constantly being changed. Unless United Kingdom depreciation is accepted as indicated above, a depreciation record will have to be kept for every ship employed at any time in the Indian trade. Depreciation must be allowed on each ship employed in the Indian trade in a given year and the allowance must be a proportion of the annual rate calculated

with reference to the number of days spent in the Indian trade, whether at sea or in harbour. Any unabsorbed depreciation in any year must be distributed among the ships in the Indian trade in that year in proportion to the capital cost of each, and the unabsorbed depreciation thus allotted to any ship can only be allowed in any subsequent year against the same ship.

" The allowance should cease : *(a)* on ships included in the fleet in the first year in which the company becomes liable to assessment in India (irrespective of whether it was actually found to have a taxable income in that year or not), after the twentieth year beginning with that year ; *(b)* on ships subsequently added to the company's fleet, after they have been borne on the fleet for twenty years. In both cases, the period may be extended proportionately where the United Kingdom depreciation is allowed in calculating the ' profits of the Indian trade ', which takes the place as already explained of the ' world profits '.

" Obsolescence cannot be allowed in these cases. "

Rail Transport.

128. As regards other transport, the common case is that of a railway passing through British India and an Indian State or French or Portuguese India. In all such cases the whole of the profits is taxable in British India, since in most cases it is received in or brought into British India. Problems of allocation therefore do not arise.

Air Transport.

129. Questions regarding air transport have not yet been considered, but under a strict interpretation of the law such enterprises would be taxable on profits arising, accruing or received in British India.

(e) Other Kinds of Enterprises.

130. No cases in which questions of allocation were raised in connection with power, light, gas, telegraph, mining or other enterprises than those dealt with above can be traced.

In all cases wherever the control and wherever the income arises or accrues, it is taxable if received for the first time in British India. Also, if anything is done in British India which adds to the value of the commodity or goods, the profit arising out of such enhanced value will be taxable, through the branch or agency which does the work.

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

131. A resident is taxable on his foreign profits — *i.e.*, accruing or arising out of British India, only if the profits relate to business *(i.e.*, trade, commerce, or manufacture, or any adventure or concern in the nature of trade, commerce, or manufacture), and if the profits are brought into British India within three years of the year of origin. If the profits, though accruing or arising abroad, are received in the first instance in British India, then the profits are taxable when received, whatever the nature of the foreign source of income.

132. Questions of allocation of profits between the head office and the branches seldom arise in such cases. If any arose, they would be dealt with very much on lines similar to those relating to the allocation of profits between branches in British India of non-residents and their head offices abroad.

133. It should be added that no profit is ascribed to the place of management merely because of the control.

C. HOLDING COMPANIES.

134. If such companies are resident, there is nothing peculiar in their treatment. They will be taxed, like any other resident, on their foreign profits from business on the basis of remittance within three years of the year of origin. A foreign company holding stock in a local company is liable to company super-tax if it receives dividends in excess of Rs. 50,000.

Annex.

TABLE OF TARIFFS.

I. Income-Tax. [1]

For 1932-33 Assessment (including Surcharge at 25 per cent over the Rates specified).

	Rate	Per cent
A. In the case of every individual, Hindu undivided family, unregistered firm and other association of individuals not being a registered firm or a company.		
1. When the total income is less than Rs. 1,000	Nil.	
2. When the total income is Rs. 1,000 or upwards but less than Rs. 2,000	Four pies in the rupee [2]	2.083
3. When the total income is Rs. 2,000 or upwards but is less than Rs. 5,000	Six pies in the rupee, plus surcharge	3.906
4. When the total income is Rs. 5,000 or upwards but is less than Rs. 10,000	Nine pies in the rupee, plus surcharge	5.86
5. When the total income is Rs. 10,000 or upwards but is less than Rs. 15,000	One anna in the rupee, plus surcharge	7.81
6. When the total income is Rs. 15,000 or upwards but is less than Rs. 20,000	One anna and four pies in the rupee, plus surcharge	10.41
7. When the total income is Rs. 20,000 or upwards but is less than Rs. 30,000	One anna and seven pies in the rupee, plus surcharge	12.36
8. When the total income is Rs. 30,000 or upwards but is less than Rs. 40,000	One anna and eleven pies in the rupee, plus surcharge	14.97
9. When the total income is Rs. 40,000 or upwards but is less than Rs. 100,000	Two annas and one pie in the rupee, plus surcharge	16.27
10. When the total income is Rs. 100,000 or upwards	Two annas and two pies in the rupee, plus surcharge	16.92
B. In the case of every company and registered firm whatever its total income.	Two annas and two pies in the rupee, plus surcharge	16.92

[1] Schedule IV, Part I, Indian Finance Act, 1931, amended by Section 9, Indian Finance (Supplementary and Extending) Act, 1931.

[2] Surcharge not applicable

II. SUPERTAX. [1]

Re 1932-33 Assessments (including Surcharge at 25 per cent of the Rates specified).

In respect of the excess over thirty thousand rupees of total income :

	Rate	Per cent
1. In the case of every company :		
(a) In respect of the first 20,000 rupees of such excess	Nil	
(b) For every rupee of the remainder of such excess	One anna in the rupee, plus surcharge	7.81
2. *(a)* In the case of every Hindu undivided family :		
(i) In respect of the first 45,000 rupees of such excess	Nil	
(ii) For every rupee of the next 25,000 rupees of such excess	One anna and three pies in the rupee, plus surcharge	9.76
(b) In the case of every individual unregistered firm and other association of individuals not being a registered firm or a company :		
(i) For every rupee of the first 20,000 rupees of such excess	Nine pies in the rupee, plus surcharge	5.86
(ii) For every rupee of the next 50,000 rupees of such excess	One anna and three pies in the rupee, plus surcharge	9.76
(c) In the case of every individual, Hindu undivided family, unregistered firm and other association of individuals not being a registered firm or a company :		
(i) For every rupee of the next 50,000 rupees of such excess	One anna and nine pies in the rupee, plus surcharge	13.66
(ii) For every rupee of the next 50,000 rupees of such excess	Two annas and three pies in the rupee, plus surcharge	17.57
(iii) For every rupee of the next 50,000 rupees of such excess	Two annas and nine pies in the rupee, plus surcharge	21.47
(iv) For every rupee of the next 50,000 rupees of such excess	Three annas and three pies in the rupee, plus surcharge	25.39
(v) For every rupee of the next 50,000 rupees of such excess	Three annas and nine pies in the rupee, plus surcharge	29.29

[1] Schedule IV, Part II, Indian Finance Act 1931, amended by Section 9, Indian Finance (Supplementary and Extending) Act 1931.

	Rate	Per cent
(vi) For every rupee of the next 50,000 rupees of such excess	Four annas and three pies in the rupee, plus surcharge	33.20
(vii) For every rupee of the next 50,000 rupees of such excess	Four annas and nine pies in the rupee, plus surcharge	37.10
(viii) For every rupee of the next 50,000 rupees of such excess	Five annas and three pies in the rupee, plus surcharge	41.01
(ix) For every rupee of the next 50,000 rupees of such excess	Five annas and nine pies in the rupee, plus surcharge	44.91
(x) For every rupee of the remainder of such excess	Six annas and three pies in the rupee, plus surcharge	48.82

III. Effective Rates of Supertax on Individuals. [1]

Approximate Percentages of the Rates on the Total Income for 1932-33 Assessments, including Surcharge of 25 per cent over the Rates specified in Table II.

	If the total income be . Rupees	Percentage rate		If the total income be Rupees	Percentage rate
(1)	30,000	Nil	(15)	750,000	31.37
(2)	50,000	2.312	(16)	850,000	33.43
(3)	100,000	6.05	(17)	950,000	35.06
(4)	150,000	8.56	(18)	1,050,000	36.37
(5)	200,000	10.42	(19)	1,150,000	37.43
(6)	250,000	12.93	(20)	1,350,000	39.12
(7)	300,000	15.04	(21)	1,550,000	40.37
(8)	350,000	17.07	(22)	1,750,000	41.31
(9)	400,000	19.62	(23)	1,950,000	42.12
(10)	400,000	21.06	(24)	2,500,000	43.56
(11)	500,000	23.06	(25)	3,000,000	44.3
(12)	550,000	25.06	(26)	4,000,000	45.5
(13)	600,000	27.00	(27)	5,000,000	46.18
(14)	650,000	28.68	(28)	10,000,000 (or upwards)	46.18

[1] This table has been prepared to give, in the case of individuals, the effective rate on total income in the amounts indicated, as contrasted with the statutory table reproduced under II, which shows the rates on successive slices of income over the exempted minimum.

IV. Effective Rate of Supertax on Companies. [1]

Approximate Percentages of the Rates on the Total Income for 1932-33 *Assessments, including Surcharge of* 25 *per cent over the Rates specified in Table II.*

	If the total income be . Rupees	Percentage rate		If the total income be . Rupees	Percentage rate
(1)	50,000	Nil	(11)	600,000	7.12
(2)	100,000	3.87	(12)	700,000	7.25
(3)	150,000	5.18	(13)	800,000	7.31
(4)	200,000	5.81	(14)	900,000	7.37
(5)	250,000	6.25	(15)	1,000,000	7.43
(6)	300,000	6.50	(16)	2,000,000	7.56
(7)	350,000	6.68	(17)	3,000,000	7.62
(8)	400,000	6.81	(18)	4,000,000	7.68
(9)	450,000	6.93	(19)	5,000,000	7.75
(10)	500,000	7.00	(20)	10,000,000 (or upwards)	7.75

[1] This table has been prepared to show the effective rates of supertax on the total income of companies in the amounts indicated as contrasted with the statutory table under II, which states the flat rate on income in excess of the exempted minimum

CANADA

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PART I. — GENERAL DESCRIPTION OF INCOME-TAX SYSTEM.[1]

The Canadian income-tax[2] is collected under the Income War Tax Act, Chapter 97, R.S.C. 1927, and amendments thereto — *i.e.*, Chapters 12 and 30 of the Statutes of 1928, Chapter 24 of the Statutes of 1930, Chapter 35 of the Statutes of 1931, Chapter 43 of the Statutes of 1932, Chapters 14 and 41 of the Statutes of 1933.

The tax is composed of a graduated scale of rates on the income of individuals in excess of statutory exemptions, and a flat rate on the income of corporations. It is collected by direct assessment on the taxpayer or his agent, except that tax is withheld from amounts or royalties paid to non-residents for anything let, leased, used or sold in Canada. The tax so withheld at the source is allowed as a credit against any tax payable by the non-resident. Furthermore, collection of tax is assured by means of information returns and by ownership certificates relating to bearer coupons or warrants.

An additional income-tax of 5 per cent is imposed on resident persons in respect of all interest and dividends paid by Canadian debtors in a currency which is at a premium in terms of Canadian funds, and on all non-residents in respect of *(a)* all dividends received from Canadian debtors irrespective of the currency in which the payment is made, and *(b)* all interest received from Canadian debtors if payable solely in Canadian funds (except in respect of all bonds of or guaranteed by the Dominion). This tax is a direct tax to be borne by the recipient of the interest or dividends, and an agreement to the contrary is void.[3]

1. TAXPAYERS.

(a) INDIVIDUALS.

The extent of liability of individuals to the income-tax depends upon residence or non-residence in Canada, without regard to their nationality or place of domicile. Individuals residing or ordinarily resident in Canada are liable to tax on income from all sources, foreign as well as domestic. This is true even though the residence, in law and in fact, is for one day only. Non-resident individuals, including non-resident citizens of Canada, are liable to tax in respect of rents and royalties received from Canada, and on profits derived from carrying on business in Canada. Likewise, a non-resident employed in Canada (" border commuters ") or non-residents who, otherwise than in the course of regular or continuous employment for any person resident or carrying on business in Canada, derive income for services rendered in Canada are liable to tax on such income. This covers mining engineers, scientists, doctors, artists or other like persons who render short service in Canada, often receiving substantial remuneration. (In practice this provision is difficult to administer, because the individual enters Canada and soon leaves its jurisdiction, and there is no withholding of tax at the source.)

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[1] Legislation in force July 1st, 1933

[2] For the fiscal year ending March 31st, 1933, income-tax receipts approximated $62,000,000, as compared with a yield during the previous fiscal year of $61,255,000 The yield of the Customs tariff for 1932-33 was about $72,000,000 ; that of the excise duties, about $38,594,000; that of the 6 per cent sales tax, over $58,000,000 ; and of various other excise and miscellaneous taxes, $27,432,000.

[3] An Act to amend the Income War Tax Act, assented to May 23rd, 1933. Statutes of 1933, Chapter 41, section 9.

Individuals who stay in Canada for more than half a year, though they be non-resident, are liable to tax technically in respect of their total income for the whole year, whether derived from sources in Canada or abroad, subject to the allowance for British or foreign taxes paid.

Resident and non-resident individuals are liable to the 5 per cent tax on dividends and interest as described above.

Non-resident individuals who are beneficiaries of an estate or trust in Canada are not liable to tax on the investment income derived from or through the estate or trust. Income accumulating in trust for the benefit of unascertained persons, or persons with contingent interests, is taxable in the hands of the trustee or fiduciary, as if such income were the income of an unmarried person (Section 11). Nevertheless, dividends and interest paid to a trustee resident in Canada are subject to the 5 per cent tax if 50 per cent or more of the income of the trust is paid or credited to non-residents of Canada.

" Residing or ordinarily resident " is not defined by the statute, and is a mixed question of fact and law, though primarily one of fact ; it must be determined in accordance with all the circumstances of each case.

Generally speaking, a person resides where he has his dwelling, home and family, but a person may be resident though such indices be not present ; residence is the quality or attribute which a person has acquired by a continuing relationship with a place in Canada ; one who regularly returns to Canada in pursuance of a settled object and not merely casually or occasionally, or on business ventures only, or as a traveller, may be deemed " resident ".

" Resident " or " ordinarily resident " are expressions in common general use. They have no well-defined meaning, no technical or scientific application, and for these reasons, in border-line cases, are about as difficult a word and phrase to interpret as could be used. Facts, intention and the law arising therefrom and applicable thereto are intricately involved, but, were we to select out of the many cases a few that tend to develop chronologically and reasonably clearly the indices which, in law, determine the meaning for tax purposes of " resident " or " ordinarily resident ", reference might be made to the cases enumerated below.[1] This list, however, is very incomplete.

(b) Partnerships.

Partnerships are not taxed as such, nor are they taxed as companies, but the individual share of the partners in the income of the partnership is taxed to the individual, whether distributed to him or not, and this would include non-resident individuals who are regarded as carrying on business in Canada with their partners.

It is immaterial whether the partnership, in point of law, is domestic or foreign, resident or non-resident. The extent to which the individual partners' income is taxable under the Dominion Act depends rather upon the residence or non-residence in Canada of the individual partners. A resident partner is liable to be assessed upon the whole of his distributive share of the net profits of the business, together with all other income, whether derived from sources within Canada or elsewhere. A non-resident partner is assessable only in respect of his distributive share (whether distributed or not) of the net profit derived from the Canadian business (Section 24).

[1] Walcot *v.* Botfield (1854), Kay 534, Eng Rep , vol 69 ; Ford *v.* Hart, 12 L R , 9 C P. 273 at 276 , *in re* Young (1875), 1 T. C 57 at pages 59 and 60 ; Lloyd *v* Sulley (Surveyor of Taxes) (1884), 2 T C. 37 at 41, as per Lord Sands, at pages 44 and 45 ; Rex *v* Aldrington Com (1916), 85 L J K B , 1753 ; Thomson *v.* Inland Revenue (1918), 56 Sc. L. R., 10 ; Weymess *v.* Weymess (1921), Sess Cases, page 30 at 40 ; Reid *v.* Commissioners of Inland Revenue (1926), 10 T. C. (page 673), as per Lord President Clyde (pages 678 and 679), as per Lord Sands (page 681), as per Lord Blackburn (page 681) ; Levene *v* Commissioner of Inland Revenue, 13 T C. (page 486 at 496), as per Lord Hanworth (page 497) , as per Sargant (L. J. page 490), as per Viscount Sumner (House of Lords) (at pages 500 and 501), as per Viscount Cave (pages 506 and 507) ; Lysaght *v.* Commissioner of Inland Revenue, 13 T C. 511, as per Rowlatt J. (pages 516 and 517), as per Lawrence (L. J. (Court of Appeal) pages 524 and 525), as per Viscount Sumner (House of Lords) (pages 527 and 528), as per Viscount Cave (L. C , page 532), as per Lord Buckmaster (pages 533, 534 and 535).

(c) COMPANIES.

Companies may be divided into four categories :

(1) Companies incorporated in Canada, either by Dominion or provincial charter, and resident therein ;

(2) Companies incorporated in Canada but whose business and assets are situated and carried on entirely outside Canada (see Section 4 *(k)*) ;

(3) Companies incorporated in Canada or in a foreign State and resident abroad ;

(4) Companies incorporated abroad but resident in Canada.

Companies in category 1 are taxable on their total income derived from whatever source, whether in Canada or abroad, without distinction as to whether the income is investment income or from the carrying on of some commercial enterprise.

Companies in category 2 are not liable to tax in Canada.

Companies in category 3 are liable to tax in Canada only upon the income from business carried on in Canada, with some allowance, hereinafter referred to, for head-office expenses of a general character.

Companies in category 4 are liable to tax, as resident in Canada, on income derived from whatever source. As a fifth possible class, any corporation resident abroad and receiving rents or royalties from sources within Canada is liable to tax in Canada on those rents and royalties.

Corporations, like individuals, are taxable on the basis of residence. An incorporated company " residing or ordinarily resident in Canada " is, in general, taxable in respect of the entire profits of the business wherever made. The term " residence ", for purposes of the Dominion Act, is interpreted by reference to the decisions of the United Kingdom courts. The place of registration or incorporation of a company is not — any more than birthplace in the case of an individual — conclusive as to its residence, nor does a company necessarily reside at the place where its registered or head office is formally situated, or at the place where its manufacturing or other business operations are carried on. The primary test for determining a company's residence for income-tax purposes is " where it really keeps house and does business ", " where its real business is carried on ", and " the real business is carried on where the central management and control actually abides ". [1]

Although resident and non-resident companies are liable to the 5 per cent tax on interest and dividends, that tax does not apply in the case of dividends paid to a non-resident company by a Canadian company, all of whose shares (less directors' qualifying shares) are beneficially owned by such non-resident company, provided not more than one-quarter of the gross income of the Canadian company is derived from interest and dividends. [2]

2. TAXABLE INCOME.

Income, whether national or foreign, is defined by Section 3 :

" For the purposes of this Act, ' income ' means the annual net profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount,

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[1] De Beers Consolidated Mines, Ltd , *v* Howe (1906), A C page 455 at 458; Cesena Sulphur Co *v* Nicholson ; Calcutta Jute Mills Co *v.* Nicholson (1876), 1 Ex. D. 428, 452 ; Swedish Central Railway Co *v* Thompson (1925), A C. 495, 501 ; Egyptian Delta Land and Investment Company, Limited, *v* Todd (1928), 44 T L. R 747 at page 749 ; (1929), A. C 1.

[2] An Act to amend the Income War Tax Act, assented to May 23rd, 1933. Statutes of 1933, Chapter 41, sections 9 and 9 B (11).

or unascertained as being fees or emoluments, or as being profits from a trade or commercial or financial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling, or from any trade, manufacture or business, as the case may be, whether derived from sources within Canada or elsewhere : and shall include the interest, dividends or profits directly or indirectly received from money at interest upon any security or without security, or from stocks, or from any other investment, and whether such gains or profits are divided or distributed or not, and also the annual profit or gain from any other source, including :

" *(a)* The income from, but not the value of, property acquired by gift, bequest, devise or descent ; and

" *(b)* The income from, but not the proceeds of, life insurance policies paid upon the death of the person insured, or payments made or credited to the insured on life insurance endowment or annuity contracts upon the maturity of the term mentioned in the contract or upon the surrender of the contract ; and

" *(c)* Any payment to any employee out of any employees' superannuation or pension fund or plan ; and

" *(d)* The salaries, indemnities or other remuneration of " certain public officials and " all persons whatsoever, whether the said salaries, indemnities or other remuneration are paid out of the revenues of His Majesty in respect of His Government of Canada, or of any province thereof, or by any person, except as herein otherwise provided ; and,

" *(e)* Personal and living expenses when such form part of the profit, gain or remuneration of the taxpayer."

No distinction is made in this definition according to whether the income is derived from Canadian or non-Canadian sources. Capital gains or profits from isolated transactions, such as a transaction in shares on the Stock Exchange, are not deemed to be taxable income.

The word " annual " occurring in the definition of income is not interpreted as meaning occurring throughout the year or from year to year, but simply as happening within a year. The definition of " income " renders those specified incomes, such as salaries, wages or other fixed amount, net income without accounting requirements, as opposed to profits from a trade, commercial, financial or other business or calling, which requires accounting.

In determining the income of individuals, the Treasury distinguishes between the chief source of income and income from other sources. Losses in secondary businesses are not allowed, if they exceed income from secondary sources, to be set off against the income from the chief source (Section 10).

Income taxable under the statute includes loans to shareholders. If shares are redeemed at a premium and the company has an undistributed income on hand since 1917 (the beginning of the Income-Tax Act in Canada), the premium is taxable ; likewise the redemption of shares, when such undistributed income is on hand, on an indirect distribution of such a surplus through the incorporation of intermediary companies.

All dividends, and those special statutory distributions deemed to be dividends (Sections 14, 15, 16, 17, 19 and 20), are taxed when received by a resident individual. Inasmuch as the Canadian Act does not provide for normal tax and the subsequent imposition of supertax or additional tax, the dividend income is treated in the same way as any other income.

The 5 per cent tax on interest and dividends is levied in addition to this income-tax.

Exemptions. — Section 4 of the Act, sub-sections *(j)*, *(n)* and *(o)*, provides for exemptions, which include, *inter alia*, income from Canadian Government bonds or other securities issued exempt from income-tax ; dividends paid to an incorporated company by a company incorporated in

Canada, the profits of which have been taxed ; and dividends received by an incorporated company from a company incorporated outside Canada to the extent that the latter corporation has earned income within Canada and actually paid tax to Canada in respect of such income.

The only persons exempt from the 5 per cent tax on interest and dividends are certain public officials and incorporated companies whose business and assets are carried on and situated entirely outside of Canada.

It is to be noted, however, that resident individuals and corporations are taxable on dividends received from British and foreign corporations, with an allowance under Section 8 in respect of dividend taxed abroad.

The income of foreign shipping companies from sources within Canada are exempt, provided equivalent exemption is accorded by the foreign country to Canadian shipping companies (Section *4(m)*). Equivalent exemptions have been ratified as between the following countries and Canada (list incomplete) :

United States	1921	Norway	1929
Germany	1928	Denmark	1929
Japan	1928	United Kingdom . . .	1929
Sweden	1928	France	1931
Greece	1929	Italy	1932
The Netherlands . . .	1929		

3. ASSESSMENT OF TAX.

(a) Computation of Taxable Income and Abatements.

Every taxpayer, whether resident or non-resident, must file, on or before April 30th of each year, a return of the income for the preceding calendar year, with the exception that, in respect of fiscal periods of corporations not coincident with the calendar year, the return of income must be filed within four months from the close of the fiscal period. The fiscal period stands in lieu of the calendar year for income tax purposes.

Every agent, trustee or person who collects or receives or is in any way in possession or control of income for or on behalf of a person who, though resident outside of Canada, is taxable in Canada, shall make a return of such income.

At the time of filing the return the taxpayer makes such deductions as he believes he is allowed to make under the provisions of the Act and computes the tax payable. He may pay the whole or one-quarter of the tax at the same time, the unpaid balance being liable to interest as provided in the Act.

The income of an individual, resident or non-resident, is reduced by the statutory allowance, as follows :

(1) $2,000 in the case of *(a)* a married person, except that where a husband and wife have each a separate income in excess of $1,000, whether taxable or not, each shall instead receive an exemption of $1,000 ; *(b)* a widow or widower with a son or daughter under 21 years of age who is dependent upon such parent for support, or, if 21 years of age or over, is likewise dependent on account of mental or physical infirmity ; *(c)* an individual who maintains a self-contained domestic establishment and who actually supports therein one or more individuals connected with him by blood relationship, marriage or adoption.

(2) $1,000 in the case of all other persons, except corporations.

(3) $400 for each child or grandchild (except one such child or grandchild on whose account the taxpayer is entitled to exemption under (1) *(b)* or (1) *(c)* above) of the taxpayer under 21 years of age and dependent upon the taxpayer for support, or 21 years of age or over and likewise dependent on account of mental or physical infirmity.

(4) The amount not exceeding $400 actually expended by a taxpayer for the support of each of the following persons (except one such person on whose account the taxpayer is entitled to exemption under (1) *(c)* above) who are dependent upon him for support : *(a)* a parent or grandparent dependent on account of mental or physical infirmity ; *(b)* a brother or sister under 21 years of age, or 21 years of age or over if dependent on account of mental or physical infirmity.

In determining income, the following specified deductions are provided for : a reasonable allowance for depreciation or exhaustion of wasting assets, bad debts, and interest on borrowed capital used in the business.

Nothing in the Act states specifically what expenses or deductions are allowed, but all other deductions fall under the general law by reason of the negative provision contained in Section 6, particularly paragraphs *(a)* and *(b)* — namely :

> No deduction will be allowed in respect of expenses unless the expenses are wholly, exclusively and necessarily laid out and expended for the purpose of earning the income ;
>
> Nor will capital losses be allowed, nor the carrying charges on unproductive property not used in connection with the business, nor the carrying charges on property the income from which is exempt (except to the extent that such charges exceed the exempted income), nor amounts credited to a reserve, contingent account or sinking fund, except such an amount for bad debts as may seem reasonable, having regard to the character and extent of the business, nor personal or living expenses.

Briefly, deductions are determined in each particular case as a question of fact and law, in accordance with the general principle that capital expenditures are disallowed, but revenue expenditures are allowed.

Companies owning or controlling all of the capital stock, less directors' qualifying shares, of subsidiary companies which carry on the same class of business may elect to file a return in which its profit or loss is consolidated with that of its subsidiaries, in which case the tax is at the rate of 13.5 per cent instead of 12.5 per cent, which is normally the rate applicable to companies. [1]

(b) Computation of Tax and Deductions.

From the income-tax as computed, a taxpayer is entitled to deduct the amount paid : (1) to the United Kingdom or any of its self-governing colonies or dependencies for income-tax in respect of the income of the taxpayer derived from sources therein ; and (2) the amount paid to any foreign country for income-tax in respect of the income of the taxpayer derived from sources therein, provided such foreign country allows a similar credit to persons in receipt of income derived from sources within Canada.

With respect to the deduction from tax of the tax paid to the United Kingdom, or any foreign country, such deduction is limited to the amount to which such income is taxable under the rates imposed by the Canadian Act and is conditional upon the taxpayer producing satisfactory evidence of payment (Section 8).

The supervisor of the district in which the taxpayer files the return, who is called the inspector, with his staff verifies the return, calculates the assessment and forwards it to the head office in Ottawa, where the returns from all districts, the valuation thereon and the calculation of the tax, including the deductions permitted or the deductions disallowed, are surveyed by a body of well-trained tax auditors, who, when in doubt on any file, have ready access to a small group of skilled officials for advice, and so the returns are approved or rejected at the head office. If approved, they are sent back to the inspector of the district, who issues the assessment and receives the payment. If rejected, the reasons for rejection are stated, and the returns are sent back to the inspector for

[1] An Act to amend the Income War Tax Act, assented to May 23rd, 1933, Statutes of 1933, Chapter 41, section 13

revaluation according to the instructions and are then submitted again for approval. If approved, they are returned to the inspector for the purposes of issuing the assessment.

At any stage, the inspector may get into touch with the taxpayer himself for further facts or explanations, or the taxpayer may call upon the inspector and, if difficulty arises, the inspector or the taxpayer may, by letter addressed to the head office, propound the particular point and ask for a ruling on his case, or the taxpayer himself, if he so desires, may go to the head office and get a ruling from the group of skilled officials above referred to. If agreement is reached, the assessment is issued and paid (if not already paid) on the procedure above outlined. If agreement is not reached as to the application of the law in the particular case, the assessment is approved by the head office, the inspector sends out the notice of assessment, and the taxpayer appeals within thirty days. The appeal, with a report from the inspector, is forwarded to the head office, and a reply is ostensibly sent by the Minister - in practice, the Commissioner of Income-Tax -- under the guidance of counsel for the department.

The taxpayer himself, or his solicitor, must then file, within one month, what is called a "notice of dissatisfaction", setting forth all the facts, reasons and statutory enactments upon which he relies for the success of his appeal. To this document, the Minister replies that he concurs or otherwise. If he agrees, the assessment is modified accordingly. If not, the taxpayer then lodges security for the cost of the appeal, which is $400, or a bond for the amount of $400, usually costing from $5 to $10. Thereupon the income-tax return referred to above, notice of assessment, appeal and decision of the Minister, notice of dissatisfaction and reply of the Minister are lodged in the Exchequer Court of Canada and, unless the judge of that court orders formal pleadings (which is usually done), the matter is thereupon ready for trial and hearing, and an application is made to the court to fix the date of the trial This procedure permits of a hearing by the court being made - - and, in fact, it has so been made (including formal pleadings) -- within less than ten days, although generally the period is much longer. An appeal lies from the decision of the Exchequer Court to the Supreme Court of Canada, and from the Supreme Court to the Judicial Committee of the Privy Council in London, England.

4. COLLECTION OF TAX.

(a) By Direct Payment.

At the time of filing the return, the taxpayer must pay not less than one-quarter of the amount of the tax which he estimates is payable by him. The balance may be paid in three equal bi-monthly instalments thereafter, with interest at the rate of 6 per cent per annum upon each instalment (Section 48).

The taxpayer's return is then investigated and, upon determination by the department of the total amount of his income, his tax is computed and a notice of assessment forwarded to him, verifying or altering the amount of tax as estimated by the taxpayer himself in his return (Section 54). Any additional tax found due over the estimated amount or the amount paid on account by the taxpayer must be paid within one month from the posting of the notice of assessment and, if not so paid, the taxpayer, in addition to the 6 per cent interest, must pay another 4 per cent, or a total of 10 per cent per annum on the unpaid balance of his tax from one month from the posting of the notice of assessment.

(b) By withholding at the Source.

The income-tax is not, as a general rule, withheld at the source. If a non-resident taxpayer owes tax to the Canadian Government and is a creditor of a resident of Canada, the Minister has power, under Section 72, to collect out of the amount owed by the resident debtor the amount of tax due from the non-resident. Under Section 52, if a non-resident person is in default in the payment

of Canadian tax, but has an agent in Canada, the Minister may require the agent to deduct the amount of such tax from the income or assets of such non-resident in his hands and pay the same to the Receiver-General of Canada.

By virtue of the amending Act of 1933, however, every person making any payment by any means whatsoever to a non-resident person on account of anything let, leased or used in Canada, or on account of royalties for anything used or sold in Canada, must deduct 12.5 per cent from every such payment and in excess of such an amount as the Minister may prescribe and remit that amount, together with a statement in prescribed form, the Receiver-General at the same time as the payment is made or credited to the non-resident person. The amount so withheld is allowed as a credit against any tax payable by the non-resident. An agent of a non-resident person receiving such rentals or royalties must withhold tax, if not already paid. [1]

As regards the 5 per cent tax on interest and dividends, in the case of bearer coupons or warrants, whether representing interest or dividends, the tax is collected by the encashing agent or debtor, who withholds 5 per cent of the obligation and remits the same to the Receiver-General of Canada. In the case of interest or dividends in respect of fully registered shares, bonds, debentures, mortgages or any other obligations, the tax shall be withheld by the debtor.

Wherever an agent of a non-resident person receives payment of any interest or dividends subject to the 5 per cent tax from which the tax has not been withheld, such agent must withhold the tax from his principal and remit the same to the Receiver-General.

The collection of the income-tax is assured to a large degree by means of information returns made at source and by ownership certificates. Information returns must be filed, on or before March 31st in each year, by employers in respect of employees' remuneration exceeding a prescribed amount, by corporations in respect of dividends and bonuses paid to shareholders and members, and by all persons having the control, receipt, disposal or payment of fixed or determinable annual or periodical gains, profits or income of any taxpayer. [2] Before any bearer coupon or warrant, representing either interest or dividends payable by Canadian, British or foreign debtors, or cheque representing dividends or interest payable by British or foreign debtors, is negotiated by or on behalf of a resident of Canada, a prescribed form of ownership certificate shall be completed and delivered by or on behalf of such resident. This provision may be extended by the Minister to bearer coupons or warrants negotiated by or on behalf of non resident persons.[3]

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[1] An Act to amend the Income War Tax Act, assented to May 23rd, 1933 Statutes of 1933, Chapter 41 section 12.

[2] Income War Tax Act, section 39

[3] An Act to amend the Income War Tax Act, assented to May 23rd, 1933 Statutes of 1933, Chapter 41, section 15

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

1. DEFINITION AND GENERAL PRINCIPLES

The Act does not deal specifically with foreign enterprises, but rather with resident and non-resident persons and persons carrying on business in Canada.

For the purposes of this study, the term " foreign enterprise " would include an enterprise belonging to :

(a) A company incorporated in a foreign country, and having its central control and management abroad ;

(b) A company incorporated in Canada, but having its central control and management in a foreign jurisdiction ;

(c) A partnership composed of non-resident persons ;

(d) A non-resident individual.

Such an enterprise would be taxable on the net profit or gain arising from the business carried on in Canada (Section 24).

2. TAXATION OF CERTAIN KINDS OF INCOME

(a) *Dividends.*

Dividends paid by a Canadian company to an enterprise outside Canada are subject to a tax of 5 per cent, which is withheld at source.

(b) *Interest.*

Interest of all kinds (except from bonds of or guaranteed by the Dominion) paid by Canadian debtors to non-residents solely in Canadian funds is subject to the source tax of 5 per cent.

(c) *Directors' Percentages.*

Directors' percentages are not customary in Canada. A non-resident individual attending a directors' meeting in Canada and receiving as fees an amount in excess of the personal statutory exemption would be liable to tax in respect of such fees.

(d) *Royalties for Use of Patents, Copyrights, Trade-Marks, Secret Processes and Formulæ and Other Similar Income.*

Corporations or individuals making such payments must deduct, from payments in excess of an amount prescribed by the Minister, tax at the rate of 12.5 per cent, the withheld amount being allowed as a credit against any tax payable by the non-resident person.

(e) *Rents from Real Estate, Mining Royalties and Similar Income.*

Rents and similar income are liable to tax on the same basis as the royalties referred to in paragraph *(d)* above.

(f) *Gain derived from the Purchase and Sale of Real Estate, Securities and Personal Property.*

These gains are not liable to tax except when the buying and selling of such property is habitual and regular and therefore amounts to a business. The gains would then be taxable. If not amounting to a business, the transactions are regarded as capital gains and are therefore not taxable.

(g) *Salaries, Wages, Commission and Other Remuneration for Services* (including Directors' Salaries and Fees).

Salaries and wages are taxed as net income. Generally speaking, they are found to be the chief or principal income.

If the salary is paid by a non-resident person or company and the recipient was not in Canada for a period equal to half a year, he would not be taxable on his salary, but the foreign party he represents would be carrying on business through its agent or employee in Canada, and would be taxable on any profit derived therefrom. If the salary is paid by a Canadian company, the recipient (in Canada for less th an half a year) is taxable on such income, but not on income from sources outside Canada.

If the non-resident stays in Canada for a period exceeding half a year, his stay puts him in the same category as a resident, and he is taxable on his income, in principle from all sources, in Canada and abroad, but in practice only on the salary paid.

(h) *Income from a Trust.*

If the trust income consists of investment income, such as dividends and interest, and the trust is so constituted that the income must be paid to the non-resident beneficiary, there is no tax either against the trust or the non-resident beneficiary, just as there is no tax where the non-resident beneficiary invested direct in Canada.

If the trust is commercial or carrying on business in Canada, the trust would be taxable as a person resident in Canada.

If the trust, although an investment trust, accumulates income for a non-resident person who has merely a contingent interest or even a vested interest subject to be divested, the trust would be taxable on the amount annually accumulated (Section 11 (2)).

As to rents and royalties, they would be taxed either against the trust or against the non-resident beneficiary, as the conditions of the trust may warrant, but in most cases against the trust.

Dividends and interest paid to a trustee resident in Canada are, however, subject to the 5 per cent tax if 50 per cent or more of the income is paid or credited to non-residents of Canada.

(i) *Income from the Carrying-on of a Trade or Business through:*

(I) *A Local Commission Agent or Broker;*
(II) *A Local Dealer or Distributor;*
(III) *A Travelling Salesman;*
(IV) *A Local Agent with Power of Attorney;*
(V) *An Agent selling out of a Stock belonging to the Foreign Enterprise;*
(VI) *A Permanent Establishment of any Kind.*

Before dealing with points (I) to (VI) it should be noted that they will be considered from two aspects: *(a)* What is meant by " carrying on of business " by a non-resident according to the general law relating to the interpretation of the term as found in jurisprudence ? *(b)* The extent to which the statutory amendments of the Canadian Act, particularly Sections 26 and 27, have amplified or gone beyond jurisprudence on the term " carrying on of business ".

The general law is interpreted by Canada in accordance with the following principles :

1. If profitable contracts by or for a non-resident for the sale of his goods are *habitually* made in Canada with persons in Canada, and the goods are delivered (whether from a stock kept in Canada or by a consignment forwarded from abroad), and payments are received by or for the foreigner in Canada, then business is carried on in Canada within the meaning of the Canadian Act, and the non-resident is liable to be assessed on the profits arising from such business. [1]

2. The result is the same if the sale contracts are concluded and the deliveries made in Canada, though the payments are received abroad. [2]

3. The result again is the same if the contracts are concluded and the payments are received in Canada, though the deliveries take place abroad. [3]

4. If the contracts are made in Canada, though the delivery and payment be effected abroad, business is carried on in Canada within the meaning of the general term, and the non-resident is liable to tax on the profits arising from such contracts. [4]

The above four propositions are greatly modified in favour of the Crown imposing tax by the statutory enactments contained in Sections 26 and 27, and under those enactments the following principles as to the fiscal liability of non-residents may be stated. These principles must be interpreted in the light of the Statute itself.

> " 1. Where a non-resident person produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part, anything within Canada and exports the same without sale prior to the export thereof, he shall be deemed to be carrying on business in Canada and to earn within Canada a proportionate part of any profit ultimately derived from the sale thereof outside Canada. " (Section 26.)

This provision would apply to non-residents who export from Canada such commodities as pulp, asbestos, lumber, etc., or, in short, raw materials partly processed in Canada and shipped abroad for further processing and manufacturing.

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[1] Pommery & Greno *v* Apthorpe (1886), 55 L J Q. B 155 ; Watson *v* Sandie & Hull (1898), 1 Q. B. 326 ; Turner *v*. Rickman (1898), 4 Tax Cas 25 ; Macpherson *v*. Moore, 49 Sc. L. R. 979 ; Weiss, Biheller & Brooks *v*. Farmer (1918), 2 K. B 725 (1923) 1 K B 226, 8 Tax Cas 381; see also Wilcock *v*. Pinto & Co. (1924), 9 Tax Cas 111; Maclaine *v*. Eccott, 131 L T 601 ; 132 L. T 173, and H L. (1926) A C 424 and 10 Tax Cas 481

[2] There appears to be but one English decision which affirmatively authorises the foregoing proposition namely, Thomas Turner, Limited *v* Rickman (1898), 4 Tax Cas 25 ; per Wills J at pages 33 and 34 But see also the reasoning in Grainger & Sons *v* Gough (1896), A C 325 , Crookston Bros. *v*. Furtado, 5 Tax Cas. 602 ; and Watson *v* Sandie & Hull, *supra*.

[3] Tischler *v* Apthorpe (1885), 52 L T 814, 2 Tax Cas. 89 ; Pommery & Greno *v*. Apthorpe, *supra;* Werle *v*.. Colquhoun (1888), 20 Q B D. 753; 57 L J. Q. B. 323, Wilcock *v* Pinto, *ibid* , *supra*, Maclaine *v*. Eccott, *ibid* , *supra*,

[4] Erichsen *v* Last (1881) 8 Q B. D., 414, per Jessel, M. R at pages 416 and 417, per Brett, L. J. at page 418. per Cotton, L. J. at page 420 ; Werle *v*. Colquhoun, *supra*, per Lord Esher, M. R at page 759; Grainger & Sons *v*. Gough, *supra*, per Lord Herschell at page 335, per Lord Watson at page 340 ; Lovell & Christmas, Ltd, *v*. Commissioner of Taxes (1908), A. C. 46, per Sir Arthur Wilson, pages 51 and 52 ; Crookston Bros. v. Furtado. 48 Sc. L. R. 134

" 2. Any non-resident person soliciting orders or offering anything for sale in Canada through an agent or employee, and whether any contract or transaction which may result therefrom is completed within or without Canada, or partly within and partly without Canada, or any non-resident person who lets or leases anything used in Canada, or who receives a royalty or other similar payment for anything used or sold in Canada, shall be deemed to be carrying on business in Canada and to earn a proportionate part of the income derived therefrom in Canada " (Section 27.)

In order to enlarge the scope of the phrase " carrying on business in Canada ", Section 27 was enacted. However, not in every case are the profits taxed when derived by a foreign enterprise marketing raw or manufactured materials in Canada through a broker who merely acts as an intermediary between the Canadian buyer and the foreign seller, the product being shipped direct from the seller to the purchaser and payment being made direct from the purchaser to the seller ; while seldom are profits in practice taxed when derived from selling through a commission agent who is operating on a produce exchange and who disposes of the consignment for anyone wishing to use his services. The facts in each case are carefully surveyed as well as the extent and magnitude of the operations.

The matter is not one of degree only, but involves all the several relationships that develop as between the foreign vendor and the domestic purchaser, and these can only be settled in the light of a full disclosure of all relevant facts in particular cases.

In the light of the above propositions, the following statements may be made :

Income from the Carrying-on of a Business or Industry through :

(I) *A Local Commission Agent or Broker.* — The non-resident is liable to tax on the profits derived from a commission agent's activities in Canada. Although the main profit goes to a country abroad, an apportionment is made of the profit deemed to have arisen in Canada.

(II) *A Local Dealer or Distributor.* — There is no tax on the non-resident from whom the local dealer or distributor may purchase. This is a case of purchasing from a non-resident in a foreign country and accepting delivery there. It is dealing *with* a non-resident in a foreign country and not dealing *by* a non-resident in Canada.

(III) *A Travelling Salesman.* — By virtue of Section 27, the business of a non-resident arising in Canada through a travelling salesman would, in a proportionate part, be liable to tax, whether or not the contract were concluded in Canada or abroad.

(IV) *A Local Agent with a Power of Attorney.* — " He who acts by another acts by himself ", and therefore the non-resident is, both in law and in fact, trading within Canada and the profits arising therefrom would be liable to tax.

(V) *An Agent selling out of a Stock belonging to the Foreign Enterprise.* — If the stock were sold in Canada through an agent by organising a sales system and selling to a number of different buyers until the whole stock was exhausted, the non-resident would be liable to tax on the profits arising from the transaction.

(VI) *A Permanent Establishment of any Kind.* — The liability of a permanent establishment in Canada for the sale of merchandise belonging to a non-resident would depend on whether the establishment bought abroad on its own account from the non-resident — in which case the non-resident would not be taxable and the permanent establishment in Canada would — or whether the permanent establishment was the agent in Canada of the non-resident for selling the non-resident's goods in Canada — in that case the non-resident would be liable to tax on the profits as well as the agent on agency profits. If a " proportionate part " of the profit is to be taxed, the phrase must be considered in two aspects. The first is continuity of the contracts themselves and the goods covered thereby. In this sense, a non-resident might in his own country undertake the partial

manufacture of the goods, but some minor operation might be performed in Canada, as, for example, where tin goods are made abroad, but wrapped here, or cloth is cut abroad but the garment put together here. The proportionate part of the profits allocable to Canada would have to be determined in the light of such circumstances. The second aspect of the phrase " proportionate part " would have no relation to the contract, to the goods or to the manufacture thereof, but would have a significance in the allowance as a deduction of head-office — in the sense of general supervision — expenses.

B. NATIONAL ENTERPRISES.

Although the term " national enterprise " is not found in the Canadian Tax Law, it will include for the purposes of this report an enterprise belonging to :

(a) A company incorporated in Canada, whether under the authority of the Dominion of Canada or under one of its nine provinces. For income-tax purposes a company so incorporated, but having its assets and business situated outside Canada, is not regarded as a Canadian enterprise. Enterprises incorporated abroad, but licensed by the Dominion or the provinces to do business in Canada, would not be regarded as Canadian enterprises, but they would be liable for tax on the profits of their Canadian business. If the seat of control or management is in Canada, though the incorporation took place abroad, the enterprise would be regarded as a Canadian enterprise.

(b) A partnership, the head office or the seat of control and management of which is in Canada. The partners resident in Canada are liable to tax on their total profit from all sources ; if any of the partners are not resident in Canada, they are liable to tax on the profits arising in the country.

(c) An individual residing in Canada - irrespective of citizenship, nationality or domicile.

A national enterprise must file a return and pay tax on its income from all sources within and without Canada, whether or not the profit be brought home to Canada.

Although the taxable income generally includes dividends from a foreign corporation, an exception is made in the case of dividends received by an incorporated company from a company incorporated outside Canada, to the extent that the latter corporation has earned income within Canada and actually paid tax in respect of such income under this Act ; provided that, in computing the proportion or fractional part of the dividend free from taxation in the hands of a recipient corporation, the Minister's determination shall be final and conclusive (Section 4 *(o)*).

Nevertheless, dividends as well as interest received from Canadian debtors in a currency which is at a premium in terms of Canadian funds are subject to the 5 per cent tax.

Credits are allowed for taxes paid in other countries with which Canada has reciprocal relations. Credit for taxes paid abroad is only allowed in respect of the income from abroad that is brought into account and taxed under the Canadian Act. For example, a tax paid abroad on capital gain by the Canadian resident would not be allowed as a deduction from the Canadian tax on the assessable income from abroad, nor would the tax be allowed as an expense in determining his income from abroad.

Since the Canadian authorities have no right to penetrate into the foreign country, checking is carried out, when deemed necessary, by authorisation from the domestic company to enter the foreign premises. In practice, a refusal has never been given ; but, if it were, the arbitrary power contained in the law to determine what the tax should be would be exercised with a view to protecting the revenue.

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

1 GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

The general provisions of the Canadian Act dealing with the question of foreign enterprises in their relations with local branches or subsidiaries and the methods of apportionment are found in Sections 23, 26 and 27. There is no statutory provision enacting any formula for apportionment of income arising within Canada, nor have any regulations been issued adopting a separate accounting method, empirical method, method of fractional apportionment or any other method.

The Minister has full discretion when determining the income from Canadian sources to adopt any method that the particular facts of the case, having regard to the nature of the business, would warrant.

(a) Book-keeping and Accounting Requirements.

The Government expects that all persons carrying on business will maintain some form of accounting which gives a reasonably true reflection of the business carried on in Canada. If not so maintained, Section 46 gives the Minister authority to require the keeping of adequate books of account.

If, in examining the accounts of foreign enterprises, the Crown officers — having regard to the nature of the business and exercising a general knowledge of what profits such a business should yield — are of opinion that the profits are not truly reflected, then the profits of the enterprise abroad would be examined. If this is necessary, the usual procedure is to demand that a full disclosure be made to the Crown officials. If this is not satisfactory, then the official may, by arrangement, go abroad. The examination would aim particularly at preventing the inclusion of undue costs in the invoice price at which the article is sent to Canada. This would apply whether the article were wholly manufactured abroad or manufactured partly abroad and partly in Canada.

As a general fact, it may be stated that experience with the majority of foreign enterprises carrying on business within the country (those of the United Kingdom and the United States) shows that there is little need on their part to minimise their Canadian profits. The reason probably is that the Canadian tax paid is allowed, within certain limitations, as a deduction from the tax levied in those countries on the foreign enterprises, and there is therefore no incentive to evade the Canadian tax.

(b) Methods of Allocation.

In determining the income of a foreign concern with a branch in Canada, reference is first made to the books of the branch in order to check the accuracy of the declaration. If the enterprise manufactures abroad and sells to its branch in Canada, the invoice price is examined. In order to test its fairness, the tax authorities frequently request information concerning the cost of manufacture.

Where the price is shown to be unfair on the basis of the information obtained, the authorities endeavour to arrive at a fair price by discussions with the taxpayer. Where this is impossible, the authorities often have recourse to apportionment on the basis of the ratio of sales in Canada to total sales. In the denominator of the fraction, however, there is used only that income of the entire enterprise which has a direct reference to the same kind of activities as that of the Canadian branch.

In general, it may be said that, whenever it is necessary to resort to an apportionment, the authorities exclude all items of the enterprise's income which can be definitely allocated as derived from sources other than its main business, and they take into account only those which have a direct connection with the activities of the branch. This same observation applies to deductions for expenditure.

Dividends and interest would be items that would not be brought into the apportionment accounting, inasmuch as they are exempt from the income-tax proper (although not from the 5 per cent tax) when paid to foreign enterprises, whether paid directly or through the medium of the branch offices in Canada.

Speaking generally on all phases of the Canadian Income-Tax Act, the Government refrains from issuing rules or laying down any specific plans, for it believes that, except in matters relating to procedure, no rule laid down beforehand can solve all the problems which the multifarious ramifications of business necessarily present from time to time and which the tax officials must settle in order to determine the true income. Therefore, the Crown officials, having regard to the law as enacted in the Statute, simply deal with each case as it comes before them, as the merits of that case and the law applicable thereto require.

Determination on the merits of each case is easy, since all income-tax returns pass through the head office and contentious or difficult problems and returns are referred to a centralised body of skilled officials, who, out of their experience and knowledge, deal with such cases on their merits.

(c) Apportionment between Branch and Parent Enterprise.

1. *Apportionment of Gross Profits of Branch to Real Centre of Management abroad.*

No part of the branch profits is allocated to the real centre of management abroad, but a deduction may be allowed against the gross profits of the branch in respect of the costs of the real centre of management, as is described under 2 below.

2. *Apportionment of Expenses of Real Centre of Management to Branch.*

If the foreign head-office expenses have a close relationship with and benefit the activities in Canada, an allowance may be granted. For example, if the real centre of management (central management and control) not only exercises a general control and direction over the policies of the management and activities in Canada, but also conducts international advertising which stimulates sales in Canada as well as in the home country, some deduction for such expenditure may be allowed. Consideration would be given to the facts of the particular case in determining the method of apportionment and the amount allowed. The allowance is made without regard to the tax imposed by the country in which the real centre of management is situated.

If the price at which goods are invoiced to the Canadian sales branch includes, as part of the cost of the commodity, a proportion of the general carrying charges, such as interest on mortgages or unsecured loans and general head-office management expenses, then, of course, no further apportionment would be allowed for income-tax purposes.

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

The profit or loss of the branch is determined without reference to any deficit that may exist abroad. If, however, the branch in Canada suffered a loss while the whole enterprise showed a

profit, the Canadian branch contributing indirectly to this profit abroad through volume output, then a part of the profit would be deemed to have been made in Canada and would be liable to tax there. Section 47 lays down :

> " The Minister shall not be bound by any return or information supplied by or on behalf of a taxpayer, and notwithstanding such return or information, or if no return has been made, the Minister may determine the amount of the tax to be paid by any person."

(d) Apportionment between Parent Enterprise and Subsidiaries.

A Canadian subsidiary may be treated in effect as a branch of the parent enterprise by virtue of Section 23, which reads :

> " Where any corporation carrying on business in Canada purchases any commodity from a parent, subsidiary, or associated corporation at a price in excess of the fair market price, or where it sells any commodity to such a corporation at a price less than the fair market price, the Minister may, for the purpose of determining the income of such corporation, determine the fair price at which such purchase or sale shall be taken into the accounts of such corporation."

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

(a) Industrial and Commercial Enterprises.

1. *Selling Establishments.*

Local Establishments selling in National Market.

When a foreign enterprise manufactures abroad and sells in Canada, Canada would grant allowances against the gross sales profit for (1) cost of manufacture; and (2) some profit to be allocated to the manufacturing end arising in the foreign country. The balance would be taxable in Canada.

When a company purchases abroad and sells in Canada, the cost of the commodity purchased and the supervising and purchasing cost would be allowed as an expense in determining Canadian profits, but there would be no allocation of a so-called " purchasing profit ".

If a foreign company both manufactures and purchases goods abroad and sells them through a permanent establishment in Canada, this country would give an allowance for the cost in each case, and would allow a manufacturing profit in respect of the manufacturing portion.

Local Establishments selling abroad.

When a foreign enterprise has a Canadian establishment (not an incorporated company) from which it sends salesmen into neighbouring countries to effect sales therein, the expenses of such salesmen would be disallowed in determining the Canadian profits, and no attempt would be made to tax the profits created by such agents through their business in neighbouring countries, provided the resulting contract is accepted in the neighbouring country or at the foreign head office. If, however, the salesmen solicit in neighbouring countries orders which are accepted in Canada, then such activities would amount to carrying on business in Canada for export purposes, and the profit resulting would be taxable.

If the activity in Canada were carried on by an incorporated Canadian subsidiary company, then that company, being a resident of Canada, would be taxable on its profits from whatever source derived, both within and without Canada.

2 and 3. *Manufacturing and Processing Establishments.*

If goods were shipped from the Canadian establishment to a foreign establishment of the same enterprise at the same price as that at which they would be shipped to an independent dearler or distributor, that price would probably be accepted by the Canadian authorities for tax purposes. Otherwise, the Minister would apportion the income (see Section 26, quoted above).

4. *Buying Establishments.*

As a general rule, no profit is deemed to arise when a foreign enterprise has an establishment in Canada for the purpose of purchasing goods which are immediately exported. If, however, the establishment improves, packs or preserves in any way the product prior to shipment, then under Section 26, quoted above, a part of the ultimate profit would be deemed to arise in Canada. For example, the packing of fish or furs or some other natural product of Canada, creating thereby a semi-preserved state of the commodity prior to shipment, would have the result tha a portion of the ultimate profit would be liable to tax.

5. *Research and Statistical Establishments, Display Rooms.*

These would not constitute carrying on business in Canada. There would be no tax liability.

(b) BANKING ENTERPRISES.

By Statute, banking is prohibited in Canada except by CanadiaC institutions authorised to carry on business under Dominion of Canada Parliamentary sanction and the Canadian Bank Act. Canadian banks are taxed on their profits in the same way as all other corporations. They are corporations resident in Canada.

(c) INSURANCE ENTERPRISES.

The income of Canadian life insurance companies is exempt from tax, except such amount as is credited to shareholders' account, which amount is liable to tax. The income o fall other insurance companies is taxed on the basis of their Canadian accounts.

(d) TRANSPORT ENTERPRISES.

The activities of such enterprises, if they are wholly within Canada would be taxed on their accounts. There are, however, between Canada and the United States certain terry companies and bridge companies. The profits of these companies, which have in fact a corporate existence in each country, are divided, each country taxing half.

The profits of foreign shipping enterprises are for the most part exempt, because of the arrangements which Canada has with many countries for the reciproca lexemption of such profits. case.

(e) POWER, LIGHT AND GAS ENTERPRISES.

The same method as indicated under A, 1, of Part III, pages 66 and 67, is applied — *i.e.*, these enterprises are taxed on their Canadian profits, with due consideration of the particular facts of each

(f) TELEGRAPH AND TELEPHONE ENTERPRISES.

The same method as that indicated pages 66 and 67 is applied.

(g) Mining Enterprises.

If the product is mined in Canada and shipped abroad without sale, the profit is apportioned (Section 26). If the product is sold from Canada, the profit is taxable as that of a commercial organisation manufacturing in Canada and, if there were a head office abroad, some allowance for head-office expenses would be permitted. In all cases, however, special allowance for depletion of the mine is given.

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

Such enterprises operating branches are taxable on their total profits, including all the profits from branches abroad · but, if business is done abroad through a foreign subsidiary company, the Canadian company is taxed only on the dividends received.

C. HOLDING COMPANIES.

1 Where a holding company in Canada controls one or more foreign subsidiary companies operating exclusively abroad, such subsidiaries are not taxed in Canada ; but, if the foreign subsidiary company remits dividends to the Canadian company, such dividends would constitute taxable income.

2. When a local subsidiary company is controlled by a foreign holding company, the local subsidiary company is taxed on its profits from whatever sources derived, inasmuch as it is a resident Canadian company. If such company pays dividends or interest to the foreign parent company, the 5 per cent tax is deducted from these dividends or interest, except in the case of dividends paid to the non-resident company by a Canadian company all of whose shares (less directors' qualifying shares) are beneficially owned by such non-resident company, provided not more than one-quarter of the gross income of the Canadian company is derived from interest and dividends. [1]

[1] Statutes of 1933, Chapter 41, sections 9 and 9B (11).

Annex.

TABLE OF TARIFFS.

I. RATE OF TAX APPLICABLE TO PERSONS OTHER THAN CORPORATIONS AND JOINT-STOCK COMPANIES.

	Per cent
On the first $1,000 or any part thereof in excess of exemptions	3
On the amount in excess of $ 1,000 but not in excess of $ 2,000	4
On the amount in excess of $ 2,000 but not in excess of $ 3,000	5
On the amount in excess of $ 3,000 but not in excess of $ 4,000	6
On the amount in excess of $ 4,000 but not in excess of $ 5,000	7
On the amount in excess of $ 5,000 but not in excess of $ 6,000	8
On the amount in excess of $ 6,000 but not in excess of $ 7,000	9
On the amount in excess of $ 7,000 but not in excess of $ 8,000	10
On the amount in excess of $ 8,000 but not in excess of $ 9,000	11
On the amount in excess of $ 9,000 but not in excess of $ 10,000	12
On the amount in excess of $ 10,000 but not in excess of $ 11,000	13
On the amount in excess of $ 11,000 but not in excess of $ 12,000	14
On the amount in excess of $ 12,000 but not in excess of $ 13,000	15
On the amount in excess of $ 13,000 but not in excess of $ 14,000	16
On the amount in excess of $ 14,000 but not in excess of $ 15,000	17
On the amount in excess of $ 15,000 but not in excess of $ 16,000	18
On the amount in excess of $ 16,000 but not in excess of $ 17,000	19
On the amount in excess of $ 17,000 but not in excess of $ 18,000	20
On the amount in excess of $ 18,000 but not in excess of $ 19,000	21
On the amount in excess of $ 19,000 but not in excess of $ 20,000	22
On the amount in excess of $ 20,000 but not in excess of $ 25,000	23
On the amount in excess of $ 25,000 but not in excess of $ 30,000	24
On the amount in excess of $ 30,000 but not in excess of $ 35,000	25
On the amount in excess of $ 35,000 but not in excess of $ 40,000	26
On the amount in excess of $ 40,000 but not in excess of $ 45,000	27
On the amount in excess of $ 45,000 but not in excess of $ 50,000	28
On the amount in excess of $ 50,000 but not in excess of $ 55,000	29
On the amount in excess of $ 55,000 but not in excess of $ 60,000	30
On the amount in excess of $ 60,000 but not in excess of $ 65,000	31
On the amount in excess of $ 65,000 but not in excess of $ 70,000	32
On the amount in excess of $ 70,000 but not in excess of $ 75,000	33
On the amount in excess of $ 75,000 but not in excess of $ 80,000	34
On the amount in excess of $ 80,000 but not in excess of $ 85,000	35
On the amount in excess of $ 85,000 but not in excess of $ 90,000	36
On the amount in excess of $ 90,000 but not in excess of $ 95,000	37
On the amount in excess of $ 95,000 but not in excess of $100,000	38
On the amount in excess of $100,000 but not in excess of $110,000	39
On the amount in excess of $110,000 but not in excess of $120,000	40

	Per cent
On the amount in excess of $120,000 but not in excess of $130,000	41
On the amount in excess of $130,000 but not in excess of $140,000	42
On the amount in excess of $140,000 but not in excess of $150,000	43
On the amount in excess of $150,000 but not in excess of $175,000	44
On the amount in excess of $175,000 but not in excess of $200,000	45
On the amount in excess of $200,000 but not in excess of $225,000	46
On the amount in excess of $225,000 but not in excess of $250,000	47
On the amount in excess of $250,000 but not in excess of $275,000	48
On the amount in excess of $275,000 but not in excess of $300,000	49
On the amount in excess of $300,000 but not in excess of $325,000	50
On the amount in excess of $325,000 but not in excess of $350,000	51
On the amount in excess of $350,000 but not in excess of $375,000	52
On the amount in excess of $375,000 but not in excess of $400,000	53
On the amount in excess of $400,000 but not in excess of $450,000	54
On the amount in excess of $450,000 but not in excess of $500,000	55
On the amount in excess of $500,000	56

II. Additional Rate of Tax applicable to all Persons except Corporations and Joint-Stock Companies in receipt of Income in Excess of Five Thousand Dollars.

Individuals in receipt of income in excess of five thousand dollars pay an additional rate of tax of 5 per cent of the amount of the tax as hereinabove set forth.

III. Rate of Tax applicable to Corporations and Joint-Stock Companies.

Corporations and joint-stock companies pay 12 ½ per cent on their total taxable income.

When a company owning or controlling all of the capital stock (less directors' qualifying shares) of subsidiary companies which carry on the same class of business files a return in which its profit or loss is consolidated with that of its subsidiaries, the rate of tax is 13 ½ per cent.

IV. Tax on Dividends and Interest.

1. An income-tax of 5 per cent is imposed on all persons resident in Canada, except municipalities or municipal or public bodies which perform a function of government, in respect of all interest and dividends paid by Canadian debtors, directly or indirectly to them, in a currency which is at a premium in terms of Canadian funds.

2. In addition to any other tax, an income-tax of 5 per cent is imposed on all persons who are non-residents of Canada in respect of :

(a) All dividends received from Canadian debtors irrespective of the currency in which the payment is made, and

(b) All interest received from Canadian debtors if payable solely in Canadian funds, except the interest from all bonds of or guaranteed by the Dominion of Canada.

JAPAN

BY

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PART I. — GENERAL DESCRIPTION OF INCOME-TAX SYSTEM.[1]

1. The Japanese taxes on income include the income tax proper and also the land tax, the business-profits tax and the capital-interest tax, the three latter being territorial in character. The income tax has the largest yield, producing in the fiscal year 1930-31 over 26 per cent of the aggregate receipts from taxes and Customs duties.[2]

The existence of the three additional taxes is justified by the fact that it is considered equitable to lay a heavier burden on income from such sources as land, capital and business undertakings than on the compensation for the personal efforts of individuals. As the income tax gives rise to international double taxation, it will be discussed first, and only a brief description will be subsequently given of the other three taxes, which are schedular in character.

2. The taxation of income is governed by the Income-Tax Law (Law of July 31st, 1920, as amended). The fundamental principles of the law may be summarised as follows :

(a) Liability to the tax depends upon two principal factors – viz., residence and origin of income. In other words the tax extends to : (1) all income accruing to a person resident in Japan[3] regardless of the place where it may arise ; and (2) all income arising in Japan, by whomsoever it may be enjoyed.

(b) With regard to resident Japanese subjects the tax is in principle a personal tax, being assessed on, and collected from, such persons in respect of all income accruing to them. Resident aliens are subject to the same liability as Japanese subjects in so far as income from Japanese sources is concerned, but they enjoy certain exemptions in respect of foreign income with a view to preventing double taxation (see paragraph 16). Non-resident Japanese and aliens are subject to the same liability in respect of income from Japanese sources.

Collection at source is confined to special classes of income.

(c) A company is regarded as an independent taxable entity, entirely distinct from its individual members. Like a resident individual, a resident company is subject to tax in respect of its entire income ; a non-resident company is taxable only on income derived from sources in Japan.

(d) A complete system of graduation is applied to individual taxpayers.

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[1] Legislation in force on March 1st, 1933.

[2] The receipts from the income tax in the fiscal year 1930-31 were 200,616,000 yen, and from the land tax, business-profits tax and capital-interest tax, 137,973,000 yen, yielding altogether 40 per cent of the total tax and Customs receipts

[3] The expression " Japan ", or " the country ", used in this report denotes geographically the territory in which the Income-Tax Law of 1920 is in force The law does not extend to Chosen, Taiwan, Karafuto, Kwantung Province (leased territory in South Manchuria), and the mandated territory and certain islands in the North Pacific. In Taiwan and Karafuto, however, a similar system of taxation of income prevails under separate legislation, and both an individual and a company is subject to income tax, while in Chosen and Kwantung Province only a company is liable to tax.

I. INCOME TAX.

1. TAXPAYERS.

(a) *Taxpayers with Unrestricted Tax Liability.*

3. In principle, any person who is resident in Japan is liable to tax in respect of his total income In other words such a person is subject to unrestricted tax liability (Income-Tax Law, Article 1).

1. Individuals.

4. An individual who has his domicile in Japan, or has had residence in Japan for over one year, is liable to tax on his total income without regard to the place where it may arise. By way of exception, resident aliens are exempt in respect of income from property, a business or a profession in a foreign country.

5. *Definitions of domicile and residence.* — The term " domicile " means the place where a person has fixed the centre of his living and of his business, with positive or presumptive evidence of an intention of making it his permanent home. The term " residence " means the place where a person actually lives It is not necessary that he has an intention to make it his permanent home. An alien, who is actually resident in Japan and exercises a profession there, is, as a general rule, regarded as being resident, but not domiciled, in that country, unless circumstances prove otherwise. A mere transient or sojourner is not regarded as a resident in Japan for the purpose of the income tax. Whether an alien in Japan is a transient or not is a problem that has to be determined in each particular case by reference to his intention as to the length and the nature of his stay. In practice, however, few questions arise in this connection, as the law exempts from tax liability a person who has been resident for less than one year.

2. Partnerships.

6 Under the Japanese law a partnership is not a taxable entity. Individual members of a partnership are assessed in respect of their distributive share, whether distributed or not, of the net income of the partnership. Such distributive share is to be included by the individual member in his income-tax return.

3. Companies.

7. Corporations and other companies with legal entity, which have their domicile in Japan, are liable to tax in respect of their total income, regardless of where it may arise, whereas those domiciled abroad are taxable only in respect of income from Japanese sources. In this study, the term " resident company " will be employed to describe one which has its domicile in Japan, and the term " non-resident company " will signify a company which is not domiciled in Japan. Under the Japanese Income-Tax Law, a company is not looked upon as a mere device by means of which a number of individuals can conveniently do business. It is regarded as a separate object of taxation, entirely distinct from those who own and control it. The law contains a separate set of provisions regarding the taxation of companies.

8. *Definition of domicile.* — The domicile of companies engaged in commerce or industry means the place in which their head office, as defined in their statutes, is situated (Commercial Code, Article 44), while that of non-commercial companies *(e.g.*, mutual insurance companies) means

the place in which their main office is situated (Civil Code, Article 50). Although the words employed differ in the Commercial Code and the Civil Code, in substance these terms " head office " and " main office " have the same meaning. By head or main office is meant, in principle, the place in which the real centre of control and management is situated. In practice, the domicile of companies is usually determined by registration. Every company incorporated under the Japanese law must have its head or main office in Japan and must be registered [1] at the place where such office is situated (Commercial Code, Article 45). With regard to companies organised under the laws of foreign countries which have their head office in Japan or which have, as their principal object, the carrying on of business in Japan, such companies must fully conform to the same regulations as companies organised under Japanese law (Commercial Code, Article 258). The fact of being organised under the law of a certain country is immaterial in determining domicile.

(b) *Taxpayers with Restricted Tax Liability.*

9. Any person other than those mentioned in paragraphs 3-8 above is liable to tax in respect of income arising in Japan. The law provides explicitly that a non-resident is liable to tax in the following cases (Income-Tax Law, Article 2) :

(1) Property owned in Japan : A non-resident is liable to tax on property which can be reasonably regarded as located in Japan. No question arises as to the location of tangible property, whether real or personal ; intangible property, such as patents, trademarks, copyrights, etc., is regarded as situated in the place where the person who enjoys the income therefrom is resident. Obligations, except those mentioned under (3) below, are not regarded as property which non-resident creditors have in Japan.

(2) Business carried on in Japan: When a non-resident has a permanent establishment in Japan through which he carries on business, he is liable to tax in respect of the income arising from such business. A permanent establishment means, as a general rule, an establishment at which business profits are reasonably expected to arise (see paragraph 84).

(3) Interest payable in Japan in respect of corporation, Government or municipal bonds ; bank deposits or a money-trust. [2] Such interest is taxable even if its recipient is domiciled abroad.

(4) A non-resident is also liable to tax when he receives from a resident company a share of profits, an allotment of surplus, a bonus paid out of profits or surplus, or any other disbursement having the nature of a bonus.

10. With regard to the classes of income under (3) and (4), it is not necessary to examine whether the recipients are individuals or companies, as the tax thereon is collected at source. Regarding the classes of income under (1) and (2), however, such examination is necessary, as the tax is directly assessed on the persons who enjoy the income. When such persons are individuals, no question arises, but when they are corporations organised under the laws of foreign countries it must be determined whether or not such companies are legal entities [3] under the Japanese law.

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[1] Unless a company is registered, outsiders may disregard it as a legal entity

[2] " Money-trust " means the money confided to trust companies to be invested only in deposits or loans

[3] It is a general principle of the Japanese law that companies organised under the laws of another country are not regarded as legal entities There are some exceptions to this general rule The most important exception is commercial companies (Civil Code, Article 36) By commercial companies are meant companies which continuously carry on a business or trade Partnerships established under the laws of foreign countries are not regarded as legal entities The tax is assessed on the representative member of the partnership

(c) *Exceptions.*

11. To the general rule mentioned above there are many exceptions. The following persons are exempted from income tax under the Income-Tax Law and other legislation, or by practice :

Foreign ambassadors, Ministers, and the staff of foreign embassies or legations who have diplomatic status.

Foreign consuls or commercial delegates not having diplomatic status are exempted from tax if they do not engage in business in Japan, and if a reciprocal exemption is given by their Government in respect of similar officials of the Japanese Government stationed in their country.

An association incorporated in accordance with Article 34 of the Civil Code for the purpose of public benefit and not for profit earning.

Local administrative bodies, such as prefectures, cities, towns and villages.

Religious corporations, such as Shinto shrines and Buddhist temples.

Co-operative societies and housing societies.

Chambers of commerce.

Associations of certain trades and industries, such as staple-commodity producers' associations, stock-breeders' associations, agricultural associations, exporters' associations, staple-export industries' associations, etc.

Public corporations in Chosen, Taiwan, Kwantung Province and Karafuto, which are exempt from income tax by legislation in the respective regions.

2. TAXABLE INCOME.

12. *Conception of income.* At the outset it would be convenient to examine the conception of income prevalent in Japan and to ascertain what income is subject to tax. The Income-Tax Law of Japan does not give any general definition of the term "income", but a study of Japanese statutes leads us to the conclusion : first, that income must be something of a recurring nature ; secondly, that it must be money or something capable of being valued in terms of money ; and, thirdly, it must be tangible. Although income need not be fixed in amount, its source must continue. An isolated transaction outside a person's trade or business does not give rise to income, as such a transaction is of a casual nature. An accretion to capital or loss realised by a sale or other disposition of assets or investments does not result in taxable gain or deductible loss, unless such a transaction is carried out in the course of one's trade or business. The general principle is that profits from trade are income, and profits not from trade are income if they are of a recurring nature. What constitutes trade is a question that can only be determined in view of concrete conditions. Under the Income-Tax Law a corporation is subject to different treatment from that of an individual and is liable to tax in respect of all its income. This treatment is not inconsistent with the general principle that proceeds from a casual transaction is not taxable. It is a principle of the Income-Tax Law that only those corporations established for profit are liable to tax. Consequently, all income accruing to such incorporated taxpayers can be regarded as income from trade or business, whatever the nature of the income, and is chargeable to tax. Income must always be money or something measurable in terms of money, and must be something of a tangible nature. Intangible income, such as the rental value of a residence occupied by the owner, is not regarded as taxable income.

13. The tax is, as a general rule, chargeable upon net income - *i.e.*, gross income less statutory deductions. Regarding certain kinds of income, gross income is taken as the taxable income without any deductions. Although the taxable income is a statutory conception, and is not always consistent with the net profits in a commercial sense, commercial net profits are normally adopted as taxable income, subject to necessary adjustments.

14. *National and foreign income.* — It is assumed that the expression " national income " means the income arising within the country, while the term " foreign income " denotes the income derived from foreign sources, such as business operations, personal services, possession or occupation of properties in other countries. National income is always taxable whether the recipient is resident in Japan or abroad, while foreign income is liable only when it accrues to persons resident in Japan. There is no difference in the procedure of assessment between national and foreign income, except in regard to the interest on bonds, bank deposits and other Class B income (see paragraph 27). If such income is national, tax is collected at source ; if it is foreign, it is subject to a direct assessment on the recipient resident in Japan and must be included in his tax return.

15. *Exceptions.* — *(a)* The following kinds of income are, although arising within the country, exempted from tax whether accruing to an individual or a company :

(1) Interest on Japanese Government bonds or securities (Law No. 7 of 1909).

(2) Interest on Reconstruction Savings Certificates (Law No. 15 of 1924). Reconstruction Savings Certificates are the debentures issued by the Hypothec Bank of Japan, under special authorisation of the Government, for the purpose of raising funds necessary for the reconstruction work of the area devastated by the earthquake of 1923.

(3) Income arising from the operation of industries manufacturing certain staple goods for some years.

(4) Income arising from the manufacture of iron or steel for some years.

(5) In certain cases a non-resident individual or a foreign company is, under reciprocal agreements, exempted from income tax in respect of shipping profits arising in this country (see paragraph 121).

16. *(b)* The following kinds of income are exempted from tax when accruing to individuals :

Interest on deposits in the postal savings banks, co-operative societies and savings banks.

Occasional or casual profit derived from transactions outside one's trade or business.

Income of resident aliens derived from property, a business or a profession in foreign countries (not including interest on non-business obligations, dividends, pensions, annuities, etc., which are taxable). The purpose of this exemption is to relieve such persons from double taxation.

Salaries and allowances of officers and men (privates) of the army and navy while engaged in war.

Allowances to widows and orphans, and pensions to sick and wounded persons.

Money received for travelling or school expenses and allowances for support legally payable.

3. Assessment of Tax.

17. The Income-Tax Law, for the purposes of assessment, classifies income under three heads, their general scope being as follows :

Class A. Income accruing to companies or any other incorporated bodies (including Class B income) ;

Class B. Interest payable in Japan in respect of bonds issued by companies, the Government or municipalities, bank deposits and money-trusts[1], and dividends paid by resident companies to non-residents ;

Class C. Income accruing to individuals (not including Class B income).

18. In general, the basis of assessment in the case of individuals is the income received during the preceding calendar year as declared on a return filed on or before March 15th. This rule applies particularly to income in Class C. Income of Class B, which is subject to withholding of tax at source, is not included in this return. A company declares its income at the close of each accounting period. These subjects will be treated in greater detail below.

[1] See paragraph 9, footnote

A. *Computation of Taxable Income and Deductions.*

1. *Class A : Income of Companies.*

19. The taxable income of companies is divided into three classes :

20. *(a) Ordinary income.* — Ordinary income means the balance remaining in each business year after deducting the total expense from the gross profits for the said period. The ordinary income of non-resident companies is assessed only in respect of the assets possessed or business done within this country.

21. Computation of ordinary income. — A company is required, within two weeks after the approval of the accounts of a period (in practice the accounting period is usually six months) to declare its taxable income to the Government. The declaration must be accompanied with an inventory of the assets, the balance-sheet, profit-and-loss account and details of the income and capital properly prepared according to the provisions of the Income-Tax Law. The declaration by a non-resident company must be accompanied with details of capital and income, as well as the profit-and-loss account, in respect of all property or business in Japan.

22. The taxable income of companies is normally ascertained on the basis of the returns and the statements furnished by them. When the return is *bona fide* and correct, the amount declared is adopted as the taxable income, but in cases where no return is made or where the return does not show the true income of the company the tax authorities determine the income by reference to the accounts of the company and other available data.

23. Since the Income-Tax Law does not contain any provisions with respect to what constitutes gross profit and gross loss, these must be determined according to commercial usage. Generally speaking, the gross profit of a company means all accretions to its net assets except the increase due to the paying-up of capital, while gross loss means the decrease in net assets, except the decrease resulting from the paying back of capital. Some important points regarding the computation of gross profit and gross loss are indicated below :

The balance of the profit-and-loss account brought forward from the preceding year is not taken into account in computing the taxable income of the year.

When a company issues shares at a premium — that is to say, at a price exceeding their face value — the total amount of the premium is comprised in gross income.

The appreciated value of assets such as business premises, machinery and plant, securities, stock-in-trade, etc., is regarded as a gain, while the depreciated value of such assets is allowed as a loss within reasonable limits. The appreciated or depreciated value is taken into account only when it is included in the company's account.

A reasonable allowance is made for depreciation,[1] wear and tear of property used in trade or business, such as buildings, plant and machinery, etc.

Bad debts ascertained to be worthless and written off are regarded as a loss, when the tax authorities are satisfied that such debts are not recoverable.

Taxes such as the income tax, the business-profits tax and local surtax thereon, chargeable for the business year are not allowed as deductions for the year.

Reserves for whatever purpose are not deductible.

24. *(b) Excess income.* — When the ordinary income of a corporation for any business year exceeds 10 per cent of its capital, the excess is subject to supertax. By capital is meant the average

[1] The Administration has prepared confidential tables of depreciation for about 400 kinds of objects, which are based on the estimated life thereof

net assets at the end of each month in the said business year — that is to say, the average amount of paid-up capital and reserves.

25. The capital of a non-resident company is determined by allocating its entire capital (paid-up capital and reserves) according to the proportion of the assets in Japan to the total assets of the company. Where the entire capital of the company is not ascertainable, the aggregate of fixed capital and working capital (not including the borrowed capital) in Japan is adopted for the purpose of determining excess income.

26. *(c) Net assets of liquidated companies.* — In the case of the dissolution of a company, the excess of the value of net assets over the paid-up capital is taxable.

2. *Class B: Income from Bonds, etc.*

27. Income under Class B includes :

(a) The interest payable in Japan on corporation, Government or municipal bonds, on bank deposits and on money-trusts[1], whoever the recipient is, and whether or not he is resident in the country ; and

(b) Dividends or any distribution of profits accruing to non-resident individuals or companies from resident companies.

28. In respect of these classes of income, the tax is charged on the amount payable, and is withheld by the payer.

3. *Class C: Income of Individuals.*

29. Class C comprises all kinds, other than those included under Class B, of income accruing to individuals. In respect of the following items of income included in this category, the individual must file a declaration on or before March 15th :

Interest on loans made outside of one's business, and interest on corporate, Government or municipal bonds or deposits which is not chargeable under Class B *(e.g.*, the interest paid in a foreign country). The tax is levied upon the gross amount received during the preceding calendar year.

Income from forests. The tax is levied upon the net profit of the preceding calendar year, which means the balance of the gross receipts and the expenses incurred wholly and exclusively for the production of income.

Dividends or allotments of surplus received from a company. The tax is chargeable upon six-tenths of the gross amount received during the period between March 1st of the preceding year and the last day of February of the current year.

Salaries, wages, allowances, annuities, pensions, retiring pensions and any other allowances of a similar nature. The tax is chargeable upon the gross amount received during the preceding year. Where the income has not been received continuously from January 1st of the preceding year, the tax is assessed, not on the amount actually received during the preceding year, but on the amount estimated to be received during that year. When the recipient is out of employment at the time of assessment, no tax is charged upon the amount he has received during the preceding year.

Bonuses or allowances of a similar nature. The tax is levied on the gross amount received during the period between March 1st of the preceding year and the last day of February of the current year.

Income from any source not enumerated above — for example, income from property, a business or profession. The tax is levied on the net profit — viz., the balance of gross receipts

[1] See paragraph 9, footnote

and expenses incurred wholly and exclusively for the production of the income in the preceding year. In the case where such income has been derived from property not in the possession of the taxpayer, or from a business or profession not continuously practised by him, from January 1st of the preceding year, the tax is assessed on an estimated amount of receipts after deduction of the necessary expenses during that year. In arriving at the profit, no deduction is made in respect of capital charges, lost capital, losses unconnected with the business, private and domestic expenses, etc.

30. *Abatements on net income.* — Out of the total of the actual income from various sources, the following abatements are allowed :

(1) Relief for earned income :

When the total income under Class C does not exceed 12,000 yen, the following deductions are allowed in respect of such income as salaries, wages, allowances, annuities, pensions, retirement allowances, bonuses and allowances of a similar nature :

When the total income under Class C does not exceed 6,000 yen, 20 per cent of the earned portion thereof is deducted from the total income ;

When the total income exceeds 6,000 yen and the unearned portion thereof is not less than 6,000 yen, 10 per cent of the earned portion is deducted from the total income ;

When the total income exceeds 6,000 yen and the unearned portion thereof is less than 6,000 yen, 20 per cent of that part of the earned income, which together with the unearned part amounts to 6,000 yen, and 10 per cent of the remaining part of the earned income is deducted.

Example :

Total income			10,000 yen	earned 6,000 unearned 4,000
Deduction	20% of 2,000 yen	400 yen		
	10% of 4,000 yen	400 yen		
	Total deduction	800 yen		

(2) Allowances for old or juvenile members of the family and for disabled or invalid dependents :

In the case where the total income does not exceed 3,000 yen (after making deduction for earned income when such deduction is allowed), an abatement at the rate of 100 yen *per capita* is allowed, on application of the taxpayer, for the member of the family who is either under eighteen years or over sixty years old, or disabled or invalid at the date of March 1st of the year. The application should be made by March 15th.

(3) Allowance for life insurance premiums :

Premiums paid by the taxpayer for life insurance during the preceding year are deducted from his income. This deduction is allowed only in respect of the premium paid in accordance with the life insurance contract in which the insured person himself, a member of his family, or his heir is the beneficiary. The maximum amount allowable as a deduction is 200 yen a year, and such deduction must be made on application of the taxpayer by March 15th of the year in question.

B. *Computation of Tax and Abatements.*

31. It is impossible to make a generalisation in regard to the method of computing the tax and the abatements allowed against it, as the basis of the tax and the rate at which it is levied, whether such rate is flat or progressive, varies with the category of the income. To understand the complicated rate structure, it is therefore necessary to give the following summary in addition to the full table of rates which is contained in an annex to the present study :

1. *Class A : Income of Companies.*

32. *Ordinary income.* – The rates payable are :

By a resident company, 5 per cent of the net income.
By a non-resident company, 10 per cent [1] of the net income.

33. *Excess profit.* – Graduated rates are applied to excess profit of a company as follows :

	Per cent
On the amount exceeding 10 per cent, but not exceeding 20 per cent of the capital. .	4
On the amount exceeding 20 per cent, but not exceeding 30 per cent of the capital	10
On the amount exceeding 30 per cent of the capital	20

34. *Net assets of a liquidated company :*

On the portion of the net assets which corresponds to reserves and income exempted from tax	5
On the rest of the net assets	10

2 *Class B : Income from Bonds, etc.*

35. *(a)* On the interest on Government or municipal bonds	4
On other interest	5
(b) On dividends, bonuses or directors' percentages which a non-resident person in Japan receives from a resident company (see paragraph 7).	7·5

36. *Abatement on Class A tax for tax paid under Class B.* — In order to prevent double taxation, the amount of the tax which the company has paid for the business year in respect of income under Class B is deducted from the amount of Class A tax for the same year. This deduction is allowed on application by the company. In this case the Class B tax is not regarded as a deduction from gross income for the year.

3. *Class C : Income of Individuals.*

37. Class C income is subject to a graduated scale of rates on successive slices of income, progressing from 0.8 per cent on income not exceeding 1,200 yen to 36 per cent on income exceeding 4,000,000 yen (see annex).

38. The tax for the head and each of the members of the family living together is determined by applying the rates to the total of their income and working out the amount thus obtained in proportion to their respective income.

[1] The reason for levying a higher rate on the profits of a foreign company is to lay upon it a burden fairly equivalent to that imposed on the profits of a Japanese company, the distributed profits of the former bearing no Japanese tax, whereas the profits distributed by a Japanese company are taxable as income of Class B or Class C according to the status of the recipient.

4. Collection of Tax.

(a) *By Direct Payment.*

39. As a general rule, income tax is collected directly from the recipients of the income, collection at source being restricted to a few items of income (see paragraph 44). It is estimated that in 1930-31 only about 14.9 per cent of the total income-tax receipts was collected at the source.

40. (Class A income.) Tax on ordinary and excess income of a company is collected from the company at the end of every business year. Tax on the net assets of a liquidated company is collected from a liquidator when the liquidation has been effected.

41. The tax on Class C income is collected from the taxpayer in four equal instalments, as follows :

First payment from July 1st-31st of the current year ;
Second payment from October 1st-31st of the current year ;
Third payment from January 1st-31st of the subsequent year ;
Fourth payment from March 1st-31st of the subsequent year.

42. No delay or default of payment is allowed, because a taxpayer is dissatisfied with an assessment and has legally filed a protest or appeal.

43. A non-resident taxpayer, individual or company must appoint a representative in Japan who is authorised to pay tax on his behalf. If a non-resident company has a registered branch in Japan, the latter will serve as the authorised representative in question.

b) *By Collection at Source.*

44. The payer of the interest on bonds, deposits, etc. (Class B income) (see paragraph 27), is obliged to deduct tax on making the payment, and to pay it over to the revenue authorities by the 10th of the month following such payment.

II. LAND TAX.

45. Owners of land situated within the country are, with certain exceptions, liable to tax under the Land-Tax Law of 1931 in respect of the income accruing therefrom.

46. *Taxpayers.* — Those liable to the land tax are, as a general rule, the owners of the land, whatever their nationality, domicile or residence.

47. *Taxable income.* — The tax is upon the income arising from land. From the practical point of view, however, it is charged on the rental value of the land. The rental value of land means the annual leasing value of the property, the landlord bearing the taxes, the cost of repairs and other expenses which are necessary to maintain the land in such condition as to yield such rent.

48. The annual value for the purpose of the land tax is determined every ten years, and the value thus fixed remains as a basis of assessment during the intervening years, unless there occurs a substantial change in the condition of the land ; for example, the development from woodland into residential land.

49. *Exemption from tax.* — Lands used for the public by the State, local governments or certain public corporations are exempted from tax. Devastated lands are also exempted from tax for a certain period.

50. *Rate of tax.* — The rate of tax is 3.8 per cent on the annual rental value.

51. *Collection of tax.* — The land tax is collected from the landowners as follows :

Tax on residential land :

First payment : July 1st-31st of the current year ;
Second payment : January 1st-31st of the subsequent year.

Tax on rice fields :

First payment : January 1st-31st of the subsequent year ;
Second payment : February 1st-last day of the month of the subsequent year ;
Third payment : March 1st-31st of the subsequent year ;
Fourth payment : May 1st-31st of the subsequent year.

Tax on other lands :

First payment : September 1st-30th of the current year ;
Second payment : November 1st-30th of the current year.

III. BUSINESS-PROFITS TAX.

52. Profit from a trade or business is liable to tax under the Business-Profits Tax Law of 1926, in addition to the income tax.

53. *Taxpayers.* — *(a)* A company which is established for profit and has its head or branch office or any other business establishment within the country.

(b) An individual who has his business establishment within the country at which he carries on business of any of the following kinds :

Sale of goods, banking, mutual loan society, moneylending, renting of goods, manufacturing (including the generating and supplying of gas and electricity and the repair of articles), transport (including transport agencies), warehousing, contracting, printing, publishing, photography, renting assembly rooms, innkeeping, restaurants, commission agency (in transactions outside of what are defined as commercial transactions by the commercial law - *e.g.*, an employment agency), representation (of a merchant in his transactions), commission agency (in commercial transactions defined by the commercial law), and wholesale commission merchant.

54. *Taxable income.* — The business-profits tax is levied upon the net profit from a trade or business and is ascertained in the same manner as income taxable under the Income-Tax Law.

55. *Exemptions.* — There are certain exceptions to the general rule. Profits from the following trades are exempted from tax :

Dealing in postal and revenue stamps issued by the Government ; manufacture, sale or repairing of scales, weights and measures ; sale of minerals mined or extracted by the dealer himself ; publishing under the Newspaper Law ; trade or business transacted at the establishment in another country ; fisheries or theatrical performances conducted by a company ; sale or manufacture of products from agriculture, forestry, livestock breeding, or the fishing industry, but such sale or manufacture in a place specially prepared for the purpose is not exempted ; iron and steel manufacture, and the manufacture of certain staple commodities for some years ; mining (as mining is liable to tax under the Mining Law, it is exempted from the business-profits tax in respect of the income therefrom); business on a stock or produce exchange (business transacted on a stock or produce exchange is subject to tax under the Exchange-Tax Law in respect of the income derived therefrom).

56. *Minimum exemption.*—An individual whose business profit is less than 400 yen is exempted from tax. There is no such minimum exemption with regard to a company.

57. *Relief against internal double taxation.* — An individual who is liable to tax is entitled to deduction of land tax paid on the business premises from business-profits tax, while a company is entitled to the deduction from tax of capital-interest and land taxes paid during the assessed period.

58. *Rate of tax.* — Per cent

On the profits of a company	3.4
On the profits of an individual.	
Where the profit does not exceed 1,000 yen	2.2
Where the profit exceeds 1,000 yen :	
On the portion not exceeding 1,000 yen	2.2
On the portion exceeding 1,000 yen	2.6

59. *Collection of tax.* — The tax is collected as follows :

(a) From a company at the end of each accounting period;

(b) From an individual, in two instalments :

First payment : August 1st-31st of the current year;
Second payment : November 1st-30th of the current year.

IV. CAPITAL-INTEREST TAX.

60 Tax is chargeable under the Capital-Interest Tax Law of 1926 upon interest on capital which is payable within the country.

61. *Taxpayers.* — An individual or company is liable to tax in respect of the capital-interest payable within the country.

62. *Taxable income.* — Class A : Interest on corporate, Government or municipal bonds, bonds issued by the Central Fund for Industrial Associations ; interest on bank deposits ; income from money-trusts (see paragraph 9, footnote). The tax is levied on the amount payable.

63. Class B : Interest on deposits or loans made on a non-business basis. These kinds of interest are liable to tax only when they accrue to persons who are assessed to income tax under Class C. The tax is levied on the amount received during the preceding year.

64. *Exemption from tax.* — *(a)* Interest accruing to a company exempted from Class B income tax under the Income-Tax Law and any other legislation.

(b) Interest on savings bonds or the " Reconstruction Savings Certificates ". It is to be noted that the interest on National Goverment bonds or stocks, which is exempted from income tax, is liable to Capital-Interest Tax.

65. *Rate of tax.* — The rate of tax is 2 per cent on the amount receivable.

66. *Collection of Tax.* — Tax on interest under Class A is collected at the source from the payer, who deducts the tax at the time of payment and pays it to the revenue authorities.

67. Tax on Class B interest is collected from the recipients in two instalments, as follows :

First payment : August 1st-31st of the current year ;
Second payment : November 1st-30th of the current year.

Procedure in Assessment and Appeals.

68. The local taxation office supplies individuals with return forms usually in February, and companies at the close of their accounting year. If the taxpayer fails to file a return, he may be assessed arbitrarily, but he does not incur any penalties except by losing the deductions to which he is entitled (see paragraphs 30, 36 and 57). The return and supporting accounts of the taxpayer are verified, and, if necessary, an official of the taxation office visits the taxpayer in order to make a thorough examination of his accounts. Normally the assessment notice is served on a company within a few months after it has filed its return, although in difficult cases a longer time may be required to make the assessment. With regard to individuals, their returns are examined by the tax-investigation committee, which must be convened once a year and at least by May, and the assessments are sent out thereafter, usually the end of May or early in June.

69. The 345 taxation offices are comprised in seven districts, over each of which there is a superintendent. The superintendents are in turn supervised by the Taxation Department of the Finance Ministry. At each taxation office there is an income-investigation committee composed of six to eight taxpayers who are elected by the taxpayers. At the district office there is an income-reinvestigation committee, which hears appeals in cases of companies as well as individuals. It consists of three tax officials and about seven or eight members of income-investigation committees.

70. Taxpayers, whether individuals or companies, who are not satisfied with assessments may appeal, within twenty days after receiving the notice of assessment, in writing to the district superintendent through the local taxation office. The reasons for appeal must be stated fully and supported by documentary evidence. The district superintendent renders judgment after consulting with the income-reinvestigation committee. An appeal against this judgment may be carried to the Minister of Finance or the Administrative Court within sixty days. The decision of either authority is final.

71. *Penalties.* — Fraudulent evasion of tax is subject to a penalty of three times the evaded amount. The penalty is waived, however, if the offender voluntarily reports the offence to the authorities before its discovery.

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

1 DEFINITION AND GENERAL PRINCIPLES.

72. The Income-Tax Law does not give any definition of the term " foreign enterprise ". The Law only provides that a non-resident individual or company shall be liable to income tax in respect of the income derived from assets or business within the country. In this study the term " foreign enterprise " is used to denote a business or undertaking carried on in Japan by a non-resident individual, partnership or company (see paragraphs 4, 6 and ;).

73. A foreign enterprise, whether carried on by an individual, partnership or company, is, generally speaking, liable to the Japanese income tax in respect of all income arising in Japan. The items of income in respect of which a foreign enterprise is liable to tax may be summarised as follows :

(a) Income arising from property situated in Japan ;

(b) Income derived from business operations through a permanent establishment in Japan ;

(c) Interest payable in Japan on company, Government or municipal bonds, bank deposits, and money-trusts [1] ;

(d) Dividends or any other distribution of profit received from a resident company.

74. With respect to income under *(c)* and *(d)*, no difference in procedure exists whether the foreign enterprise enjoying such income is an individual, a partnership or a company. The income tax at the fixed rate is collected at the source from the payer at the time of making the payment. The treatment to which income under *(a)* and *(b)* is subjected depends upon whether the foreign enterprise is an individual or a company (see paragraph 10).

2. TAXATION OF CERTAIN KINDS OF INCOME.

(a) *Dividends.*

75. A foreign enterprise is liable to tax in respect of dividends which it receives from resident companies, whether the enterprise is an individual, a partnership or a company. The tax is normally withheld at the source from the payer of the dividends. When a foreign enterprise has a permanent establishment in Japan at which the dividends are received, and the shares or stocks are possessed solely in connection with the business of that establishment, the dividends are subject to direct assessment to that establishment in whose gross income the dividends must be included.

[1] See paragraph 9, footnote.

(b) *Interest.*

76. *Interest on bonds issued by the Government, municipalities and companies and on bank deposits.* - Income tax is collected at source from the payer, who deducts the tax on paying the interest. A foreign enterprise is always liable for the tax whether it is an individual, a partnership or a company and whether it has an establishment in the country or not.

77. *Interest of other kinds.* - Interest of other kinds, such as interest on loans secured or unsecured, discount on bills, etc., is paid in full without deduction of tax. Income of this kind is subject to direct assessment in the name of the recipient in whose gross income the interest is included. Where the enterprise has a permanent establishment in Japan which receives interest arising in connection with the business transacted at that establishment, such interest is normally included in the gross income of that establishment. Otherwise the tax is not chargeable, as loans and other interest-bearing obligations of a resident in Japan owned by a foreign enterprise are not regarded as property in Japan, which is subject to tax in respect of the income therefrom. Where such obligations have arisen in connection with business transacted in Japan by a foreign enterprise, the interest thereon is regarded as income accruing from business in that country and is taxable as such, and since a foreign enterprise is not liable to tax on business transacted in the country, unless it has a permanent establishment there, such interest is taxable only when there is such an establishment to which the interest is ascribed. For example, if a foreign enterprise has in Tokio a selling establishment which sells to customers on account and charges interest on debit accounts, the interest is included in the general business income of the establishment.

(c) *Directors' Percentages.*

78. In the case where a resident company pays to its non-resident directors a share of the profits, the company is required to deduct tax on paying the percentages

(d) *Royalties for the Use of Patents, Copyrights, Trade Marks, Secret Processes, Formulæ and Similar Income.*

79. As intangible property is regarded as situated at the place where the persons enjoying the income therefrom are resident, the income from such property is not taxable, in principle, if the recipients reside abroad. Nevertheless, it may be taxed as business income if the non-resident enterprise has in Japan a permanent establishment which receives income of this kind, and if such income constitutes a part of the business income of the establishment.

(e) *Rents from Real Estate, Mining Royalties and Similar Income.*

80. A foreign enterprise is liable to tax in respect of this income whether it has or not a permanent establishment in Japan, because such income is regarded as being derived from property in Japan. Usually such income is included in the gross income from business. The cases where a foreign enterprise owns property in Japan not connected with its business are very rare. If a non-resident enterprise has no permanent establishment in Japan which pays tax on such income, it must appoint a representative there to pay the tax.

(f) *Gain derived from the Purchase and Sale of Real Estate, Securities or Personal Property.*

81. In the case of a non-resident individual or partnership, no income tax is chargeable except in cases where such individual or partnership is carrying on, at its permanent establishment in Japan, a business of dealing in real estate, securities or personal property. A non-resident company is chargeable if its permanent establishment in Japan deals in such property or sells a part of its assets consisting of such property.

(g) *Salaries, Wages, Commissions and Other Remuneration for Services.*

82. No tax is chargeable on salaries, wages, commission or any other remuneration of a similar nature which a non-resident individual receives for his employment or any other services rendered in Japan.

(h) *Income from Trusts.*

83. Income from money which is in trust with trust companies and is invested in loans or deposits is chargeable with tax which is collected at the source by the payer, who deducts tax on paying the income. Even when a part of the trust money is invested in Government or municipal bonds, the income from the trust would be subject to tax which is deducted at source. Other kinds of income from trusts are assessed directly to the beneficiaries. The various items of income derived by non-residents are treated as described in the preceding paragraphs.

(i) *Income from carrying on a Business or Industry.*

84. The Income-Tax Law does not contain any provisions which precisely define the extent of the liability of a foreign enterprise carrying on a business in Japan. It only provides that such an enterprise is liable to income tax in respect of the income derived from such business. This provision has been interpreted to mean that a foreign enterprise carrying on business in this country is not liable to the Japanese income tax, unless it has here a permanent establishment at which the income from trade or business is reasonably expected to arise.

There is no provision in the Income-Tax Law as to what constitutes a permanent establishment. It is a problem to be determined in each concrete case by reference to various circumstances.

85. Where business is done through a *broker* or *general commission agent*, a *local dealer* or *distributor* having the exclusive right to handle a line of goods but buying and reselling them for his own account, or a *travelling salesman*, whether or not having power to conclude a contract, no tax is normally charged on the foreign enterprise, as it is not regarded as having a permanent establishment in Japan.

86. If the foreign enterprise has such a *local agent with power of attorney*, its liability depends on whether or not the agent constitutes a permanent establishment. The fact that the agent has power to sell goods for the foreign enterprise would be immaterial if he transacts business in his own establishment, and acts in general as an independent business man. The foreign enterprise would, however, be considered as having a permanent establishment if the agent received a salary and could be considered as its employee.

87. If a foreign enterprise does business through an *agent selling out of a stock of goods* belonging to the enterprise, it would not be liable to the Japanese income tax, unless the agent is empowered to control or to take charge of the stock belonging to the enterprise, as well as to sell the goods constituting the stock.

B. NATIONAL ENTERPRISES.

I. DEFINITION AND GENERAL PRINCIPLES.

88. It is assumed that the term " national enterprise " means an enterprise belonging to a resident individual, partnership or company.

89. Generally speaking, a national enterprise is liable to income tax in respect of all income arising from foreign as well as domestic sources. A resident alien is exempted from tax in respect of the income arising from property, business or the exercise of a profession in foreign countries.

2 TAXATION OF CERTAIN KINDS OF INCOME.

(a) *Dividends and* (b) *Interest.*

90. Where persons resident in Japan receive dividends or interest on foreign securities, they are required to include such items in their return of income for direct assessment. But if bond interest is collected through banks in Japan, the banks are required to withhold tax from the interest paid. Apart from the ordinary examination of returns by the officials and any necessary information requested from the taxpayers, there is no special check regarding these items of income.

(c) *Directors' Percentages.*

91. Where persons resident in Japan receive directors' percentages from a foreign establishment they are required to include such items in the return of income.

(d) *Patent and Copyright Royalties, etc.*

92. A national enterprise in Japan is chargeable with tax in respect of foreign patent or copyright royalties, etc.

(e) *Rents from Real Estate, Mining Royalties and Similar Income.*

93. Rents from real estate abroad, mining royalties and similar income are liable to income tax, when derived by a national enterprise.

(f) *Gains from the Purchase and Sale of Real Estate and Securities.*

94. If the resident in Japan deriving income in this way is an individual, he is not liable to tax, unless he carries on a business of dealing in real estate or securities. If the national enterprise is a company, it is chargeable with tax in respect of all income derived from such transactions, whether or not it carries on such transactions as part of its business.

(g) *Salaries, Wages, Commissions and Other Remuneration for Services.*

95. A person resident in Japan is liable to pay tax on any remuneration for service abroad, even though remuneration for such service is paid abroad.

(h) *Income from a Trust.*

96. A national enterprise would be liable to tax in respect of income received from a foreign trust.

(i) *Income from carrying on a Business or Industry.*

97. A national enterprise is liable to tax in respect of all income from trading operations abroad. It should be noted that the business-profits tax is not chargeable on the income derived from a business carried on at establishments abroad. In the case of a partnership, which is not a taxable entity under Japanese law, with partners resident in this country and abroad, liability would normally be restricted to the share of the income arising abroad attributable to the partners resident in Japan.

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

I. GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

(a) Book-keeping and Accounting Requirements.

98. Every person engaged in commerce must keep account-books in accordance with the provisions of the Commercial Law. A person engaged in commerce means, in commercial law, a person carrying on commercial operations, and by commercial operations are meant any operations coming under the category of business operations prescribed in paragraph I of Chapter III of the Commercial Code. The regulations applicable to persons engaged in commerce are applied also to commercial companies.

99. The account-books which persons engaged in commerce are required to keep must clearly show the daily business done and the disposition of capital. Upon opening business, or upon registering an establishment in the case of a company, a person engaged in commerce must make a comprehensive inventory of all personal and real property, accounts payable and accounts receivable and all other objects of property belonging to him. He must also draw up a balance-sheet showing the relation between assets and liabilities. He must prepare similar balance-sheets at the close of every business year. The duration of each business year is not to exceed twelve months. Account-books and business correspondence must be retained for a period of ten years.

100. The branch or any other permanent establishment which is established in this country by a foreign enterprise (see paragraph 72) is treated in the same manner as a national enterprise, and is subject to the foregoing requirements. The regulations regarding commercial registration are also applicable to such an establishment. When a foreign enterprise establishes a branch in this country, it must register it, as well as the name and domicile of a person representing it, at the registration office of the local law-court. Any subsequent change of the representative, the removal of the branch or any other change in the registered information must also be inscribed.

(b) Methods of Allocation.

1. *Method of Separate Accounting.*

101. The income of the local branch of a foreign enterprise is determined separately on the basis of its accounts, when it is possible to ascertain through those accounts the true income of the branch. It would seem that there should be no difficulty in determining the Japanese profits on the basis of the accounts furnished, but in practice considerable trouble has been experienced in

ascertaining the Japanese income, even in cases where separate accounts have been available. This is mainly due to the interlocking and complicated transactions between the foreign enterprise and its establishment in this country. It needs a great deal of effort on the part of the administration to check the accounts furnished and to ascertain the reasonable amount of Japanese income, in order to prevent evasion of tax by shifting the profit of the branch to the establishments in other countries. For this purpose, however, the general practice is to require the submission of only those accounts which reflect the business of the local establishment and its relations with other establishments of the enterprise.

102. The methods of checking which are usually employed by the administration may be summarised as follows :

(a) Acquiring a clear understanding of the course of business between the foreign and the Japanese establishments ;

(b) Analysing in detail the interlocking transactions and the methods of internal accounting ;

(c) Taking an independent market quotation for similar goods or the price at which similar goods are sold by the foreign enterprise to an independent customer in this country ;

(d) Making a comparison with similar businesses.

2. *Empirical Methods*

103. In cases where the real amount of the income cannot be successfully ascertained, the taxation authorities may, if they think fit, charge the foreign enterprise on a percentage of the turnover of the business conducted through the establishment in this country In practice this method is rarely employed.

3. *Method of Fractional Apportionment.*

104. The income of a branch is not generally determined as a fraction of the entire income of the foreign enterprise to which the branch belongs. When, however, both the method of separate accounting and that of the percentage of turnover fail, owing either to the lack of separate accounts or the nature of the business, some other conventional method is adopted. Whether the total profit should be apportioned by the ratio of assets or receipts or any other factors between the foreign enterprise and the Japanese branch is a problem to be determined by the administration in view of the nature of the business and other circumstances.

4. *Requirements for Selection and Comparative Value of Various Methods.*

105. The Japanese branch of the foreign enterprise is required by the Income-Tax Law to submit to the taxation office at the end of every accounting period a return of income with an inventory of assets, together with the balance-sheet and profit-and-loss account. When the authorities consider that the return shows the true income, they adopt it. But in cases where no return is submitted or where it is unsatisfactory, the authorities are empowered to determine the amount of taxable income after due inspection. In such cases the authorities may employ any methods which they regard to be most adequate.

106. From the viewpoint of normal use and prevention of tax evasion, the method of separate accounting is considered to be the most satisfactory. Although it is not easy for the administration to check the accounts where there are interlocking transactions, most of the difficulties can be overcome by a clear understanding of the course of the business and a study of the internal accounting methods.

(c) Apportionment between Branch and Parent Enterprise.

1. *Apportionment of Gross Profits of Local Branch to Real Centre of Management abroad.*

107. If a foreign enterprise transacts business through a branch in Japan, it is liable to tax on the profits arising in this country, and none of such profits is ascribed to the real centre of management in the foreign country. If the foreign company has a subsidiary company in Japan, the latter is liable in respect of its total income, and none of its profits is ascribed to the parent company abroad.

2. *Apportionment of Expenses of Real Centre of Management to Branch.*

Interest Charges.

108. When a foreign enterprise has a general debt, whether or not represented by bonds, the interest payable thereon is not ascribed solely to the real centre of management, but is apportioned to the different permanent establishments in the various countries on a reasonable basis (for example, on the basis of gross income arising or of the assets invested in the various countries). If the foreign enterprise proves to the satisfaction of the tax authorities that a certain debt has been contracted solely for the purpose of financing trading operations in this country, the interest thereon is deducted from the gross profit attributable to this country as an expense necessary for the production of the income.

General Overhead Expenses

109. General overhead expenses are generally apportioned according to the ratio of gross receipts arising within the country to the total gross receipts, or some other factors which are appropriate to particular cases.

3. *Apportionment of Net Profits.*

110. When the Japanese branch operates at a profit, whereas the entire enterprise suffers a loss, no account is taken of the loss in determining the income of the branch.

111. When the Japanese branch operates at a loss, whereas the entire enterprise realises a profit, no tax liability arises in respect of the business carried on in Japan, if the accounts of the branch have been kept correctly and the loss is a *bona fide* one. It is quite probable that the administration pays special attention to such cases in order to prevent tax evasion by shifting the profit of the branch to the parent or other establishments abroad.

(d) Apportionment between Parent Enterprise and Subsidiaries.

112. A subsidiary company is regarded under Japanese law as a body absolutely independent from its parent company. A subsidiary company controlled by a foreign enterprise is liable to income tax in respect of all income, whether arising within the country or abroad, so far as it has its head office or main place of business within the country. Therefore, there is usually no problem of allocation. In view, however, of the close connection between a subsidiary company and its parent, strict measures are usually taken by the administration in assessing the subsidiary company, special reference being made to interlocking transactions with its foreign parent by whom it is controlled.

II APPLICATION OF THE METHODS OF ALLOCATION IN SPECIAL CASES.

(a) INDUSTRIAL AND COMMERCIAL ENTERPRISES.

1. *Selling Establishments.*

Local Establishments selling in National Market.

113. Where a foreign enterprise manufacturing or buying abroad sells through a branch in this country, the whole profit arising from the sales is liable to tax in this country. The law does not recognise any distinction between manufacturing profit and sales profit, but if the taxpayer can show that a reasonable manufacturing profit is attributable to the foreign establishment, the authorities may allow such profit to be excluded from the assessment. In no case is an allowance made for a foreign buying profit. The taxable income is determined by means of the methods already mentioned in paragraphs 101-104. In cases, however, where the operations of the establishment in Japan are restricted to the delivery of the goods sold, and the settlement of accounts or other transactions are conducted by the establishment abroad, no profit is generally ascribed to the Japanese establishment.

Local Establishments selling abroad.

114. Where a foreign enterprise has a branch in Japan which makes sales in a third State without having there a permanent establishment, the foreign enterprise is liable to Japanese tax in respect of the profits which the branch in Japan derives from the sales in the third State.

2. *Manufacturing Establishments.*

115. In the case of a foreign enterprise manufacturing in Japan and selling abroad, a profit may be ascribed to the manufacturing establishment. As there are no criteria for measuring the manufacturing profit, its amount will be determined according to the circumstances of each case. If the Japanese establishment makes a sale in another country in which the foreign enterprise has no establishment, the merchanting profit, as well as the manufacturing profit, is ascribed to the Japanese establishment. When the establishment in this country sends manufactured goods to the establishment abroad which makes sales in other countries, only the manufacturing profit is ascribed to the Japanese establishment.

3. *Processing Establishments.*

116. With regard to a foreign enterprise producing goods in one foreign country, processing them at an establishment in this country and shipping them to an establishment in a third country for further processing or sale, the profit derived from the processing performed in Japan is ascribed to the Japanese establishment. Cases of this kind are extremely rare.

4 *Buying Establishments.*

117. When the activities of the Japanese establishment are restricted to the purchase of goods and their transfer to the establishment abroad, and other transactions, such as selling, are conducted by the establishment abroad, no profit is generally ascribed to the Japanese establishment.

5. *Research or Statistical Establishments, Display Rooms, etc.*

118. If a foreign enterprise has an establishment in this country which does not directly engage in any profit-making transactions but renders services to the enterprise which contribute indirectly to the realisation of profits - *e.g.*, a statistical bureau, display room, etc. — no profits are ascribed to such establishment, as there are no trading operations in this country which are assessable to income tax.

(b) Banking Enterprises.

119. Banks and banking companies having their head offices abroad are required under the Banking Law to obtain the sanction of the Japanese Government for establishing their branch or any other business establishment in this country. The Japanese establishment of a foreign banking company is subject to strict regulations. It must keep accounts according to the provisions of the law. It must submit regularly a detailed report to the Government for each business year, and must also publish its balance-sheet in a fixed form. This enables the tax administration to assess in most cases on the basis of separate accounting with comparative ease. Even where the accounts submitted by the foreign enterprise are not satisfactory from the viewpoint of assessment, the determination of the income of a banking enterprise is not so difficult because of its nature. The allocation of expenditure is not so easy as that of the income In principle, interest charged by the foreign bank on advances to its branch in Japan is deductible to the extent that the advance is not made out of capital, and provided the rate is reasonable. In practice, where it is difficult to ascertain how much of the advance consists of capital, a reasonable bank rate of interest may be deducted. General overhead charges are, as a general rule, allocated according to the proportion of the gross income arising within the country to the total gross income of the enterprise.

(c) Insurance Enterprises.

120. Most of the foreign insurance enterprises having establishments in this country are assessed on the basis of separate accounting. In order to carry on insurance business in Japan, a foreign enterprise must obtain the sanction of the Japanese Government and must establish its branch or agent in this country. The enterprise is required to submit to the Government, not only the report on the business carried on in this country, but also the inventory, balance-sheet, profit-and-loss account and business report drawn up at its head office. As to the determination of the income of insurance enterprises, few questions arise because of its nature, but difficulties are sometimes encountered in allocating the expenditure, such as general overhead charges or interest on general debt. The method of allocation generally employed is that such expenditure is apportioned according to the ratio of premium receipts in this country to the total premium receipts of the enterprise.

(d) Transport Enterprises.

121. With regard to such transport enterprises as railways, motor-bus and air lines, no cases have as yet been known. Regarding shipping enterprises, few questions arise as to allocation, since many important foreign countries have entered into agreements with this country for the reciprocal exemption of shipping profits. Such agreements have now been concluded with the United States of America, United Kingdom, France, Canada, Brazil, Denmark, Norway and the Netherlands. In cases where the reciprocal exemption does not apply, the income is determined on the basis of separate accounting ; general profits and expenses are usually allocated according to the proportion of the freight and fare receipts in this country to the total freight and fare receipts of the enterprise.

(e) Power, Light and Gas Enterprises.

122. There are no cases of allocation known with regard to enterprises of this nature.

(f) Telegraph and Telephone Enterprises.

123. Enterprises of this nature are normally assessed on the basis of their separate accounts. Expenses incurred exclusively in respect of the business in Japan, including the charges paid to other companies for further transmission, are deductible from the gross receipts of the Japanese establishment. General overhead charges are allocated by whichever method the administration considers most adequate *e.g.*, by the ratio of assets or business receipts.

(g) Mining Enterprises.

124. No cases are known, as under the Japanese law only Japanese subjects, or companies organised under the Japanese law, are allowed to operate mining undertakings in this country. The problem of allocation may arise if the persons having the right to carry on the mining enterprise in Japan are resident abroad or have the seat of management abroad, but such cases are extremely rare.

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

125. National enterprises are liable to income tax in respect of all profits whether arising within the country or abroad, consequently no questions normally arise as to the allocation of profit in various countries.

126. When the real centre of management of a company is in Japan, the company is assessed to income tax in respect of its entire income. The company must include in its income-tax returns the income derived from its business carried on in another country.

C. HOLDING COMPANIES.

127. Where a holding company in Japan controls one or more foreign subsidiary companies, it would normally be assessable in respect of its own profits, including any dividends received from the subsidiary companies, and also in respect of interest, whether on bonds or advances and whether payment is effected abroad or in Japan by the foreign subsidiaries. In view, however, of the interlocking connection between a holding company and its subsidiaries, the administration generally takes every precaution to prevent tax evasion by means of ascribing the profits of the holding company to its subsidiaries.

128. When a local subsidiary company is controlled by a foreign holding company, it is liable to tax for its own separate profits. Dividends paid to the parent company are taxed by deduction at source of the income tax. Bond interest paid by the subsidiary to the parent is likewise subject to the income tax (Class B) and to the capital-interest tax by deduction at source, unless it is contracted that the interest be paid abroad. Interest on advances made by the foreign parent to

the subsidiary is not taxed. Where the relations between the holding company and the subsidiary are such that the accounts do not show the true profits, the administration is authorised to take proper measures to prevent tax evasion.

D. ALLOCATION OF PROFITS FOR THE PURPOSE OF THE BUSINESS-PROFITS TAX.

129. As mentioned in paragraph 53, the business-profits tax is chargeable solely in respect of business transacted within this country, whether it is carried on by national or foreign enterprises. In general, the profit allocated to Japan for the purposes of the income tax on foreign companies serves as well as the basis of assessment for the business-profits tax. In order to assess the Japanese profits of national enterprises to the business-profits tax, the rules of allocation described above in connection with the income tax on foreign enterprises are applied, *mutatis mutandis*.

Annex.

TABLE OF TARIFFS.

INCOME TAX.

CLASS A : INCOME OF COMPANIES.

(a) *Ordinary Income.*

The rates payable are :

(i) By a resident company, 5 per cent of the net income ;
(ii) By a non-resident company, 10 per cent of the net income.

(b) *Excess Profit.*

Graduated rates are applied to excess profits of a company as follows :

	Per cent
On the amount exceeding 10 per cent, but not exceeding 20 per cent of the capital.	4
On the amount exceeding 20 per cent, but not exceeding 30 per cent of the capital .	10
On the amount exceeding 30 per cent of the capital	20

(c) *Net Assets of a Liquidated Company.*

On the portion of the net assets which corresponds to reserves and income exempted from tax	5
On the rest of the net assets	10

CLASS B : INCOME FROM BONDS, ETC.

(a) On the interest on Government or municipal bonds	4
On other interest	5
(b) On dividends, bonuses or directors' percentages which a non-resident person in Japan receives from a resident company	7·5

CLASS C : INCOME OF INDIVIDUALS.

Amount of income (Yen) Between	And	Percentage applicable to the slice of income comprised between the two corresponding figures of the "Amount of income" column	Effective rate on the total amount of the corresponding income
			Per cent
0	1,200	0.8	0.8
1,200	1,500	2	0.8 — 1.04
1,500	2,000	3	1.04— 1.53
2,000	3,000	4	1.53— 2.35
3,000	5,000	5	2.35— 3.41
5,000	7,000	6.5	3.41— 4.29
7,000	10,000	8	4.29— 5.50
10,000	15,000	9.5	5.50— 6.77
15,000	20,000	11	6.77— 7.82
20,000	30,000	13	7.82— 9.55
30,000	50,000	15	9.55—11.73
50,000	70,000	17	11.73—13.23
70,000	100,000	19	13.23 —14.96
100,000	200,000	21	14.96—17.98
200,000	500,000	23	17.98—20.99
500,000	1,000,000	25	20.99—22.99
1,000,000	2,000,000	27	22.99—24.99
2,000,000	3,000,000	30	24.99—26.66
3,000,000	4,000,000	33	26.66—28.24
Over 4,000,000		36	28.24

LAND TAX.

The rate of tax is 3.8 per cent on the annual rental value.

BUSINESS-PROFITS TAX.

	Per cent
On the profits of a company	3.4
On the profits of an individual :	
Where the profit does not exceed 1,000 yen	2.2
Where the profit exceeds 1,000 yen :	
On the portion not exceeding 1,000 yen	2.2
On the portion exceeding 1,000 yen	2.6

CAPITAL-INTEREST TAX.

The rate of tax is 2 per cent on the amount receivable.

MEXICO

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PART I. — GENERAL DESCRIPTION OF INCOME-TAX SYSTEM.[1]

1. The income tax of Mexico is imposed by the Federal Government, and, although at the present time it yields less than one-tenth of the federal revenue,[2] it is expected that, in the future, its importance will increase. Preparations are being made for an agreement between the Federal Government and the various States concerning the fiscal jurisdiction of each, but it is expected that the income tax will remain exclusively a federal levy, whereas the States will be restricted to taxes primarily on property.

2. The income tax is imposed by the Law of March 31st, 1925, as amended, and has been interpreted by Regulations issued and amended from time to time, and also by circulars.[3] The underlying principles of the tax are that Mexicans, wherever domiciled, are taxable on their total profits and income from all sources, whereas foreigners, whether domiciled in Mexico or abroad, are taxable only in respect of income from sources situated or transactions realised in the territory of the Republic. Companies and corporations of all kinds and estates are taxable in accordance with the foregoing principles. For example, a company organised under Mexican law is taxable on its total income from all sources, whereas a company organised under the law of a foreign country, even though it is domiciled through having its real centre of management in Mexico, is taxable only on income from Mexican sources.

3. The application of these principles in Mexico differs from their application in other countries. Mexico holds its citizens and companies organised within its territory fully liable to tax, even though the domicile of the taxpayer is in a foreign country. The State, however, allows its citizens domiciled in a foreign country to deduct from the tax owed to Mexico the tax payable on total income to the country in which he resides. Foreigners, including companies organised in foreign countries, even if domiciled in Mexico, are taxed in accordance with the principle underlying pure schedular taxes — that is to say, only on defined local sources of income.

4. Subject to these fundamental principles, the tax is imposed under seven schedules in the Income-Tax Act which are similar to the schedules in the British Income-Tax Act, in that they contain special rules for taxing income from a specified source. The schedules are described in the Regulations as follows : Schedule 1, Commerce ; Schedule 2, Industry ; Schedule 3, Agriculture ; Schedule 4, Credits *(Créditos)* ; Schedule 5, Participations in Concessions ; Schedule 6, Wages, Salaries and Emoluments ; Schedule 7, Professions. The character of the rate of tax — *i.e.*, whether flat or progressive, varies with the schedule. Thus commerce and agriculture are subject to

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[1] Legislation in force on March 1st 1933

[2] In 1930, the income tax yielded 20,088,000 pesos, in 1931, 14,721,000 pesos The most important sources of revenue for the Federal Government are the import and export duties, consular fees, navigation charges and other duties on foreign trade which yield roughly one-third of the federal revenues. The taxes on extractive industries (mining and petroleum) have been second in importance, although the revenues from this source have declined in recent years because of reduced oil production

[3] The Income-Tax Law will be referred to in this report by the word "Law" and the Regulations by the abbreviation " Reg ". The Law, the Regulations and the circulars are published in a compilation by Antolin JIMENEZ, entitled " Ley del Impuesto sobre la Renta " fifth edition, 1932.

progressive rates, credits and participations in concessions to flat rates, salaries and professional income to progressive rates (see Annex).

5. The Mexican income tax has been described as being essentially democratic in character, in that the assessments are made by an Assessment Board *(Junta calificadora)*, which is attached to each of the sixty-one tax offices situated in as many districts throughout the territory of the Republic. The Assessment Board in Mexico City is composed of five members, of whom three are permanent officials and the two others are representatives of the taxpayers. Thus two business men serve in assessing taxpayers under the first schedule, two industrialists in making assessments under the second, two agriculturists in making assessments under the third schedule, two bankers in assessing taxpayers subject to the fourth and fifth schedules, and two professional men in assessing tax under the seventh schedule. In the last-mentioned case, the assessment of a man of a given profession is made by other men of the same profession. In the districts outside the capital of Mexico, the assessment board is made up of two permanent officials and one representative of the taxpayers, the last-mentioned being of the same category as the assessee. Similarly, the Board of Revision, to which taxpayers may bring an appeal against their assessment within twenty days, consists of three Government officials and two representatives of the taxpayers, the last-mentioned being named in accordance with the rules applying to the selection of taxpayers as members of the Assessment Board.

1. TAXPAYERS.

(a) Individuals.

6. Mexican citizens are taxable in accordance with the principle of nationality and are therefore liable, whether domiciled in Mexico or abroad, in respect of their total income from all sources, Mexican or foreign.

7. Aliens, regardless of where they reside, are taxed only on income from sources of wealth situated or transactions realised in Mexican territory (Law, Article 1).

(b) Partnerships.

8. A partnership *(sociedad in nombre collectivo)* is taxed in the same manner as a corporation, and the partners are not taxed in regard to their distributive shares.

(c) Companies.

9. Companies, including corporations *(sociedades anonimas)*, like individuals are taxable on their total income from all sources if they are organised in Mexico, but are taxable only on income from sources of wealth situated, or from transactions realised, in Mexico if they have been organised under the law of a foreign country. This rule applies regardless of where the company may have its real centre of management or where it may be domiciled or resident in accordance with the law of a foreign country.

2. TAXABLE INCOME.

10. Income derived from a source of wealth described in one or another of the seven schedules is either national or foreign according to the situation of its source or to the place where a business transaction is realised. In the case of a business enterprise, the income is definitely Mexican if derived through the activities of a permanent establishment in Mexico. Income from transactions which are casual or are not effected through a permanent establishment will, as a general rule, be regarded as taxable if the transaction was realised in Mexico — that is to say, if the contract was carried out in Mexico. If the contract involved the sale of goods, liability would

be incurred if delivery of the goods and the payment therefor were effected in Mexico. The place where the contract was concluded is of secondary importance.

3. ASSESSMENT OF TAX.

11. For the purposes of assessment, the taxpayer must file a declaration, but the requirements as to filing and the computation of the taxable income differ under the various schedules. Although required to file declarations, business men, industrialists and agriculturists are not required to pay income tax if their annual income does not exceed 10,000 pesos.

12. For the purposes of the law, the term " income " *(ingreso)* means every receipt in cash, in valuables or in credit which, under any of the provisions of the law, modifies the wealth of the taxpayer and is susceptible of being used by him without any obligation to return its value. The term " income " does not include receipts in the form of new acquisitions of capital, provided these acquisitions do not proceed from profits obtained in the year of taxation.

Schedule 1. — *Commerce.*

13. This schedule includes taxpayers which habitually or occasionally perform acts of commerce (Law, Articles 6 to 13). To clarify this rule, the administration issued a circular which states that foreign enterprises not maintaining stocks of merchandise in Mexico but effecting, through agents or representatives in Mexico, sales of merchandise situated abroad to be delivered abroad to the purchaser are not subject to tax on income derived from such transactions. The representative or agent in Mexico, however, is taxable on his commission, brokerage or other remuneration under this schedule (Circular No. 14, of August 24th, 1925 ; JIMENEZ, page 158).

14. The tax is computed on the difference between the items of income received by the taxpayer and the expenses, deductions and allowances for amortisation or depreciation pertaining exclusively to the enterprise authorised by the Regulations.

15. Taxpayers engaged in commerce, deriving an income greater than 100,000 pesos, must present at the tax office of the jurisdiction in which they are domiciled or have their principal establishment in Mexico a final return within three months following the date on which they close their annual accounts. If the annual income is 100,000 pesos or less, they will submit biennial declarations during the month of January of even years *(pares)*. The declaration must be accompanied by the following documents :

(1) An extract from the contracts for leasing the premises destined directly for the business ; for concessions obtained from the Federal Government, the States and municipalities for patents used, if any amount is paid to the owner, and of all other contracts and documents that justify any allowable deduction ;

(2) A summary of the number of employees or workers and their compensation ;

(3) A classified summary of the inventory made in accordance with the Regulations (Articles 15 to 20) ;

(4) With regard to the amounts deducted for amortisation and depreciation, the following information :

(a) A classified summary of investments and expense subject to amortisation ;

(b) A classified résumé of the value of property subject to depreciation ;

(c) A statement of the annual amounts amortised in previous years, and of that deducted in the year for which the declaration is made ;

(d) A statement of the annual amounts depreciated in previous years and of that deducted in the year for which the declaration is made.

16. In the returns, the taxpayers will give assurance that the information contained in the summary corresponds exactly to the entries in their books of account and to the documents used in making up the books, and that they have taken exact note of all the stocks and that all the costs are calculated in accordance with the Regulations.

17. Companies must deliver to the local tax office, once only, a résumé of the data required by paragraphs I to VIII of Article 95 of the Commercial Code. Companies engaged in insurance, bonding or banking, and other companies with a share capital must present a copy of their general balance-sheet and a profit-and-loss statement, as of the close of the period included in the return.

18. *Allowable Deductions.* — To compute the taxable profit, Article 28 of the Regulations provides that, from the gross income of the period included in the declaration, the following amounts may be deducted :

(a) The cost of the merchandise sold. — This cost is determined by adding to the amount of the inventory, made at the beginning of the year for which the declaration is made, the cost of the merchandise bought in this period (computed in accordance with Reg., Articles 17 to 20, see paragraphs 66 and 67) and from this amount is deducted the amount of the inventory made at the end of the year in question.

(b) An amount up to 5 per cent annually for amortisation of the investments or expenses described in Article 23 (see paragraph 70). — This deduction may be increased to 10 per cent for certain industries, or even to a greater amount in exceptional cases, provided the authorisation of the Department of Finance is obtained.

(c) An amount up to 10 per cent annually for depreciation of investments described in Article 24 (see paragraph 71). — This allowance may be increased to 20 per cent for certain industries or even to a greater percentage in exceptional cases, provided the authorisation of the Department of Finance is obtained.

(d) The rent paid for leasing real property used directly in the business, such as stores, offices, warehouses, factories, storerooms, lands and forests. — In case the property belongs to the taxpayer and is exclusively used in the business, there must be deducted as equivalent to rent an amount equal to the sum fixed for payment of the land taxes if this legal basis has been adopted for the payment of the land taxes, or of 6 per cent of the cadastral or fiscal value of such property, when such values serve legally as a basis for the payment of the same tax. If the property is owned by the taxpayer, but is used only in part for his business, the taxpayer must deduct an amount equivalent to the rent corresponding to the part used for the business, which is determined in a manner similar to that just described.

(e) The wages, salaries, commissions, and other compensation treated in schedules 6 and 7, when it is shown that the persons to whom these payments have been made have complied with the requirements of the respective schedules. — This deduction does not include amounts assigned to partners, directors and to managers and members of boards of directors, supervision and management *(comisarios)* of companies with share capital, or the salaries included in the cost price of merchandise and manufactured products.

(f) Amounts expended for social insurance, savings funds, labour accidents, workmen's insurance, schools belonging to the enterprise, workmen's assistance funds and others of a similar nature.

(g) Interest on capital borrowed and used for business purposes, provided the requirements of the fourth schedule are fulfilled.

(h) Premiums paid, except for maritime and transport insurance, for insurance against risks pertaining to the real and personal property of the enterprise and for the bonding of agents and employees, when paid by the taxpayer. — If the premiums are paid to foreign insurance companies not having a place of business in the Republic, this deduction must be justified by submitting documents bearing cancelled stamps representing the amount of the tax.

(i) Losses of property not covered by insurance.

(j) The normal expenses of the business, such as books, stationery, postage, telegrams, telephone, light and other office expenses.

(k) Taxes paid to the Federal Government, to the States and to the municipalities, excepting Customs and consular duties and the federal income tax. Income taxes paid to foreign Governments by Mexican enterprises are also deductible.

(l) Bad debts, legally irrecoverable.

The agents or representatives of foreign enterprises which are engaged exclusively in the purchase of goods for exportation must declare the total amount of their purchases. Similarly, the travelling salesmen, commission agents or employees of foreign companies must declare the total amount of sales made through them. For this purpose, they must keep a special book of orders in which will be noted in chronological order the operations made through them, a description of the merchandise sold, the sales price, the name and domicile of the purchaser and the number of the invoice, if any. They will keep their correspondence in accordance with the requirements of the Commercial Code.

Schedule 2. — Industry.

19. This schedule includes taxpayers engaged in any kind of an industrial enterprise. This schedule also applies if the owner of a mining concession exploits the mine himself (Circular No. 21-11-125 of April 1st, 1929 ; JIMENEZ, page 267). The taxable income is computed in accordance with the rules applicable to the commercial enterprises under Schedule 1, and the requirements concerning the declaration and supporting documents are the same.

20. *Allowable Deductions.* — From the total gross income received during the period for which the declaration is made, the following items are deductible :

(a) Cost of raw materials and manufactured articles sold during this period. — This cost is determined by adding to the value of the inventory, made at the beginning of the taxable period, the cost of raw materials purchased and articles manufactured during this period (computed according to Reg., Articles 17 to 20), and from this sum is deducted the value of the inventory made at the end of the period for which the declaration is made.

(b) Cost of conserving buildings, mines, tunnels, galleries, shafts, ways of communication and similar works, destined directly for use in the industry, without including therein expenditure for work (see paragraph 70).

(c) The cost of fuel, motive power and similar expenses required in running the machinery.

(d) Expenditure for social insurance, workmen's insurance, and similar outlay.

Schedule 3. — Agriculture.

21. This schedule applies to taxpayers engaged in any kind of agriculture. The net income is computed in accordance with the rules applicable to commerce in Schedule 1.

Schedule 4. -- Credits.

22. The taxpayers included in this schedule are those who normally or occasionally receive the following items of income :

(a) Interest on loans in general.

(b) Interest on amounts owed in payment of goods, excepting sales of merchandise or products with time payment *(hechas a plazo)* made by merchants, industrialists or agriculturists, and sales of real estate made by enterprises organised for this purpose and instalment sales *(ventas en abonos)*.

(c) Discounts or advance payments on titles or documents.

(d) Interest on bonds except bonds of the Mexican Public Debt, if the holders thereof are included in this schedule by virtue of any existing laws.

(e) Shares in corporations and ordinary or limited partnerships, bonds and any investment in foreign enterprises, when the latter are not subject to the Mexican income tax. Taxpayers who, in addition to their Mexican business, deal in bonds, shares and other securities must make a special return, in accordance with this fourth schedule, of the result of their operations (Reg., Article 38).

(f) The leasing of commercial, industrial or agricultural enterprises.

(g) Foreign companies deriving income from the leasing or exhibition of cinema films. The distributing or leasing enterprise in Mexico which pays to the foreign enterprise rent or royalties must withhold from such amounts this tax (6 per cent). The debtor must declare and pay, during the first ten days of each month, the amount withheld during the preceding month (Circular No. 59, of August 2nd, 1926 ; JIMENEZ, page 201).

(h) All other payments in the nature of interest, and income from operations or investment of capital, whatever they may be called, provided they are not included in another schedule of the law nor expressly excluded by the law.

23. *Exemptions.* -- The following, however, are excluded from liability .

(a) Rent from real property ;

(b) Interest paid to depositors by savings banks and by banking companies that operate in accordance with the Bank Law ;

(c) Interest and similar payments made to banks operating in accordance with the Bank Law, such enterprises being liable only to the tax on profits under Schedule 1 ;

(d) Premiums or other income received by bonding companies, such companies being taxable under Schedule 1.

24. *Allowable Deductions.* -- The tax is imposed on the gross amount of the income included under this schedule except that, in the case of leasing commercial, industrial or agricultural enterprises, the taxpayer may deduct from the leasing value the allowable deductions for amortisation or depreciation for the leasing of real or personal property.

25. *Payment of Tax.* -- The tax must be paid by the creditor, and any agreement to the contrary is void. The creditor who receives interest on a loan, represented by a public instrument, or which is payable at a fixed period greater than one year must give a stamped receipt in duplicate of the amount received, and must file, in the months of January and July, a statement of the interest obtained in the preceding half-year, together with a copy of each of the contracts and of the receipts given.

26. If the loan is for a year or less, and is represented by a private document, the tax is paid by cancelling stamps on the same document. If the creditor extends the term of the loan for a year or less, the tax is paid by cancelling stamps on the same document. If the loan is for an indefinite time, the creditor will stamp the document for an amount equal to the tax corresponding to the interest of a half-year, and if the loan continues beyond this time without a new document being made, the tax is payable by stamping within the first fifteen days from the beginning of each new half-year.

27. If the document representing a loan does not specify the rate of interest payable, or indicates a rate lower than 6 per cent or states that the creditor will receive no interest, the tax will be computed at the rate of 6 per cent annually on the capital. Exceptions to this rule include deposits made to guarantee contracts, provided no interest is payable thereon, deposits made in courts and those made in the Treasury of the Federal Government, of the States and of the municipalities. In the case of Mexican and foreign bonds, and bonds issued by banks and by public service enterprises and bearer bonds issued in conformity with the law on companies, the agreed interest serves as basis for the tax.

28. In the case of current accounts, the tax is calculated on the interest due half-yearly, or for the period of less than a half-year that the account has run. If the debtor credits interest to the account of the creditor, he must send him a notice and cancel affixed stamps to the value of the tax. This rule applies in the case of interest on current accounts, the tax being retained by the debtor.

29. When the taxpayer resides abroad, the debtor will retain the amount of the tax and deliver it to the Public Treasury, except that public service enterprises and those whose debts are guaranteed by the Federal Government may obtain an exemption from this obligation if they prove to the Finance Department that, in accordance with contracts concluded abroad and because of their economic situation or other reasons of this character, they are not in a position to effect the withholding ; in this case, however, such interest may not be deducted in computing the taxable profits (Reg., Article 52).

30. Credit institutions, banking companies, exchange and stock brokers who make payments for the account of others or receive, on commission for collection, coupons, dividends, bonds or any other instrument of credit, are required to retain the tax and are jointly liable with the recipient for the payment.

Schedule 5. - *Participations in Concessions.*

31. This schedule applies to the following taxpayers (Law, Articles 26 and 27) :

(a) Taxpayers who normally or occasionally receive participations, whether in the form of rent or any other form, derived from the exploitation of the subsoil or from concessions granted by the Federal Government, the States or municipalities. Taxpayers who receive such income in the form of a participation in the profits of the exploiting enterprise are excluded from this schedule.

(b) Taxpayers who transfer in any manner, wholly or in part, their ownership in a concession granted by the Federation, the States or the municipalities or the rights derived therefrom.

(c) Those that transfer their right to the exploitation of the subsoil.

32. The tax is levied on the gross income at the rate of 10 per cent. Taxpayers included in

paragraphs *(b)* and *(c)* above pay the tax rate of 10 per cent on the excess of the transfer price over the price of the concession or the rights of exploitation.

Schedule 6. — *Wages and Salaries.*

33. This schedule applies to taxpayers who, regularly or occasionally, receive wages, salaries or any other form of compensation for their personal services (Law, Articles 28 to 30). Salaries paid by foreign Governments to diplomats, consuls and other official representatives are exempt. The tax is levied on total monthly income less certain allowances for dependents : taxpayers resident in the Republic are allowed to deduct for one dependent, 20 pesos ; for two, 25 pesos ; for three, 30 pesos ; for four or more, 35 pesos. Taxpayers residing in the Federal District, in the cities near the United States, in Tampico, Vera Cruz, Tuxpan, Progreso, Merida and certain other neighbouring places, as well as those residing abroad are granted higher allowances for dependents, as follows : for one, 40 pesos ; for two, 50 pesos ; for three, 60 pesos ; for four, 70 pesos.

Schedule 7. — *Professions.*

34. This schedule applies to the following :

(a) Those who exercise a liberal, literary, artistic or unnamed profession.

(b) Those who exercise an art or office.

(c) Those who, without being included under the preceding heads, obtain income or gain through their skill, their knowledge or their ability, in any sport, spectacle or other occupation of a similar kind (Law, Articles 31 and 32).

Allowable Deductions. The net income is computed by deducting from gross income the following :

(a) Rent paid for premises used in the profession.

(b) Salaries of employees.

(c) Normal expenses for carrying on the profession, such as correspondence, telegrams, office expenses, light, telephone and the like.

(d) Participations in the honoraria obtained through professional associations which pay the tax collectively.

4. COLLECTION OF TAX.

(a) By Direct Payment.

35. The tax is assessed directly against the taxpayer who is engaged in commerce, industry, agriculture or a profession (Schedules 1, 2, 3 and 7). Likewise taxpayers receiving at their domicile or establishment in Mexico interest (Schedule 4), royalties or other income from the exploitation of the subsoil or concessions granted by the Federal Government, the States or the municipalities (Schedule 5) must pay the tax direct. The payment of tax is effected, to a certain extent, at the same time as the return is made.

36. Taxpayers engaged in commerce, industry or agriculture (Schedules 1, 2 and 3) must make a provisional return of their probable taxable profits and pay tax on this amount within the seventh month from the beginning of the accounting period which will serve as a basis in making their final return. The tax on the provisionally declared income is computed by first calculating the

percentage of taxable profit according to the previous definitive return to the total gross income in said return, and applying this percentage to the total gross income of the first six months covered in the provisional return.

37. From the amount of the tax payable on the basis of the definitive return, there is deducted the amount paid on the provisional return. If the provisional tax exceeds the amount of definitive tax owed, the excess will be reimbursed to the taxpayer.

Definitive returns are made by taxpayers to the local tax offices in the districts where they have their domicile or principal establishment in Mexico, as follows:

(a) Persons engaged in commerce and industry (Schedules 1 and 2) who receive annual income exceeding 100,000 pesos must present a definitive return within three months following the closing of their accounts. Agriculturists (Schedule 3) receiving annual income exceeding 100,000 pesos must present a definitive return within three months following the date on which they make their annual inventory (required by Reg., Article 15).

(b) Persons engaged in commerce, industry or agriculture (Schedules 1, 2 and 3) receiving annual income of 100,000 pesos or less, present biennial returns in the month of January of even years.

(c) Persons engaged in professions (Schedule 7) must make a six-monthly return in the months of January and July.

(d) Persons obtaining occasional income from commerce, industry and agriculture (Schedule 1) must present a return within ten days following the date on which they receive the income.

(e) Enterprises engaged in producing public spectacles (Schedule 1) at the beginning of their work must declare the duration of their activities and the number of performances.

(f) Lessors of industrial, commercial or agricultural enterprises (Schedule 4) must declare, within fifteen days after concluding the contract, the rent corresponding to the real or personal property and to the exploitation, and must pay the tax every six months by affixing stamps to a declaration presented in January and July of each year.

(g) Agents or representatives of foreign enterprises engaged in purchasing articles for exportation (Schedule 1) will make a return in the months of July and January of the total amount of their purchases during the first and second half of the year respectively.

(h) Agents or representatives of navigation companies (Schedule 1) will make a return in the months of January and July of the total receipts from passengers and merchandise embarked from Mexican ports during the preceding six months.

(i) Taxpayers, who close their establishments or businesses, must present, within ten days, a notification of the exact date of closing. At the same time, they must present separately a return relative to the period included between the last return and the time of closing. Persons engaged in commerce, industry or agriculture receiving annual income of 100,000 pesos, must present the declaration just mentioned within ninety days following the date of the definitive close. If the return on closing embraces an irregular period, the tax is calculated as if the period were a year, and the liquidation of the same is made proportionately to the months transpired.

38. The returns are signed by the taxpayer or his authorised representative. Taxpayers engaged in commerce, industry or agriculture receiving income from two or more businesses included in the same schedule will make respective returns comprising the total of the income received through said businesses. If an enterprise has various branches, it must declare the total income of the enterprise at the tax office situated in the district of the head office of the enterprise.

39. When several companies have a distinct legal entity but carry on business relations in such a way that they merge their accounting, their management, and carry out their transactions in common, they may make, provided previous notice is given to the Finance Department, returns of the total income received from such companies ; but, once this form of return has been adopted, they cannot modify it without the previous permission of the Finance Department.

40. No final return may include a period greater than twelve months. Taxpayers must notify the local tax office within ten days when they begin business, change the purpose of their business, their name, company name, domicile, or alter the capital of the company.

41. The tax is paid by cancelling stamps affixed to the declarations, receipts or pertinent documents. The tax may also be paid in cash or drafts or certified cheques.

(b) BY WITHHOLDING AT THE SOURCE.

42. Tax is paid by withholding at the source under Schedule 4 when interest is paid to a creditor who does not himself acquit the tax, and, in any event, when the creditor is outside Mexico ; under Schedule 5, when the recipient of mining royalties or similar income is outside Mexico ; and under Schedule 6, whenever an employer in Mexico pays wages, salaries, etc. The taxpayers who retain any amount of tax must make a monthly return of the amounts withheld, indicating the schedule under which it was withheld, and will pay the tax as previously described.

43. The following are required to withhold the tax, and are jointly liable with the taxpayers for its payment :

(1) Credit institutions and banking companies, stockbrokers and those who pay for the account of others, or receive on commission for collection, coupons, dividends, part-interests, bonds or any other instruments of credit, security or title of investments in foreign enterprises not themselves subject to the Mexican tax law.

(2) Debtors of interest in accordance with the Regulations. Public service enterprises and those whose debts are guaranteed by the Federal Government may be exempted from this obligation if they prove to the Finance Department that, in accordance with contracts concluded abroad in virtue of their economic situation or other reasons of this nature, they are not in a condition to withhold the tax. In this case, they may not deduct the interest in computing their taxable income (Law, Article 36).

(3) Employers and those paying wages, salaries, emoluments, pensions or any other type of income included in Schedule 6 are required to deduct the corresponding tax, and declare and pay over this amount, as described above, to the local tax office (Law, Article 35).

5. PROCEDURE IN ASSESSMENT AND APPEALS.

44. The return of income submitted to the local tax office [1] is referred to a Board of Assessment *(Junta calificadora)* attached to the tax office (see paragraph 5). The Board of Assessment may require of the taxpayer whatever data it may consider necessary in making the assessment, and it must make the assessment within one year after the taxpayer has submitted his return.

45. If the taxpayer wishes to contest the assessment, he may, within twenty days, appeal to the Board of Revision. On the other hand, the Income-Tax Department of the Finance Ministry may appeal against the assessment fixed by the Board of Assessment to the Board of Revision (see paragraph 5). The decision of the Board of Revision is final.

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[1] Failure to make returns in the period required, evasion of tax through false declaration or book-keeping and other infringements of the law are subject to fines which range, on the average, from 10 to 1,000 pesos.

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

1. Definition and General Principles.

46. For the purposes of this report a foreign enterprise may be defined as one belonging to a company organised under the law of a foreign country, to a partnership organised in a foreign country, or to an alien individual domiciled in a foreign country [1]. The concept of the real centre of management is unknown in Mexican law. Consequently, if a company organised under the law of a foreign country had, in fact, its real centre of management in Mexico, it would nevertheless be treated as a foreign enterprise.

47. A foreign enterprise is taxable on income from sources of wealth situated in Mexico, and on income from transactions realised in Mexico. The liability is incurred if the foreign enterprise has a permanent establishment in Mexico, or even if it realises casual transactions in Mexico. For casual transactions, the law authorises a flat rate of tax applicable to each transaction. The question as to whether a foreign enterprise has a permanent establishment in Mexico is important in connection with the method of collecting tax under the fourth schedule. If the foreign enterprise receives directly interest of any kind, for example on bonds or unsecured loans, the debtor is required to withhold the tax. On the other hand, if such income is payable to the local establishment of the foreign enterprise, and if such establishment declares the income and pays the tax, the debtor is not required to deduct the tax.

2. Taxation of Certain Kinds of Income.

(a) *Dividends.*

48. The profits of a Mexican company being taxed as such, no tax is imposed on dividends when distributed, and the foreign enterprise receiving them is not liable to any tax in their respect.

(b) *Interest.*

49. Interest on bonds and loans, secured or unsecured, is taxable under the fourth schedule, the tax being withheld by the debtor when paid to the foreign enterprise which has no permanent establishment in Mexico. If the interest is paid to a local establishment of the foreign enterprise, tax is not withheld, provided the local establishment declares the income and pays the tax.

[1] If the individuals are Mexican citizens, they are taxable in respect of their total income regardless of where they may be resident.

(c) *Directors' Percentages* (Tantièmes).

50. The allotment of profits to directors is not taxed as such, but is included in the taxable income of the company.

(d) *Royalties for Use of Patents, Copyrights, Trade-marks, Secret Processes and Formulæ, and Similar Income.*

51. Such income is taxable under the fourth schedule, in the same manner as interest.

(e) *Rents from Real Estate, Mining Royalties and Similar Income.*

52. Rents from real estate are not subject to the income tax, the real estate itself being subject to local property taxes imposed by the States and municipalities.

53. Mining royalties are taxable under the fifth schedule, the tax being withheld by the debtor.

(f) *Gain derived from the Purchase and Sale of Real Estate, Securities and Personal Property.*

54. If a foreign enterprise is engaged in the business of dealing in real estate, securities, or other kinds of property, it is liable to tax even on a single transaction, provided it is an act of commerce as defined in the Commercial Code. In practice, however, the foreign enterprise which bought and sold in Mexico real estate or securities would probably not be assessed to tax unless it did so through a local establishment. The purchase and sale of personal property in Mexico is subject to Article 12 of the Law, which states that the taxable profits obtained from even an occasional act of commerce are subject to a flat rate (see Schedule 1). No tax is levied if it is not an act of commerce -- *i.e.*, if the sale is not made for the purpose of gain.

(g) *Salaries, Wages, Commissions and Other Remunerations for Services.*

55. Such income is taxable under Schedule 6. If the foreign enterprise sends employees or officials to Mexico, they are taxable on their remuneration from the time of their arrival. A local establishment of the foreign enterprise is required to deduct wages or salaries paid to employees or workers, declaring the same and remitting the withheld amount monthly to the tax office. Salaries paid in foreign money are reduced to Mexican money for tax purposes at the official rate of exchange in force on the date of payment.

(h) *Income from a Trust.*

56. The trust as known in Anglo-Saxon law does not exist in Mexico.

(i) *Income from carrying on a Business or Industry.*

57. A foreign enterprise is taxable on income from transactions realised in Mexico, whether the transactions are occasional or are carried out regularly through an agent or Mexican establishment belonging to the foreign enterprise. The test of liability is therefore whether or not the transaction has been *realised* in Mexico. In the practice of the administration and in the unpublished jurisprudence of the Board of Revision, the realisation of a transaction is generally interpreted as meaning the delivery of the merchandise and the payment of the price, rather than the conclusion of the contract regarding such sale and payment. In consonance with this theory, if the foreign enterprise, in pursuance of a contract for the sale of goods to a Mexican customer, makes delivery

abroad, for example, ships f.o.b. foreign port, and receives payment abroad, the foreign enterprise would not incur liability, even though the sales contract were closed by a travelling representative in Mexico, or even by an agent in Mexico whose power is limited to forwarding orders for merchandise, or even closing contracts for the sale thereof.

58. The attitude of the administration has been explained in a circular which states that, if a foreign enterprise has in Mexico a representative or agent but maintains no stock of merchandise in Mexico and only sells from merchandise kept abroad and which will be delivered abroad to the customer, the foreign enterprise will not be taxable on the profits from the sale brought about through the medium of the agent or representative. The latter is, however, taxable on his commissions or other income (see paragraph 13).

59. In the light of these principles, as a general rule, a foreign enterprise will not be held liable to the Mexican income tax if it markets its products through :

(a) *A local commission agent or broker ;*

(b) *A local dealer or distributor* who has the exclusive right to handle a line of goods, but buys or resells them for his own account ;

(c) *A travelling salesman*, whether or not having the power to conclude a contract ;

(d) *A local agent with a power of attorney* which merely authorises him to represent the foreign enterprise in closing contracts, but provided he does not make sales out of a locally maintained stock of goods.

60. On the other hand, liability will be encountered if a foreign enterprise markets its products through :

(e) *An agent selling out of a stock in Mexico belonging to the foreign enterprise ;*

(f) *A permanent establishment of any kind.*

B. NATIONAL ENTERPRISES.

61. For the purposes of this report, a national enterprise may be defined as one belonging to a company or partnership organised in Mexico or belonging to Mexican citizens.

62. A national enterprise is taxable in respect of income from all sources, domestic and foreign. If a Mexican enterprise has a branch in a foreign country, the tax paid on its income derived therein may be deducted from the gross income of the Mexican enterprise.

63. The general principle enunciated above, which is contained in Article 1 of the Law, may be supplemented by Article 20 (VIII), regarding the fourth schedular tax, which holds taxable income from shares and participations of any kind in companies or partnerships, as well as interest on bonds or any other investments in foreign enterprises which are not themselves subject to the Mexican law. National enterprises which, beside their principal business, invest in bonds, shares or other securities, must make, not only the usual declaration of profits, but also a special declaration of income from transactions in such securities (Reg., Article 38).

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

I. GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

(a) Book-keeping and Accounting Requirements.

64. The Mexican Income-Tax Law requires that all taxpayers, except those included in Schedule 6 (recipients of salaries, etc.), keep books of account prescribed by the Regulations (Article 33). The Regulations state that persons engaged in commerce and industry must keep the books of account prescribed in the Commercial Code when their working capital *(capital en giro)* exceeds 5,000 pesos, and only a book of items of income and expense when the capital is less. The books required by the Commercial Code (Article 33) are the following : the day-book or journal *(libro general de diario)* ; the ledger *(libro mayor)* ; the book of inventories and balances *(libro de inventarios y balances)* ; and companies with share capital must keep books of company acts *(libro de actos)* - for example, decisions of directors and of general meetings of shareholders.

65. Persons engaged in agriculture must keep the same books when their working capital exceeds 10,000 pesos, after deducting the cadastral value of the real property destined for use in the exploitation ; if the capital is less, they must keep a book of items of income and expense. Taxpayers included in the fourth and fifth schedules (creditors and participants in concessions), receiving items of income in excess of 2,000 pesos annually, must maintain at least a book of income and expenditure. Persons included in Schedule 7 (professions) must in any event keep a book showing items of income and expense (Reg., Article 13).

66. The above-mentioned books must be legalised by the Tax Collector's office *(Oficina receptora)* of the district in which the taxpayer is situated. The taxpayers who are required to keep the books of account prescribed by the Commercial Code must make in them the respective entries *(asientos)* within sixty days following the date of the transaction, and must always refer to said date. Those who are required to keep a book of income and expenditure may make the entries within thirty days following that on which the transaction was completed. Taxpayers deriving income from the production, transformation or sale of raw materials extracted from immovable property *(inmuebles materias primas)*, merchandise, natural products, live-stock *(semovientes)* and fruits must make an annual inventory of the stocks maintained (Reg., Article 15). The inventory must state in detail the separate stocks of goods and their cost. For manufactured products, the cost includes the amount paid for raw materials and for labour. For merchandise, the cost is the net price of acquisition plus freight, transportation, insurance and the necessary expenditures of agents and commission agents and Customs and consular duties. For fruits and natural products or live-stock, the preceding rule applies if the taxpayer acquires them from third parties ; if the taxpayer produces them himself, they will be valued at the price prevailing in the region for wholesale *(al mayoreo)* and cash transactions in such products.

67. If a taxpayer acquires different shipments of a raw material without being able to determine separately the cost of each shipment, he will divide the total cost between them according to his ordinary practice, allotting to each the corresponding part of the total cost (Reg., Article 19). If the taxpayer lists in his inventory a lot of merchandise or articles of the same class that he has acquired or produced at different prices and in different parcels, the cost will be the average price of the different acquisitions.

68. Instalment sales are subject to special requirements. By instalment sale *(venta en abonos)* is meant every transaction in which the ownership of an article may be acquired through periodical payments and provided the amount which must be covered by the different payments represents at least 75 per cent of the total amount of the transaction. Taxpayers who sell exclusively on the instalment plan or have a department for that purpose must observe the following rules : (1) they must keep a book in which is indicated the cost of the goods sold in each transaction, the total amount, and the estimated profit ; (2) they must determine annually the average profit estimated for transactions realised during the year in accordance with the information contained in the previously described book ; (3) they must keep separately the accounts of the payments that have been made with regard to the operations realised in each year.

69. When the taxpayer is not engaged exclusively in instalment selling, but has a department for that purpose, he will calculate his profits in accordance with the preceding rules and add the amount to the general profits of his business in order to calculate the amount of tax.

70. The only deductible expenditure for maintenance are the amounts paid for maintaining the assets of the enterprise in a good working condition without adding a new value to such assets. The following rule applies to amounts expended in the restoration or reconstruction of property. Taxpayers engaged in commerce or industry or in the leasing of commercial, industrial or agricultural enterprises *(negociaciones)*, in order to take the allowable deduction for amortisation[1] *(amortización)*, must enter in their accounts the investments *(inversiones)* and expenses exclusively incurred in connection with or for the purpose of the business, whose utility disappears during its course or at its close, and which constitutes an investment of fixed capital — such as outlays for the constitution of companies, the organisation of the enterprise, installation of the business ; payments for the granting of goodwill *(credito mercantile)* ; cost of acquisition of concessions, patents for inventions, trade-marks, or copyrights for literary and artistic property, acquisition of forests, sand or stone quarries ; cost of acquisition of land for ways of communication ; expenses for the making of plans or designs, for the execution of permanent and necessary improvements which are not the property of the taxpayer and which, in conformity with leasing agreements, remain the property of the lessor ; costs of construction, enlargement and permanent improvement of buildings which, because of their structure or special constitution, can only be used for the commercial or industrial purposes for which they are destined ; cost of construction of conduits, canals, ditches *(bordos)*, and aqueducts, of ways of communication (with regard to material employed as well as labour, when it is a matter of making new ways or their entire replacement, but not their reparation) ; cost of installation of machinery, storage tanks and piping for water or oil (Reg., Article 23).

71. Taxpayers engaged in commerce, industry or agriculture or in the leasing of enterprises must, in order to take advantage of the allowable deduction for depreciation *(depreciación)*, inscribe in their accounts the amounts invested in the acquisition of property which deteriorates through use, the action of time, work or obsolescence *(incostabilidad)*, provided that this property is used exclusively in the exploitation and may be realised separately, such as : furniture and fixtures,

[1] The term " amortisation " applies to cost of installation or cost of organisation of company.

machinery, vehicles, apparatus, scientific instruments, posts, cables, storage tanks, pipes for supplying water or oil, and working animals which do not constitute the object of the exploitation (Reg., Article 24).

72. Persons engaged in commerce, in claiming the allowance of up to 5 per cent, and by special authorisation in the case of certain industries, of up to 10 per cent for amortisation of the investments or expenditure described above, and in order to claim the depreciation allowance of up to 10 per cent, or if authorised in the case of certain industries, of up to 20 per cent (Reg., Article 28), must observe the following rules :

(1) The amounts representing amortisable or depreciable investments must be entered in the books of account, or in the book of income and expenditure, according to the case, at the original value of the investment.

(2) For fiscal purposes, the amortisation and the depreciation will be calculated by applying a fixed and constant percentage to the total investment. The percentage will be selected by the taxpayer or fixed by the Department of Finance, within the above-indicated limits, in accordance with the nature of each exploitation.

(3) The investments or expenditure considered as amortisable or depreciable will be redeemed, for fiscal purposes, within the period resulting from the application of this percentage, except when a higher percentage of amortisation or depreciation has been accepted by the Finance Department. After the expiration of that period, the taxpayer may not make any deduction for amortisation or depreciation in his declaration, which would correspond to investments already redeemed for tax purposes.

(4) The amounts allowed for amortisation or depreciation in the preceding sub-paragraph as deductions in the declaration must be entered in the books of account or in that of income and expenditure, according to the case, in the same amount as appears in the declaration.

(5) In every case, the deductions for amortisation or depreciation will be computed on the original value of the unredeemed investment (Reg., Article 24 *bis*).

73. If a business is liquidated, without its investments subject to amortisation or depreciation having been completely amortised or depreciated, it may deduct in its last declaration the balance to be amortised or depreciated and will consider as profit the commercial value of the assets involved at the date of liquidation. If, on liquidating the business, said investments have already been completely amortised or depreciated and there exists some assets which may be realised by sale, the taxpayer should indicate expressly in his last declaration, as taxable profit, the commercial value that they represent on the date of liquidation (Reg., Article 25).

74. In case an enterprise occupies property which should be included in the accounts of amortisable capital or of depreciation, but which does not belong to the taxpayer because of being leased, it is incumbent upon the owner of such property to declare the income therefrom and to produce the accounts of amortisable capital and of depreciation of such property (Reg., Article 26).

75. In addition to the above articles contained in the Income-Tax Regulations, various circulars interpreting or amplifying the provisions in the articles have been issued from time to time.

(b) Methods of Allocation.

1. *Method of Separate Accounting.*

76. The income of a foreign enterprise derived from sources situated within or from transactions realised within the territory of Mexico is taxed on the basis of the separate accounts which the

enterprise must keep in accordance with the provisions previously described. The policy of the administration is to tax the local branch as if it were an independent enterprise and on the basis of its accounts. It is only when such accounts are inadequate, or are not produced, that the local assessment board *(Junta calificadora)* resorts to making an estimative assessment.

77. The Mexican Income-Tax Law does not contain any principles of apportionment, but requires that the accounts of the Mexican branch reflect the entire net income pertaining to the business in Mexico — that is to say, in the case of an industrial and mercantile enterprise, the total difference between receipts and allowable deductions. There is no distinction between buying profit, manufacturing profit, and selling profit. If a foreign enterprise manufactures abroad and sells in Mexico, the total profit realised in Mexico is taxable, without any allowance for a manufacturing profit allocable to the factory abroad. Inversely, if an enterprise manufactures in Mexico and sells abroad, the total net profit, including what might be considered a foreign sales profit, is taxable within the Republic, but the tax paid abroad on the income derived there is deductible from gross income.

2. *Empirical Methods.*

78. If the local assessment board, to which the declaration of the taxpayer is referred, is not convinced of the accuracy of the declaration, as supported by the balance-sheet and profit-and-loss statement submitted, it ordinarily resorts to making an assessment based on exterior signs, for example, the size of the establishment, its turnover, the amount of capital invested, the number of employees and the salaries paid them. If the taxpayer accepts this assessment, further enquiry is seldom made. If the taxpayer considers it to be excessive, he may appeal against it within twenty days to the Board of Revision *(Junta revisora)*. This Board will reduce the assessment, only if the taxpayer produces all the accounts and other information necessary to prove that the true income is lower in amount.

3. *Method of Fractional Apportionment.*

79. This method is not employed, as it is contrary to the essential spirit of the Mexican law. The Assessment Board looks to the sources of income within Mexico without considering their place or importance in the world activities of the enterprise.

4. *Requirements for Selection of Methods and Value of the Various Methods.*

80. The method of separate accounting is the one intended by the law and it is always employed, unless the insufficiency of the declaration and accounts of the taxpayer forces the Assessment Board to resort to an empirical assessment.

(c) Apportionment between Branch and Parent Enterprise.

1. *Apportionment of Gross Profit of Local Branch to Real Centre of Management abroad.*

81. As the tax is imposed upon the entire net profit from Mexican sources, no part of the profit is allocated to the real centre of management in a foreign country. The importance of the part that the real centre of management abroad may have played in earning the profit realised by the Mexican branch is not considered.

2. *Apportionment of Expenses of Real Centre of Management to Branch.*

Interest Charges.

82. If a foreign enterprise has a general debt, whether or not represented by bonds,

and definitely uses a part of the borrowed funds for its branch in Mexico, the interest paid on such part by the branch may be deducted from its profits, provided the tax imposed on interest by Schedule 4 is withheld.

General Overhead.

83. No deduction of a proportionate part of the general overhead of the real centre of management abroad is allowed against the gross profits of the local branch.

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

84. As the branch in Mexico is taxed independently of the rest of the enterprise abroad, no account is taken of profit or loss of the enterprise as a whole in assessing the branch.

(d) Apportionment between Parent Enterprise and Subsidiaries.

85. A company organised under Mexican law, which is a subsidiary of a foreign company, is taxed as an independent Mexican company on the basis of its own accounts. If the declaration and accounts of the subsidiary are insufficient, the Assessment Board may make an empirical assessment, subject to appeal to the Board of Revision within twenty days, in the same manner as has been described in connection with branches.

II APPLICATION OF THE METHODS OF ALLOCATION IN SPECIFIC CASES

(a) Industrial and Commercial Enterprises.

1. *Selling Establishments.*

Local Establishments selling in National Market.

86. A foreign enterprise which sells at its Mexican establishment goods which have been *(a)* manufactured abroad, or *(b)* bought abroad, or *(c)* in part manufactured and in part bought abroad, is subject in every case to tax on the entire profit in excess of the cost of the goods and other allowable deductions. In other words, no allowance is made for a foreign manufacturing or buying profit. The tax return for enterprises deriving a profit of over 100,000 pesos calls for a statement of cost of the goods, as well as the receipts derived from their sale. In practice, the price at which goods have been invoiced to the local branch by the foreign enterprise is taken as the cost price, especially if it has served as the basis of payment of Customs duties. This price is not conclusive, however, and if the Assessment Board considers it necessary, it will request full information as to the foreign cost of manufacture or purchase.

87. Travelling salesmen, commission agents or employees or companies domiciled abroad must declare the total amount of sales made through them. For this purpose, they must keep a special book of orders in which they enter chronologically the transactions effected through them, specifying the merchandise sold, the sale price, the name and domicile of the purchaser and the number of the invoice, if any. They must keep, furthermore, their correspondence in accordance with the requirements of the Commercial Code (Reg., Article 40 *bis*). [1]

[1] Representatives or agents of foreign houses are required to pay the income tax under Schedule 1 of the Law in respect of their commissions and any other compensation received for their services The foreign undertakings which they represent, which do not maintain stocks of merchandise in the country and only make sales from goods in stocks situated abroad and to be delivered abroad to purchasers, are not subjet to payment of the tax on the profits made on such sales (Circular No. 14, of August 24th, 1925 ; see Jimenez, page 158).

Local Establishments selling abroad.

88. If a foreign enterprise with its real centre of management in a foreign country has a branch in Mexico which makes sales in a third State in which the enterprise has no permanent establishment, the profits derived from the sales in the third State will be ascribed to the branch in Mexico if they have been realised through its activities — that is to say, if the contract of sale has been made there, or if the delivery of the goods or the payment therefor has been effected there.

2. *Manufacturing Establishments.*

89. If a foreign enterprise manufactures goods at its factory in Mexico for exportation and sale at another establishment in a foreign country, the whole of the profit derived from the manufacture and sale is taxable in Mexico. If goods have been invoiced from the factory to the foreign sales branch, in practice the invoice price may be taken as indicative of the gross receipts of the local factory, provided it affords a reasonable factory profit. The invoice price is not conclusive, however, and the authorities may require full information as to the eventual sale price of the goods exported in order to calculate the total net profit allocable to Mexico.

3. *Processing Establishments.*

90. If a foreign enterprise produces goods in one foreign country, processes them at an establishment in Mexico and ships them to an establishment in a third country for further processing and sale, the profit attributable to the processing establishment will be computed in the same way as has been described above in connection with a local manufacturing establishment.

4. *Buying Establishments.*

91. No attempt is made to compute a buying profit as such, but, under Article 9 of the Income-Tax Law, agents and commission agents and representatives of foreign enterprises who purchase articles for exportation pay a tax of 0.5 per cent on the total amount of their purchases. They must make a declaration, in the months of July and January, of the total amount of their purchases during the first and second half-years respectively. Purchases made direct from abroad, even from a local subsidiary, are not taxable.

5. *Research or Statistical Establishments, Display Rooms, etc.*

92. If a foreign enterprise has an establishment in Mexico which does not directly engage in any profit-making transactions, but renders services to the enterprise which contribute indirectly to the realisation of profit — *e.g.*, a statistical bureau, a display room — in principle no profits will be ascribed to it, but the enterprise will be taxable on any profit realised in Mexico at another establishment or through an agent or employee.

(b) Banking Enterprises.

93. The branch in Mexico of a foreign bank is taxable on its receipts, less allowable deductions. In practice, foreign banks allot to the local branch a sufficient capital and the branch is carried on, and its books are maintained, as if it were an independent bank. The branch charges the foreign parent for collection or for other services rendered to it. Interest paid by the branch to the foreign bank is subject to the Schedule 4 tax by withholding at source. The balance-sheet and other accounts of the branch are examined by official bank examiners, and their determination of the income of the branch is accepted by the tax authorities.

(c) Insurance Enterprises.

94. The profit of a Mexican branch of a foreign life insurance company is computed from its profit-and-loss statement, in accordance with the insurance law and the provisions regarding deductions in Article 28 of the Regulations. The taxable profit of the local establishment or agency of companies engaged in other kinds of insurance is ascertained from its profit-and-loss statement which shows the reserves on premiums of the previous year, the amount of the premiums due in the current year and all the other items of income corresponding to the same period from which are deducted the amounts actually paid in indemnities, together with the premium reserves of the year to which the declaration refers and the amount of the expenses allowed under Article 28, paragraphs II and XII of the Regulations (see Part I, paragraph 18). The premium reserves last mentioned may not exceed the premiums corresponding to the year in question and they may only be deducted if it is shown that the amount of such reserves is maintained in the country.

(d) Transport Enterprises.

95. In the case of foreign railroad companies operating within and without Mexico, the taxpayer keeps accounts of amounts received for transportation in Mexico, and from these receipts are deducted the expenses pertaining to the operation of the railroad in Mexico. Similarly, the Sleeping-Car Company pays tax on the basis for receipts for accommodation in Mexico, less expenses relating thereto.

96. Maritime navigation companies having branches in Mexico are taxed on the net income resulting from subtracting from amounts received in Mexico, in payment for freight or passages, the expenses of the local branch together with a certain portion of the expense incurred in operating the ships outside Mexican waters. The determination of this portion gives rise to difficult questions of apportionment, and these cases are generally appealed to the Board of Revision for final determination. If the foreign steamship company has no branch in Mexico, but sells tickets through an agent, a stamp tax is paid on the amount of the ticket.

97. Air navigation companies are taxed in a manner similar to maritime navigation companies — that is, on amounts received in Mexico less expenses allocable to Mexico.

(e) Power, Light and Gas Enterprises.

98. The administration has never had occasion to formulate any special method for apportioning the profits of such enterprises. In some instances, companies in a contiguous country sell power, light or gas to another company across the border in Mexico, and the latter is taxed on its receipts less the prices paid for power, light or gas, and other expenditure.

(f) Telegraph and Telephone Enterprises.

99. The telegraph belongs to the State, but the private telephone enterprises are taxable on the basis of their separate accounts showing receipts in Mexico, less expenses.

(g) Mining Enterprises.

100. Foreign enterprises carry on mining in Mexico through local companies, and the profit from mining is shown by the books of the Mexican company. It is ordinarily the difference between

the price received for the minerals or oils on the world markets, less the cost of extraction and other deductible expenses. As, under the Mexican constitution, the subsoil belongs to the State, the local company receives only a concession to extract the oil or mineral, and is not allowed any deduction for depletion. [1]

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

I. GENERAL METHODS OF ALLOCATION.

101. An enterprise belonging to a Mexican company or to Mexican citizens, singly or in partnership, is taxable on the whole of its profits derived from operating abroad as well as in Mexico. Consequently, there is no question of allocation or apportionment. The declaration of the taxpayer, as supported by its accounts, is taken as the basis of assessment, subject of course to verification, and, if necessary, to the making of an empirical assessment.

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

102. A Mexican company and Mexican citizens are taxable on the whole of their business profit, and consequently there is no question of any special allocation of profit to the real centre of management of their enterprise in Mexico. If a company organised abroad has its real centre of management in Mexico, it would be taxable on income from transactions realised by such an establishment, but otherwise no income would be allocated to the establishment by reason of management alone.

C. HOLDING COMPANIES.

I. NATIONAL HOLDING COMPANY CONTROLLING ONE OR MORE FOREIGN SUBSIDIARY COMPANIES.

103. The Mexican holding company would be taxable on dividends, interest, or other income received from the foreign subsidiaries.

II LOCAL SUBSIDIARY COMPANY CONTROLLED BY A FOREIGN HOLDING COMPANY.

104. Dividends paid by a local subsidiary to a foreign holding company are not subject to any special tax, but interest paid by the local company in respect of bonds issued to the foreign holding company, or loans obtained from the foreign holding company, is subject to withholding of tax by the debtor.

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[1] In addition to the income tax, special taxes are levied on the production and exportation of minerals and oil.

Annex.

TABLE OF TARIFFS.

The Law of March 31st, 1925, as amended, herein referred to by the word " Law ", authorises the following rates :

Schedule 1. — *Commerce.*

Rates for taxpayers receiving annual income greater than 10,000 pesos :

	Annual taxable income				Rate per cent
For the fraction between	0.01	pesos and	2,000.00	pesos	Exempt
,, ,, ,, ,,	2,000.01	,, ,,	5,000.00	,,	2.00
,, ,, ,, ,,	5,000.01	,, ,,	10,000.00	,,	2.50
,, ,, ,, ,,	10,000.01	,, ,,	15,000.00	,,	3.00
,, ,, ,, ,,	15,000.01	,, ,,	20,000.00	,,	3.50
,, ,, ,, ,,	20,000.01	,, ,,	30,000.00	,,	4.00
,, ,, ,, ,,	30,000.01	,, ,,	40,000.00	,,	4.50
,, ,, ,, ,,	40,000.01	,, ,,	50,000.00	,,	5.00
,, ,, ,, ,,	50,000.01	,, ,,	60,000.00	,,	5.50
,, ,, ,, ,,	60,000.01	,, ,,	70,000.00	,,	6.00
,, ,, ,, ,,	70,000.01	,, ,,	80,000.00	,,	6.50
,, ,, ,, ,,	80,000.01	,, ,,	90,000.00	,,	7.00
,, ,, ,, ,,	90,000.01	,, ,,	100,000.00	,,	7.50
,, ,, ,, ,,	100,000.01	,, ,,	150,000.00	,,	8.00
,, ,, ,, ,,	150,000.01	,, ,,	200,000.00	,,	8.50
,, ,, ,, ,,	200,000.01	,, ,,	250,000.00	,,	9.00
,, ,, ,, ,,	250,000.01	,, ,,	300,000.00	,,	9.50
,, ,, ,, ,,	300,000.01	,, ,,	350,000.00	,,	10.00
,, ,, ,, ,,	350,000.01	,, ,,	400,000.00	,,	10.50
,, ,, ,, ,,	400,000.01	,, ,,	450,000.00	,,	11.00
,, ,, ,, ,,	450,000.01	,, ,,	500,000.00	,,	11.50
,, ,, ,, ,,	500,000.01	,, ,,	over		12.00

Corporations and all kinds of companies or associations subject to this schedule are not entitled to the exemption of 2,000 pesos, but pay the rate of 2 per cent on the fraction between 0.01 (1 centavo) and 5,000 pesos. (Law, Article 8, as amended by Decree of December 23rd, 1931.)

Agents and commission agents purchasing articles for exportation pay, on the gross amount of their purchases, 0.5 per cent (Law, Article 9).

Persons effecting occasional acts of commerce *(e.g.*, sale for profit) pay on the taxable profit of each operation, 4 per cent.

Schedule 2. — Industry.

The scale of rates given in schedule 1 is also applicable in this schedule (Law, Article 15).

Persons effecting occasionally an industrial transaction pay, on the taxable profit thereof, the rate of 4 per cent.

Schedule 3. Agriculture.

The rates applied under this schedule are the same as those applied above under schedule 2 (Law, Articles 18, 19).

Schedule 4. - Credits.

Rate 6 per cent (Law, Article 21).

Schedule 5. - Participations in Concessions.

Rate 10 per cent (Law, Article 27).

Schedule 6. - Wages, Salaries, etc.

Taxable monthly income								Rate (per cent)
For the fraction between				0.01	pesos and		170.00 pesos	Exempt
,,	,,	,,	,,	170.01	,,	,,	200.00 ,,	1.3
,,	,,	,,	,,	200.01	,,	,,	300.00 ,,	1.4
,,	,,	,,	,,	300.01	,,	,,	400.00 ,,	1.5
,,	,,	,,	,,	400.01	,,	,,	500.00 ,,	1.6
,,	,,	,,	,,	500.01	,,	,,	600.00 ,,	1.7
,,	,,	,,	,,	600.01	,,	,,	700.00 ,,	1.8
,,	,,	,,	,,	700.01	,,	,,	800.00 ,,	1.9
,,	,,	,,	,,	800.01	,,	,,	900.00 ,,	2.0
,,	,,	,,	,,	900.01	,,	,,	1,000.00 ,,	2.1
,,	,,	,,	,,	1,000.01	,,	,,	1,500.00 ,,	2.6
,,	,,	,,	,,	1,500.01	,,	,,	2,000.00 ,,	3.1
,,	,,	,,	,,	2,000.01	,,	,,	2,500.00 ,,	3.6
,,	,,	,,	,,	2,500.01	,,	,,	3,000.00 ,,	4.1
,,	,,	,,	,,	3,000.01	,,	,,	4,000.00 ,,	4.6
,,	,,	,,	,,	4,000.01	,,	,,	over	5.0

(Law, Article 30.)

Schedule 7. — Professions.

Scale A.

I. Persons engaged in liberal, literary, artistic or unnamed professions.

II. Those exercising an art or office.

	Half-yearly income				Rate (per cent)
For the fraction between	0.01	pesos and	1,000.00	pesos	Exempt
,, ,, ,, ,,	1,000.01	,, ,,	1,200.00	,,	1.3
,, ,, ,, ,,	1,200.01	,, ,,	1,800.00	,,	1.4
,, ,, ,, ,,	1,800.01	,, ,,	2,400.00	,,	1.5
,, ,, ,, ,,	2,400.01	,, ,,	3,000.00	,,	1.6
,, ,, ,, ,,	3,000.01	,, ,,	3,600.00	,,	1.7
,, ,, ,, ,,	3,600.01	,, ,,	4,200.00	,,	1.8
,, ,, ,, ,,	4,200.01	,, ,,	5,400.00	,,	1.9
,, ,, ,, ,,	5,400.01	,, ,,	6,000.00	,,	2.0
,, ,, ,, ,,	6,000.01	,, ,,	9,000.00	,,	2.6
,, ,, ,, ,,	9,000.01	,, ,,	12,000.00	,,	3.1
,, ,, ,, ,,	12,000.01	,, ,,	15,000.00	,,	3.6
,, ,, ,, ,,	15,000.01	,, ,,	18,000.00	,,	4.1
,, ,, ,, ,,	18,000.01	,, ,,	24,000.00	,,	4.6
,, ,, ,, ,,	24,000.01	,, ,,	over		5.0

Scale B.

Taxpayers, not included under scale A, earning money through their skill, knowledge, or ability in a sport, spectacle or similar occupation.

	Daily taxable income				Rate (per cent)
For the fraction between	0.01	pesos and	6.00	pesos	Exempt
,, ,, ,, ,,	6.01	,, ,,	10.00	,,	1.00
,, ,, ,, ,,	10.01	,, ,,	20.00	,,	1.25
,, ,, ,, ,,	20.01	,, ,,	30.00	,,	1.50
,, ,, ,, ,,	30.01	,, ,,	50.00	,,	1.75
,, ,, ,, ,,	50.01	,, ,,	100.00	,,	2.00
,, ,, ,, ,,	100.01	,, ,,	200.00	,,	2.50
,, ,, ,, ,,	200.01	,, ,,	500.00	,,	3.00
,, ,, ,, ,,	500.01	,, ,,	1,000.00	,,	3.50
,, ,, ,, ,,	1,000.01	,, ,,	2,000.00	,,	4.50
,, ,, ,, ,,	2,000.01	,, ,,	5,000.00	,,	6.00
,, ,, ,, ,,	5,000.01	,, ,,	over		10.00

NETHERLANDS EAST INDIES

BY

N. F. DIJKEMA,

Inspector, First Class, Fiscal Administration.

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PART I. — GENERAL DESCRIPTION OF INCOME-TAX SYSTEM.[1]

1. The income-tax system in the Netherlands East Indies,[2] hereinafter referred to as N.E.I., consists of an income tax *(Inkomstenbelasting)* on individuals and partnerships (including limited partnerships) and a tax on companies *(Vennootschapsbelasting)*. These two taxes constitute the most important source of governmental revenue, yielding about one-third of the total receipts from taxes.[3]

2. Originally — during the period 1920-1924 — companies were subject to the same income tax as individuals and partnerships (Ordinance of May 19th, 1921, as amended). In 1925, however, companies were made subject to a special tax (Ordinance of July 7th, 1925, as amended), and the income tax remained applicable only to individuals and partnerships. The Income-Tax Ordinance was amended by Ordinance No. III, of March 23rd, 1932, hereinafter called Income-Tax Ordinance, 1932, which is effective from January 1st, 1933, and the Company-Tax Ordinance was amended by Ordinance No. 196 of April 28th, 1932, hereinafter called the Company-Tax Ordinance, 1932.

3. Since January 1st, 1932, individuals (not companies) also pay a property tax which is in the nature of a supertax on account of the possession of property which increases the fiscal capacity of the taxpayer. The tax is payable on the same property as that which yields income subject to the income tax. The rate is 2.50 per 1,000 on net property between 25,000 and 120,000 florins and 2 per 1,000 of the excess. The tax is levied in the same way as the income tax (Ordinance No. 405 of July 25th, 1932). There is also a special ground tax on real property situated in N.E.I., which is payable without regard to whether the owner is an individual or a legal entity, or whether he is a resident or a non-resident (Ordinance of August 12th, 1928, as amended). Although this tax is not on the income from real property, it is computed on the basis of its valuation ; for example, the valuation of leased buildings is based on rent ; that of buildings occupied by the owner is determined by a comparison with the value of rented buildings, or by a certain percentage of the purchase price. With the exception of jungle and other unproductive ground, which is exempted,

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[1] Legislation in force on March 31st, 1933.

[2] The Netherlands East Indies consist of a series of island groups, which extend from the continent of Asia to Australia. The principal groups are : (1) the greater Sunda Islands — *i.e.*, Java and Madura, Sumatra, Borneo (excepting a part of North Borneo which is a British protectorate) and Celebes, with the adjoining smaller islands ; (2) the lesser Sunda Islands — *i.e.*, Bali, Lombok, Sumbawa, Flores, Timor (excepting a part which belongs to Portugal), Sumba, Rotti and several other smaller islands ; (3) the Moluccas and New Guinea as far as 141° East longitude.

[3] In 1930, the yield of the income tax was 53,200,000 florins (or 17 per cent), and that of the company tax 40,000,000 florins (or 15 per cent), as compared with total tax receipts of 313,100,000 florins. The other important levies yielded in 1930 : Import and export duties, 86,500,000 florins ; Excise, 3,100,000 florins ; Stamp duties, 13,900,000 florins ; Native land taxes in Java and Madura, 33,700,000 florins ; Ground taxes in Java and Madura, 4,200,000 florins ; Taxes on houses, property, etc., 3,900,000 florins.

In the same year the other important sources of revenue were : Monopolies (opium, salt, pawn-houses, 45,100,000 florins ; Governmental exploitation of raw products (tea, tin, coal, etc.), 15,000,000 florins ; Government industries and services (railways, post and telegraphs, etc.), 35,700,000 florins.

the valuation of land is fixed at seven times the yearly income (calculated according to the results of the past five years). Because of its not being an income tax, no more detailed description of the ground tax will be given.

I. INCOME TAX.

1. Taxpayers.

4. *Individuals.* — Regardless of their nationality, individuals are subject to the income tax on their total income if they reside in N.E.I. If non-resident, they are taxable only on income from specified sources (see paragraph 9). Individuals who are normally resident in N. E.I., but go abroad temporarily, remain taxable as residents unless they stay abroad more than one year, in which case their liability is restricted to that of non-residents.

5. An individual is generally regarded as being resident in N.E.I., for the purposes of the income tax, if he lives in the country, or intends to live there for an indefinite period, whether in a rented house, a hotel, or any other dwelling-place, the liability extending from the beginning of this period. If an individual enters N.E.I. temporarily, and remains taxable as a resident in his own country, he will not be taxable in N.E.I. as a resident unless his stay lasts for more than one year, the liability to taxation as a resident beginning with the second year. The term " non-resident " refers to a person who does not fulfil this requirement. A non-resident does not incur any liability in respect of income from a trade, profession or employment which is exercised in N.E.I. for less than three months ; but, if he is engaged in such activities for more than three months, he is taxable on the income derived from the beginning of that period. The circumstances of the numerous individuals who make short trips to N.E.I. on behalf of foreign enterprises are so varied, that the application of the principles just stated depends largely on the facts of each particular case.

6. *Partnerships.* — If resident in N.E.I., a partnership is not ordinarily taxed itself, but its members are assessed on their respective shares of its income. Thus, if a member is an individual or another partnership, the distributive share will be included in the assessment to the income tax or, if a company, in the assessment to the company tax. However, if one or more of the members of a resident partnership are unknown, or if their distributive share of its income is uncertain, the authorities may tax the partnership instead of its members. A non-resident partnership is subject, as a partnership, to the income tax in respect of income from specified sources (see paragraph 9). The tax may be assessed, however, on each partner of the non-resident partnership if he chooses to declare his share of its income from the indicated sources.

7. For the purposes of this report, a partnership is regarded as being resident in the country where it is organised, or where it has its real centre of management, if the latter is in a different country. In fact, except for partnerships organised by citizens of the Netherlands, most partnerships composed of nationals of other countries are organised and registered in N.E.I., and therefore come within the term " resident partnerships ".

2. Taxable Income.

8. In general, income of resident individuals or partners includes the total net amount of what is derived in money, valuables or kind from the following sources, whether situated abroad or in N.E.I. :

(a) Real property ;
(b) Personal property ;
(c) Profession or trade, scientific or other work, whether temporary or regular, and salaried employment ;
(d) Periodical payments.

9. The taxable income of non-resident individuals or partnerships includes income from one or more of the following categories derived from local sources — *i.e.*, sources in the N.E.I. :

(a) Real property ;
(b) Interest on loans secured by mortgages on real property ;
(c) Income from a profession, trade, etc. ;
(d) Periodical payments by the Treasury or public funds for past or present services.

10. A non-resident is not taxable on foreign income. A non-resident partner is taxable only on his share of the income of the resident partnership which is derived in N.E.I., provided the partnership gives satisfactory information in regard to its partners, the sources of its income and the basis of its distribution.

11. The categories of income referred to in paragraphs 8 and 9 are defined more fully below :

(a) The income from real property includes all income derived by the taxpayer in virtue of ownership or any other title to the income therefrom, provided such income is not derived from capital invested by the taxpayer in his own trade or profession. The owner of a house is taxable on its rental value.

(*b*) The income from personal property includes dividends (stock dividends or bonus shares), interest of all kinds, rent from leasing personal property and all other income from personal capital, provided it is not used in the taxpayer's own business or profession. In the case of repayment of borrowed money, if the amount exceeds that originally borrowed, the excess is regarded as income.

(c) Income from a profession or trade includes the earnings of the taxpayer in money or kind, and what he takes from his own produce for his personal use, as well as profits from the carrying on of agriculture, maritime commerce, handicraft, mining, manufacturing, practising an art or science or from any other profession or trade. The income from a salaried employment includes everything earned by the taxpayer in money or in kind, whether in the form of a fixed salary, a share of the profits or any other remuneration. Income also embraces the enjoyment of free board and lodging, free house rent, medical attendance, medicine, allowance for table expenses, as well as all bonuses and other gratuities.

(d) Periodical payments embrace furlough allowances, half-pay, subsistence allowances, pensions, wages, annuities and, generally speaking, all payments which are not connected with the carrying on of a trade, the exercise of a profession or the performance of a service, and which end with the decease of the person interested or of a third party.

3. Assessment of Tax.

(a) *Computation of Taxable Income and Deductions.*

12. The tax is assessed on the basis of a return which includes income of all categories. All individual taxpayers whose gross income exceeds 1,200 florins must file, before April 1st of each year, either personally or, if they do not reside in N E.I., through a representative, a return of their income. This return must be made whether or not a form has been received from the authorities. As a general rule, the tax-year, or year for which tax is paid, is the current calendar year, but the basis of assessment is the income derived during the preceding year from the sources existing on January 1st of the tax-year. By way of exception, salaries are assessed on an amount estimated on the basis of the salary received at the beginning of the tax-year ; further, in the case of income from a profession or trade, the accounting year of the taxpayer, if it overlaps the calendar year by its first half or more, is taken instead of the calendar year.

13. *Allowable Deductions.* — The following are deductible: cost of repairs and of maintenance in their original state of property exclusively used in the taxpayer's profession or trade, and also

depreciation of those objects, so far as such depreciation is consistent with the efficient management of the business ; expenses for wages, gratuities, etc., freights, insurance premiums, store rent, interest on mortgages, debts of whatever nature (including interest paid to bankers on money borrowed for the purchase of securities), and, in general, all disbursements required to obtain the income or to carry on the profession or trade. Foreign taxes paid abroad on foreign income, ground tax and other charges due by the taxpayer in accordance with legal ordinances and local custom are also deductible. A business loss for a fiscal year may be deducted from the profit made during the following two years, starting with the first of these years. Losses suffered in one category of income are deductible from income in all the other categories. Other deductions are : periodical payments, alimonies or other payments due under a legal obligation, premiums on life insurance not exceeding 5 per cent of income and subject to a maximum of 800 florins.

14. *Non-allowable Deductions.* — The following are not deductible : household expenses of the taxpayer and of his family, personal taxes of whatever kind, the part of the income invested as capital or laid up as reserves, disbursements for purchasing, founding or improving grounds, buildings, etc., disbursements for taking over, buying or extending a profession or trade (capital expenses), interest on the taxpayer's capital invested in his trade or profession.

15. *Abatements.* — No allowances are given in respect of minimum of existence, marital status, or dependents, other than ascendants or descendants. An allowance is given for each of such dependents, the amount of which varies with the income of the taxpayer.

(b) *Computation of Tax and Deductions.*

16. The tax is levied, on the whole of the net taxable income computed as described above, at progressive rates (see Annex).

17. Abatement of tax is granted to a resident if he dies or leaves N.E.I., and to a non-resident if he ceases to derive income from one of the sources mentioned in paragraph 9. Abatement is also granted to residents, but not to non-residents, in case of suspension of a trade or a profession, or discharge from an office, or other exceptional circumstances, if evidence is given that, through these circumstances, the taxed net income differs more than one-quarter from the amount the taxpayer really earned during the tax-year.

18. In order to prevent double taxation, a resident taxpayer who also pays tax in the Netherlands, Surinam or Curaçao, may deduct from his N.E.I. tax on total income the amount of tax which would be due on the part of his income derived from those countries. The Governor-General is authorised to issue ordinances in consonance with provisions in the legislation of other countries, effecting total or partial relief from double taxation, on condition of reciprocity (Netherlands Law of June 14th, 1930, *Official Gazette*, No. 244, published in N.E.I. *Official Gazette* 1930, No. 310). Non-resident individuals and partnerships are not taxable on profits derived from shipping between ports in N.E.I. and abroad (Income-Tax Ordinance, 1932, effective January 1st, 1933).

4. Collection of Tax.

19. There is no withholding of tax at source, the only method of taxation being direct assessment against the taxpayer or his representative in N.E.I. A resident pays the tax, after receiving his notice of assessment in as many instalments as the number of months in the calendar year which have not yet elapsed ; and in five instalments if the notice is received after July 31st. Non-residents pay tax before the 15th day of the third month after the month in which the notice has been received. The Treasury has, to a certain extent, a preferential claim on the property of a taxpayer.

5. Procedure and Appeals.

20. The local inspector of finance examines the return of the taxpayer, computes the assessment, enters it in a register, and notifies the taxpayer. The latter can ask the inspector for a revision of the assessment, and, if necessary, he may carry his objections to the Court of Tax Appeals.

21. *Penalties.* — Failure to make a return, the filing of a false return and the refusal to supply requested information are subject to heavy penalties. If information obtained subsequently to the original assessment shows that it was too low, an additional assessment may be made within three years after the beginning of the tax-year to which the assessment relates, and the additional tax will be increased by 200 per cent.

II. COMPANY TAX.

1. Taxpayers.

22. The liability of a company to the company tax depends upon its nature and upon whether it is resident or not in N.E.I. The company tax is payable by a resident share company *(naamloose vennootschap)*, or limited partnership with share capital *(commanditaire vennootschap op aandeelen)*, other associations whose capital is entirely or in part divided into shares, co-operative societies and mutual insurance companies on their total income from all sources. Non-resident companies, limited partnerships with a share capital, and other associations whose capital is wholly or partially divided into shares are taxable only in respect of specified items of income (see paragraph 25). The company tax is also payable by associations, organised in N.E.I. with no share capital and not being partnerships, in respect of income from business activities other than activities conducted for the general welfare.

23. The term " resident " is used in the preceding paragraph to interpret the word " *gevestigd* ", which is used in the Company-Tax Ordinance. This word is not defined in the Ordinance ; but, according to a decision rendered by the Chief Inspector of Taxes, [1] it indicates the place where a company has its registered office. If the company's real centre of management *(hoofdleiding)* is in another country, then the latter is the deciding factor in determining the extent of tax liability. Thus, if the registered office is in N.E.I., where the company was organised, but if the directors live and meet in another country, and if the annual meeting of shareholders takes place and the central book-keeping is maintained in the other country, the company will be treated as resident in that country.

2. Taxable Income.

24. According to the Company-Tax Ordinance, companies resident in N.E.I. are taxable on their total profits obtained in whatever form or name, whether through the carrying on of a business or the investment of capital outside of that business. It is immaterial whether the sources of the income are situated abroad or in N.E.I.

25. Non-resident companies are taxable only on income from the following sources in N.E.I. :

(a) Income from business [2] carried on in N.E.I. ;

(b) Income from real property situated in N.E.I. or rights therein ; [3]

(c) Interest on loans, not connected with a business, which are secured by mortgages on real property situated in N.E.I.

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[1] This decision was rendered in regard to the stamp tax of N.E.I., but is followed in income-tax matters No. 484, Compilation of Decisions regarding the N.E.I. Tax Ordinances.

[2] For exemption of shipping profits, see paragraph 31.

[3] Under categories *(a)* and *(b)* are also classed royalties from concessions, grants, leaseholds, etc., provided they are based on output or gross receipts ; such royalties are taxed by assessment against the recipient, but royalties calculated on a profit-sharing basis — *e.g.*, 10 per cent of the profits — are taxed as part of the profits of the enterprise which pays them and not as the income of the recipient.

26. According to an official commentary of the Ordinance, tax liability arises in the case of non-resident companies when they have economic relations *(economische betrekking)* with N.E.I. — for instance, carry on a business or own real property in the country. Such economic relations determine the extent of the tax liability, as only the profit accruing from such relations is taxable. The Ordinance does not specify the circumstances in which a foreign company is considered as carrying on business within N.E.I. In practice, however, liability arises if the foreign company has a permanent establishment there.

27. A foreign enterprise carrying on business through a subsidiary company organised in N.E.I. has not been treated until now as a taxpayer, but the question as to whether or not the subsidiary company should be treated as a branch is still much debated. Except in some parts of Northern Sumatra, where native princes rule, only Dutch subjects or companies incorporated in the Netherlands or in N.E.I. may hold a title of leasehold or concession (Article 11 of the Agrarian Ordinance, 1872, No. 116). Thus a foreign company, wishing to carry on an agricultural or mining enterprise in N.E.I., is compelled to organise a subsidiary company (dummy) in the Netherlands or N.E.I. As the concessions or leasehold are registered in the name of the dummy, this company is taxed for the profits of the enterprise, though it exists only juridically and is totally dependent on the holding company for its financial resources. If, however, the transactions between the subsidiary and the parent company were conducted in such a manner that the true profits of the subsidiary did not appear in its books, certain officials would be inclined to assess the foreign holding company itself through the dummy as its organ.

3. Assessment of Tax.

(a) *Computation of Taxable Income and Deductions.*

28. The tax is assessed on the basis of a return, which is made on a form supplied to the company by the local inspector. The tax-year is the company's accounting year ; otherwise, the calendar year. The basis of assessment is the net income of the preceding accounting or calendar year. The basis embraces all income derived from the carrying on of a business and from investing capital outside the business, including profits made through the disposal of assets not belonging to the company's stock-in-trade, and, in general, every gain made through sale.

29. *Allowable Deductions.* — In calculating net profit, the gross amount may be reduced by expenses incurred in the making, collection and maintenance of such profit. Deductions from gross profit include interest on loans, depreciation of assets used in the business, bad debts contracted in conducting the business and written off according to business usage, and the amount necessarily written off on account of the expiration of rights *(e.g.*, leaseholds) which are subject to a limited period. In practice, taxes paid abroad on foreign income are deductible. A loss suffered in one year may be deducted from the profit made during the two succeeding years. Cost of organising, reorganising or increasing the capital of a company is deductible as from January 1st, 1933.

30. *Non-allowable Deductions.* — No deduction is allowed for capital expenditure, for the creation or increase of a reserve fund, for interest on capital invested in the business, or for any tax *(i.e.*, the N.E.I. company tax or a foreign tax) on profits derived in N.E.I. The Ordinance allows no deduction whatever for payments out of profits, or surplus, with the exception of payments to the Government otherwise than as shareholder, and of payments (bonuses) granted for services rendered to persons other than managing directors, directors, managers or managing partners. When a company borrows from its shareholders amounts far in excess of what could be obtained from disinterested sources, no deduction is allowed for any interest on the part of the loan which exceeds that which could be borrowed from such disinterested sources. As the borrowing company is assessed, no tax is levied on the creditor company in respect of the interest in question.

31. *Double Taxation Relief.* — If a resident company pays tax to the Government of the Netherlands, Surinam or Curaçao or a foreign country, on profits derived from business conducted or property (including rights therein) situated within those countries, N.E.I. exempts two-thirds of the profit acquired in the Netherlands, Surinam or Curaçao, and half of the profit acquired in foreign countries. The same exemption is granted to resident companies holding 90 per cent of the registered stock of non-resident companies which are taxed by the above-mentioned Governments. The Governor-General has special powers to effect relief by ordinance (see paragraph 18). Non-resident companies are not taxable on profits derived from shipping between ports in N.E.I. and abroad (Company-Tax Ordinance, 1932, effective January 1st, 1933).

32. To prevent double liability to the N.E.I. tax, no tax is levied on dividends received by an N.E.I. or foreign company from an N.E.I. company or a foreign company deriving at least 90 per cent of its income from sources in N.E.I., provided the shares held in the distributing company are registered in the name of the shareholder.

33. *Assessment of Non-resident Insurance Companies.* — Special rules are given for the computation of the taxable income of foreign insurance companies. This taxable income is fixed for life insurance companies at 5 per cent, and for all others at 10 per cent, of the amount received in premiums or capital from insurees living or incorporated within N.E.I , or for risks within this country. No deductions are allowed for brokerage or other commissions, rebates, reinsurance or other expenses. As an exception to the preceding regime, the taxpayer may request to be taxed on an amount representing the same proportion of the whole net profit of the insurance business as the above-mentioned amount received in premiums and capital in N.E.I. bears to the total amount received in the same year in premiums and capital from insurees.

(b) *Computation of Tax and Abatements.*

34. The tax is computed on the total net taxable income of the company at a proportional rate plus a surcharge (also proportional) on the preceding rate (see Annex).

35. No abatements are allowed against the tax. For double taxation relief, see paragraph 31.

4. Collection of Tax.

36. Tax is never withheld at source under N.E.I. law, but is always levied by direct assessment against the taxpayer or his representative in N.E.I. The inspector of finance or his substitute notes the assessment in a register and notifies it to the management of the company. The company tax must be paid as a rule within one month from the date of the assessment notice, but the inspector of finance can allow a postponement, in which case interest will be due on the amount for which postponement is granted at a rate of ½ per cent for every month. The Treasury has, to a certain extent, a preferential claim for the tax on all property of the company, etc.

5. Procedure and Appeals.

37. In general, the district inspector of finance sends the company a return form, which is filled in and returned to the inspector after the books are closed. The taxpayer must comply with all requests for verbal or written information necessary to verify the return. Usually, copies of the annual balance-sheets and profit-and-loss statements are requested. Upon request, the taxpayer must open his books and pertinent documents to the examination of the inspector of finance, of any persons named by the head inspector, or of experts appointed for that purpose.

38. After having secured the necessary information, the inspector computes the assessment, enters it in a register, and serves a notice of assessment on the taxpayer. The taxpayer may lodge an appeal in three months to the head inspector and thence to the Court of Tax Appeals, which is the final authority.

39. *Penalties.* — If, after receiving a return form and a written reminder, the taxpayer makes no declaration, or if he refuses to give access to the books and to related documents when requested, the assessment will be increased by 100 per cent. Provisional assessment may be imposed on the basis of the amount declared, or on the basis of an estimated amount if accounts have not yet been closed. If it appears through later information that the assessment was too low, an additional tax may be assessed, and increased 100 per cent, provided five years have not elapsed since the end of the year for which the tax is levied.

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES

A. FOREIGN ENTERPRISES.

1. Definition and General Principles.

40. For the purpose of this study a foreign enterprise may be defined as a non-resident enterprise — *i.e.*, belonging to an individual residing abroad, or to a partnership or company which has its registered office in a foreign country. If the real centre of management of a partnership or company is in a country other than that of its registered office, the former will determine its place of residence (see paragraphs 7 and 23).

41. A general rule regarding the liability of foreign enterprises cannot be given, as, under the Ordinance, it is necessary to examine the circumstances of each case. A foreign enterprise is taxable if it derives income from economic relations with N.E.I., such as by carrying on business in N.E.I. for more than three months, or by having an establishment there (see paragraphs 9 and 25). It is also taxable on income from certain specified sources, such as income from participations in a resident partnership, income from real property, interest on mortgage loans (see paragraph 45), and mining royalties. With regard to income from the taxable sources indicated, other than income from a profession or business, the liability exists irrespective of whether it is received at a N.E.I. establishment or abroad.

2. Taxation of Certain Kinds of Income.

(a) *Dividends.*

42. As a rule, dividends on shares of a company incorporated in N.E.I. are not taxable when received by non-resident individuals, partnerships or companies. They may be taxed only when considered business income. For example, when a non-resident enterprise carries on a business in N.E.I. and invests its reserve funds or surplus cash temporarily in shares of any company, N.E.I. or foreign, the dividends are considered to be a part of the business income of the establishment in N.E.I., and are therefore taxable as such.

(b) *Interest.*

43. *Interest on Bonds.*[1] — Interest on bonds issued by N.E.I. companies are not taxed when received by a non-resident enterprise unless, as has been described above in connection with dividends, the non-resident enterprise has in N.E.I. a business which invests its reserve funds or cash in such bonds.

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[1] In practice, N.E.I. companies do not frequently resort to bond issues, and those which are issued are in the form of debentures secured on the general assets of the company. Such bonds, therefore, would not be taxable under paragraph 44, as this provision applies only to loans, whether or not represented by bonds secured by a specific immovable property and registered in the mortgage register.

44. *Interest on Secured Loans.* — When loans made by non-residents are secured by mortgage or otherwise on immovable property situated in N.E.I., the interest is taxable as from January 1st, 1933 (Income-Tax Ordinance, 1932, Article 2 *(b)* and a similar amendment to the Company-Tax Ordinance 1932, both effective January 1st 1933). The creditor is required to declare this income, together with his other taxable income from N.E.I., and pay tax thereon at the rate applicable to individuals or companies according to the status of the taxpayer.

45. *Interest on Unsecured Loans.* — Interest on unsecured loans paid by a local company to a foreign enterprise and interest on bank deposits are not taxable unless they constitute income from an investment of reserve funds or cash of the business in N.E.I. as described above in paragraph 43.

46. Interest on capital invested by non-resident limited partners in a N.E.I. partnership is considered taxable income on the same basis as other profits derived from such partnership.

(c) *Directors' Percentages.*

47. Directors' percentages are taxed at the source as profits of the company. The non-resident, whether an individual or company, receiving the *tantième* is exempt from tax.

(d) *Royalties for Use of Patents, Copyrights, Trade-Marks, Secret Processes, Formulæ and Similar Income.*

48. As a rule, such royalties are not taxable, and, in fact, there are very few instances where foreign patents, copyrights, etc., are licensed to local enterprises.

49. Foreign enterprises having an establishment within N.E.I., and engaged in the profession of buying and selling copyrights, are taxable on the income derived therefrom.

(e) *Rents from Real Estate, Mining Royalties and Similar Income.*

50. Such income is, as a rule, subject, on the basis of a declaration, to income tax if the beneficiary is an individual or partnership, or to the company tax in all other cases. The only exception is that royalties paid to a non-resident company which are computed as a percentage of the whole profit of the exploiting company and are taxed as a part of such profit are not taxed again as income of the recipient. Such royalties received by a foreign individual or partnership may, however, be taxed again, as the Income-Tax Ordinance does not contain an exemption for the recipient of royalties which have been taxed at source.

(f) *Gain from the Purchase and Sale of Real Estate, Securities or Personal Property.*

51. These profits are only taxable in case they are considered to be part of the income derived from the business activity of the enterprise within the country. A foreign company, which has no establishment here, is not taxed for the gain derived from the purchase and sale of real estate or securities. If such company has such an establishment here, and is therefore considered a taxpayer, the profits derived from the sale of any assets belonging to the N.E.I. business — *e.g.*, plant, rubber or tea estates — or gain from purchase and sale of securities purchased out of reserve funds, such profits are included in the taxable income of the accounting year. The Company-Tax Ordinance includes profits acquired through the disposal of goods not intended for sale, and, in general, every gain made through such transactions, even if received after the business has ceased to operate.

(g) *Salaries, Wages, Commissions and Other Remuneration for Services.*

52. The recipient of any of these items of income will be taxable if he is in N.E.I. for more than three months, the liability extending to what he has earned since the beginning of that period. Under the Income-Tax Ordinance, this liability arises from the fact of carrying on a professional

activity within N.E.I. for more than three months. In practice, a foreign company would be taxable under this head, only if the remuneration were received for services rendered by an establishment within N.E.I. The maintenance of an employee in the country for more than three months might be construed to constitute an establishment. Employers established in N.E.I. must file an information return of amounts paid to employees. If the employee receives more than 1,200 florins, he also must file a return.

(h) *Income from a Trust.*

53. The trust does not exist in the law of N.E.I. In the case of a foreign trust deriving taxable income from N.E.I., the question as to whether the taxpayer will be the beneficiary or the trustee depends upon the provisions of the deed of trust. The taxpayer's status will determine whether the income tax or company tax is payable.

(i) *Income from carrying on a Business or Industry through.*

(54. The term " carrying on a business " applies, not only to producing or selling in N.E.I., but also to purchasing through a permanent establishment.)

55. (1) *A Local Commission Agent or Broker.* — Where a local commission agent or broker is carrying on business independently as such, and does not belong to the staff of the foreign enterprise, the income derived by the latter from selling or purchasing through such an intermediary cannot be taxed. The most frequent example of this class of business is where a foreign enterprise sends a consignment of cotton goods to a local commission agent who sells them, for the account of the consignor, to merchants throughout the islands. The fact that the local commission agent receives a *del credere* commission would, as a rule, be taken as an indication of his independence. Still, there is reason to study each case, as an enterprise not settling down in this country ought not to be in a more favourable position than an enterprise having an establishment in N.E.I. The question may be of great importance when the country is the special buying market for some product, as N.E.I. is for sugar. Though it is not very probable that a foreign enterprise will abstain from founding an establishment only on account of tax liability, the circumstances of each case ought to be studied in order to ascertain if the relations between the commission agent and the foreign enterprise are of such a nature that the latter may be regarded as carrying on business itself.

56. (2) *A Local Dealer or Distributor.* — As long as this dealer is buying and reselling for his own account, whether he has or not the exclusive right to sell the goods in a particular district, the foreign enterprise itself is not taxable on profits made on the goods sent to this dealer. This is true even though the foreign enterprise has in N.E.I. an engineer to supervise the installation of machines sold by the dealer, or to inspect the goods from time to time. If the dealer or distributor is not, in fact, independent - for example, if he has not sufficient capital of his own — but is selling goods belonging to the foreign enterprise, which carries the risk of bad debts, the latter can be considered as carrying on business, and the tax will be levied on its profits.

57. (3) *A Travelling Salesman, whether or not having Power to conclude a Contract.* — Under the Income-Tax Ordinance, if the foreign enterprise sends to N.E.I. an employee who travels from place to place taking orders or closing contracts for the sale of goods, the enterprise is taxable on its profits if the salesman remains in N.E.I. for more than three months, and the salesman is likewise taxable on his remuneration. Although the Company-Tax Ordinance does not contain a similar provision, by analogy the company would be taxable on profits derived from carrying on the business in N.E.I. for more than three months. Thus, in practice, liability would arise if the foreign company maintains a salesman in N.E.I for more than three months, and, consequently, might be regarded as having become established. Liability does not depend upon where the contract of sale is actually closed, but rather upon the fact that the profits resulted from the activities of the employee in N.E.I. for the indicated period.

58. If the travelling salesman does not belong to the staff of the foreign enterprise, but is a local person receiving a commission only when sales are made, the enterprise is generally not taxable.

59. (4) *A Local Agent with a Power of Attorney.* — The question of liability under this head depends upon the extent of the powers given the agent. If the local agent has an independent position *(e.g.,* a local individual operating from his own home or office), and is merely authorised to collect orders for the foreign enterprise, for which he receives a commission, whereas the transaction is closed directly between the foreign company and the buyers, and the goods are sent directly to the latter, the foreign enterprise cannot be considered as itself carrying on business in N.E.I. The situation is not altered even if the agent acts as intermediary for the payments and eventually for claims, and even if the goods are shipped to the agent for distribution to the purchasers. If the powers of the agent are broad enough to close contracts for the sale of goods or services which bind the non-resident enterprise, the latter is taxable on its profits.

60. (5) *An Agent selling out of a Stock belonging to the Foreign Enterprise.* — This is a case that seldom arises in practice. In the light of general principles of liability, however, if the stock is maintained in a godown or warehouse belonging to, or leased by, the foreign enterprise, and if the agent makes sales in the name of the foreign enterprise, the latter would be regarded as having an establishment and would be taxable on its profits. On the other hand, if the foreign enterprise consigns goods to an independent merchant who disposes of them in his own name, the foreign enterprise is not taxable.

61. (6) *A Permanent Establishment of Any Kind.* — As has been mentioned before, in such a case the foreign enterprise is considered to carry on business itself through an " organ ", and it is taxable on all income derived from this source. In the N.E.I. fiscal law no definition is given of the term " permanent establishment ", because such term is not used. For the purposes of this study, the term " permanent establishment " includes the centre of direction, the real centre of management, branches and agencies, factories, offices and premises, and the representation by a member of the staff of the foreign enterprise. In the past, a subsidiary company has not generally been considered as a permanent establishment, even when it is independent only in legal form.

B. NATIONAL ENTERPRISES.

62. For the purposes of this study, an enterprise is a national enterprise if it belongs to an individual, partnership or company resident in N.E.I. as defined in paragraphs 5, 7 and 23.

63. Both the ordinances declare liable to tax the whole income of national enterprises, including the income derived from foreign sources. To avoid double taxation, both ordinances allow certain relief against the N.E.I. tax (see paragraphs 18 and 31).

64. It is unnecessary to discuss the different items of income of a national enterprise as its total income is taxable, whether under income tax or company tax. The income tax is generally levied on the partners in a resident partnership and not on the partnership itself (see paragraph 6).

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

I. GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

Introductory Observations.

65. The question of allocation is still in its initial stage. It was not only the great increase in the levies during and after the war which made the taxation problems more and more the centre of public interest, [1] but also the considerable expansion of the tax department, and the affiliated tax-accountancy department, which have brought the problem of the apportionment of profits to the fore. The international interest taken in these questions, especially from the viewpoint of the prevention of double taxation, has roused the taxpayers to greater activity. They in turn have made the taxation experts enter more deeply into the study of the problems which must be settled by the administration. Although it is impossible to give positive answers to the questions on apportionment, they will be treated from the viewpoint of practical experience, which is still in a state of constant growth and change. Needless to say, the viewpoint is bound to vary with these changes.

66. *Basic Principles for allocating Profits.* — Foreign enterprises are taxable on the profits derived from carrying on an enterprise — *i.e.*, a business or industry, in this country (Company-Tax Ordinance, Article 1, paragraph 1, sub-head 30). According to the official theory liability arises if the foreign enterprise maintains economic relations with N.E.I., and is delimited by the extent of these economic relations. It is evident that tax liability is not restricted to profits from business activities taking place within the boundaries of N.E.I. On the contrary, the business unit in N.E.I. is taxable on income from all its activities even if some of such activities are carried outside N.E.I. If the non-resident enterprise has, however, a permanent establishment in the other countries to which the activities of the N.E.I. business extend, then the profits attributable to such establishment are not taxable in N.E.I.

There is no statutory or administrative rule as to which method should be applied for a proper apportionment of the profits, or which factor should be taken into account. The circumstances and conditions of each enterprise have to be studied individually in order to arrive at an equitable apportionment. The study of the nature of the business will show the value of the profit-making factors inherent therein, and will furnish an answer to the other question — viz., whether and to what extent profits should be attributed to business activities outside the N.E.I., and therefore excluded from the assessment. The Court of Tax Appeals has repeatedly upheld the administration in refusing to reduce the assessment when the taxpayer contended that a part of the profits should be allocated to activities outside N.E.I., when such activities were, in fact, non-productive of

[1] During 1920 and 1921, the first advisory bureaux on taxation matters were established in the N.E.I.

profits — *e.g.*, book-keeping and technical supervision. In due time, certain general principles will emerge, and the Court of Tax Appeals will doubtless assist in establishing them.

67. *Allocation of Income from Reserves.* — A corollary of the above principle is that all income derived from capital set aside by a foreign enterprise for carrying on economic relations with N.E.I. is taxable. Consequently, income is allocated to N.E.I. for tax purposes, whether it is in the form of income derived from using the capital in the business in N.E.I., or placing capital temporarily unemployed for such purposes on deposit in a bank in N.E.I. or abroad, or investing it in bonds or stocks in N.E.I. or abroad.

68. The amount of money needed in the carrying on of the business in N.E.I. fluctuates from time to time, especially in the case of agricultural enterprises, and the funds temporarily unemployed or waiting to be used in the business obviously cannot be separated from the business itself. Consequently, when directors have set aside a part of the profits as a reserve, these funds really belong to, and fulfil a function in the business here, even though they are deposited in a bank abroad or invested in foreign securities. If placed on deposit, there is no essential difference whether the funds are deposited by the branch of the enterprise in the N.E.I. branch of a bank or by the head office of the enterprise in the principal establishment of the bank abroad. It is also immaterial whether the bonds or stocks purchased are kept by the head office or the branch, and whether the income is received abroad or in N.E.I.

69. Similarly, income from securities used as collateral on loans to be employed in the business here is considered a part of the earning of the N.E.I. business. The cardinal test is whether the funds belong to or are destined for use in the N.E.I. business, regardless of what they are called. Such funds include, *inter alia*, funds to pay cost of leave of employees, depreciation reserves or repair funds, pension reserves, reserves for taxes or for other purposes.

70. When the funds lose their character as a reserve for the N.E.I. business, the income therefrom ceases to be taxable. Such is the case when the " reserves " have grown so large that they are more than adequate for the possible need of the business in N.E.I., and the directors give this excess the character of a permanent investment outside the local business. For example, such an investment is constituted when the money is invested in another business in N.E.I. or abroad, through organising a subsidiary company or buying the shares of an existing company.

71. *Allocation between Netherlands and N.E.I.* — Between the Netherlands, where the assessment of companies is based on distributed dividends, and N.E.I., where the tax is on profits, difficulties on account of double taxation arise repeatedly. These difficulties also arise in connection with the difference in the rate of tax. Article 27 of the Netherlands Law on Dividends and Percentages Tax only allows remission for two-thirds, when the profits, out of which the dividends are paid, have been made in N.E.I. The so-called Indian profits are therefore taxed at one-third of the normal rate. Moreover, there is often a difference of opinion between the Dutch and N.E.I. tax authorities on the question of what should or should not be considered as (so-called) Indian profits. Double taxation is, therefore, not only the result of the difference between legal provisions, but also of this discrepancy in opinion. In order to avoid such double taxation, the authorities of N.E.I. are in constant consultation with those of the mother country. As a result of this collaboration, a satisfactory solution, or at any rate an approximate solution, is to be expected for the problem of the apportionment of profit between the two jurisdictions.

(a) Book-keeping and Accounting Requirements.

72. According to Article 13 of the Company-Tax Ordinance of 1925, foreign companies working in this country must arrange their book-keeping in such a way as to show all the data necessary for calculating the profits made by the enterprise in N.E.I. The taxpayers are expressly informed that, in the checking of their return, their book-keeping will be taken as a starting-point.

73. The dealings of companies incorporated in N.E.I. must be recorded in such a manner that the profit made through the carrying on of the business, or from the capital employed or invested outside, can be ascertained through the books. Companies incorporated abroad must keep their books in such a manner as to show, not only the profit made through the business in N.E.I., but also income from reserve funds belonging to that business, regardless of where such funds may be invested. The books must be kept in either Dutch, Malay or Chinese, or in another language approved of by the director of finance (French, English, German). The book-keeping must include a continuous record of the cash position, and a statement of debtors, creditors and stocks, which must be kept up regularly and closed off annually, and, furthermore, a balance-sheet must be made up every year. The books and documents relating thereto must be kept for ten years.

(b) Methods of Allocation.

74. It is clear that different methods will have to be applied for the various categories of enterprises. A careful study of the peculiarities of each separate enterprise will lead to a better understanding of the value of the various factors which contribute to the making of profits. Some of the factors which will always receive careful consideration in the course of the checking of the taxpayers' returns are: the fact whether the activities of the business are industrial or agricultural, or exclusively buying and selling; the turnover; the analysis of the costs; the fixed capital and the fluid capital used in N.E.I.

75. Practically all the great industries producing raw material or staple products operate exclusively in N.E.I, and therefore raise no problems of apportionment. Problems arise, however, in the case of enterprises whose products for some reason or other have no regular quotation in the world market, and have to undergo more or less intensive treatment before being ready for consumption. Up to the present, it has been possible to arrive at a reasonable assessment by making a comparison with the proceeds from the sale of raw material by other enterprises, or by an estimate of the influence of the manufacturing process on the sale price. But the fact that many difficulties have to be faced cannot be denied. For instance, many point out that, as a result of increasing competition or of other causes, the organisation of the sales outside the N.E.I. territory is a factor of ever-growing importance for the making of profits. This makes it urgent to study more intensively the structure of the business, so as to be able to decide whether a part of the total profit may be attributed to this sales organisation, because of its having a permanent influence in making the profit.

76. Similar difficulties arise, when the producing department has been formed into a separate corporation, and the sales are entrusted to another company, which forms part of the same world concern. The relation between the sales corporation and that concern may be similar to that of a branch and a parent company, or it may be that the production and the sales corporations are both subsidiary companies of another company which holds their capital stock. When such is the case, the N.E.I. tax administration is naturally not tied to any juridical limits. Endeavours will have to be made to determine the profits realised by the company working in this country — *i.e.*, the profits derived from the production of the raw material, and this, if necessary, independently of the data furnished by the parties interested. In some instances, it may be necessary to examine the results obtained by the entire composite body, so as to obtain a correct idea of the profits made in this country.

77. With regard to companies whose activities in N.E.I. are limited entirely to the buying of produce, the assessment of the profits offers many divergent points of view. In such cases, the books are often inconclusive, because the concern abroad looks upon the organisation in this country as only an item of expense, and does not recognise that buying as well as selling are factors in the making of profits. When the buying is carried on wholesale, there will often be arguments for fixing the gross profits at the same amount as the buying commission which would be paid to a third

party. When there is an extensive organisation for buying transactions, a different procedure will have to be found for the determination of the Indian profits (see paragraphs 109 and 110).

78. It also occurs — and apparently these difficulties are found throughout the world — that the books and accounts of a branch, however complete and perfect, cannot be taken as the basis for the calculation of the profit derived in this country. This is the case, for example, when it is impossible to verify the invoicing of the head office or the branches abroad to the branch in this country. In these cases taxable income is estimated, as a rule, on the basis of a presumed yield at the prevailing rates of interest on the capital invested, or on the turnover. As this method does not assure accuracy, the results may be further verified by examining the invoices showing the cost to the head office or the branch shipping the goods to N.E.I.

1. *Method of Separate Accounting.*

79. In general, the fiscal authorities start from the principle that the profit made by the N.E.I. part of the enterprise must be proved by the book-keeping carried on in this country. The annual statements sent in with returns, and containing the data for the so-called East Indian profits, will serve as a basis of assessment. This procedure is just ; *bona-fide* taxpayers, who have arranged their book-keeping in such a way that it gives a clear insight into the profit made by the " branch ", need not have their entire book-keeping examined. Of course, the taxpayer may at all times be asked to give any information with regard to the book-keeping of the branch, its relation to the chief book-keeping and to that of other branches, the manner of invoicing, the calculation of compensation for services rendered by the other branches to the Indian branch. This procedure has also practical advantages, because the Company-Tax Ordinance imposes on the taxpayer an obligation the ignoring of which will place him in the position of a defaulter. The administration may then estimate the taxable income.

80. A considerable number of the enterprises working in N.E.I. are resident in the Netherlands. A few years ago a branch of the N.E.I. tax-accountancy service was instituted in the Netherlands ; this enables the administration to examine the chief book-keeping of those bodies established in the Netherlands, with their consent. Up to the present, no objections have been raised by the taxpayers against this examination. It goes without saying that there is a perfect co-operation between the two services, the one in N.E.I., the other in the mother country. In a few instances, the N.E.I. authorities have examined the principal book-keeping of businesses established in other countries with the consent, of course, of the taxpayer.

2. *Empirical Methods.*

81. When the book-keeping and other detailed evidence regarding the business in N.E.I. are insufficient, so that it is impossible to calculate the local profits on the basis thereof, some other method of allocation must be employed. Efforts are made to collect as much data as possible, so as to obtain a reasonable basis to start from. When the gross receipts, or turnover figures, are known (and, as a rule, they are), a gross profit may be computed by applying to the gross receipts a percentage based on data obtained from similar enterprises. From the gross profit thus estimated, the expenses of the local establishment are deducted in order to arrive at the taxable net profit. As a rule, valuation of the net profit with reference to gross receipts is not to be recommended, as this method is not exact enough, and is apt to neglect differences in costs of doing business in the various countries where the enterprise has branches. The book-keeping of the local branch should show the actual expenditures in N.E.I. The problem of the extent to which the general expenditure of the enterprise is deductible from the profits of the local branch is not be solved along general lines, but depends on the circumstances of the particular kind of business.

82. In certain cases it is assumed that a certain amount may be allowed for the buying office as buying commission, and that it should be equal to the usual buying commission paid to a third person. But this method has the drawback that profit is always attributed to the country where the buying is done, without taking into consideration the total results of the business. Hence, preference is given, on practical and theoretical grounds, to the method of expressing the N.E.I. profits as a fraction of the total profits.

3. *Method of Fractional Apportionment.*

83. If the accounts of the head office show the total net profit of the foreign enterprise, an analysis of the structure of the activities of such an enterprise and of its possibilities for making profit in N.E.I., as compared with those in the other countries in which the enterprise operates, will indicate which part of the total profit should be taken as a minimum to represent the so-called N.E.I. profit. The fixing of this proportion may be facilitated by making a comparison with other enterprises. Another method is to take the net results of the entire enterprise as a basis and calculate how much should be allocated to the part of the enterprise abroad and therefore excluded from the assessment. In some cases, an apportionment of profit in accordance with the turnover figures will be the most practical method.

84. On the part of the taxpayers, repeated efforts have been made to arrive at an apportionment of profits on the basis of wages paid for labour performed in obtaining the profits. In order to have a reliable basis of comparison, it may be necessary to correct these figures, so as to take into account the difference in the wage standard prevailing in different countries. This reasoning is based on the thesis that the carrying on of a business consists of the organic use of the means of production - viz., labour, soil and capital; and that the two latter elements ought not be taken into consideration for the allotment of profits. The N.E.I. authorities have rejected, in principle, this basis for the apportionment of profits, and they have been upheld by the Court of Tax Appeals. The primary reasons for rejecting this basis are that the wage-scale varies so greatly from country to country that it cannot be taken as a common basis for comparing the profit-earning capacity of the branches in the different countries, and also that, in the case of many enterprises producing raw materials, their very life is due to the soil, climate and other circumstances peculiar to N.E.I. For example, this country in 1931 produced 90 per cent of the world supply of cinchona from which quinine is made, and the tobacco of Sumatra has a certain quality which is not found elsewhere.

85. It has therefore been definitely settled that the amount of wages paid out in the different countries cannot be taken as a basis for the apportionment of the profits. There remains the difficulty of selecting a guiding principle for apportionment. Happily, certain opinions are developing, and these are carefully watched, both by the taxpayer and the administration. For instance, for enterprises which buy at their head office in Europe and sell in N.E.I., the profits are apportioned in the ratio of 25 per cent to the buying office and 75 per cent to N.E.I. These figures may vary, however, for each individual concern.

86. The international trade in raw products offers particular difficulties, because it is frequently carried on by enterprises with their head office in Amsterdam, London, New York or elsewhere, and with purchasing branches in N.E.I., and selling branches in other countries. The N.E.I. branch is instructed by cable to make purchases, sometimes for subsequent sale abroad, sometimes to cover sales already made, sometimes for a mere speculation. It is often impossible to determine the results obtained by the various transactions, because buying and selling are intermingled in such a way that the value, or at any rate the result of each transaction, cannot be traced separately. And, even if the result could be traced, there remains the difficulty of deciding to whose initiative, or to which other activities, the profit derived from the buying or selling is to be attributed, and whether these factors are within or without N E.I. The total or general results will have to be found in the

annual accounts. In practice, the taxpayers have always shown great willingness in supplying the authorities with the information desired, and the profits are allocated as described under the heading " Buying Establishments " (paragraphs 109-114).

87. On the whole, the verification of general results should be restricted to a written explanation of the items in the annual accounts and written answers to certain questions about the system of valuation of stock, depreciation, overhead and running expenses, reserves, etc. Delicate questions are always presented by the manner in which the head office charges the local branch with supplies, services and overhead expenses. The examination of the principal book-keeping is usually only possible in the case of Dutch companies operating in N E.I. Although it must be admitted that this is an unsatisfactory state of affairs, it is plain that a satisfactory solution is hard to find.

88. Subsidiary companies of large concerns have sometimes caused difficulties when the annual statements of the parent company were subjected to a closer examination. The taxpayer argued that it is not necessary to examine the results of the other subsidiary companies abroad for the sake of verifying the profits of the subsidiary company here, once they have - in their opinion — provided sufficient data for the latter.

4. *Requirements for the Selection of Methods and Value of the Various Methods.*

89. The Ordinances in force do not lay down any rules for the application of one or another method. The authorities have perfect liberty in selecting any method of apportionment. Foreign concerns may not demand the application of a certain method. However, as the Company-Tax Ordinance requires foreign concerns to keep their books in such a way as to show the East Indian profits, the authorities first examine the separate accounting. They will only deviate from this method when they find that the figures actually fail to show clearly the profits made by the enterprise in N.E.I., or when this method is precluded by the nature of the business. The Ordinance makes an exception only for insurance companies which may choose between separate accounting and fractional apportionment (see paragraph 33).

90. It cannot be said positively which method is considered the most practical and satisfactory from the viewpoint of normal use and of prevention of tax evasion, because the circumstances of one concern will point to one method, and those of another concern to a different one, or even to a combination of various methods. Generally speaking, it may be stated that, for the great agricultural and mining concerns, it is possible to arrange their accountancy in this country in such a way that the figures give a clear idea of the financial results. At the same time, it will be necessary to verify the branch accounts in the light of annual accounts, invoices and compensation accounts of the head office, and, as a rule, this can easily be done. The export and import concerns present the real difficulties, and there is a growing tendency to fix the Indian profits at a certain portion of the total result.

(c) Apportionment between Branch and Parent Enterprise.

1. *Apportionment of Gross Profits of Local Branch to Real Centre of Management abroad.*

91. The mere fact that the management of a business is not established in N.E.I., whereas the business itself is carried on entirely in N.E.I., cannot be considered of sufficient importance to justify holding that part of the profits have been made in the country where the management is situated. This standpoint is due to the fact that the enterprises in N E.I. are primarily agricultural and mining enterprises. The former might be called agricultural-industrial concerns, because they turn the raw material into the product fit for the international market in their own factories on their

own estates. For staple produce (sugar, tea, coffee, pepper, copra, tin and rubber), world market prices exist, and many of these products are sold by tender or sealed bids [1]. Consequently, the work of the directors with regard to the selling is of very little importance in the making of profits. Moreover, the fact that a corporation is established outside of the N.E.I. is often of a purely formal nature.

92. Sometimes the management abroad performs services to which part of the profits may be attributed ; but, in principle, no special part of the profits is to be apportioned to the management as such. Practice will, no doubt, reveal that, in many concerns, it is impossible to keep strictly separate the management as such and its activities with regard to the making of profit.

2. *Apportionment of Expenses of Real Centre of Management to Branch.*

Interest Charges.

93. When only the real centre of management is established outside N.E.I., while the entire business of the foreign enterprise is carried on in this country, the total interest carried by the centre of management on behalf of the enterprise will be charged to the account of the profits taxable in this country. When, on the other hand, the foreign company has several branches, the interest will have to be divided among them. We take, for example, an English rubber company operating exclusively in Sumatra. One day it decides to open rubber estates in Liberia. For the financing of the latter, it is compelled to negotiate a loan. In such case the interest on the loan will not be charged against the East Indian profits. When, however, an import firm has branches in different countries, it will be pretty well impossible to assign loans to any particular branch, and the apportionment of the interest charged will be made according to the degree of importance of each branch in the business complex. As a rule, the turnover figure may be taken as a basis of apportionment.

General Overhead.

94. A similar reasoning is applied for the overhead expenses, on the understanding that, for these expenses, the importance of the branch in the business complex is always the basis for the apportionment. When the enterprise in India is the only business of the foreign company, so that only the management has its seat outside this country (a form which is found very generally in agricultural and mining enterprises), the overhead expenses are, as a general rule, deducted from the profits. Then the profits are put down in total as N.E.I. profits.

95. Some concerns contend that the charges, commissions, etc., made for services to the branch should be deducted from the East Indian profits, but the Court of Tax Appeals has confirmed the opinion of the administration that such deductions should not be allowed. Although it might be fair to allow such deductions in the case of banks and import and export enterprises, it will never be easy in their case to settle the question directly in figures.

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[1] For example, tobacco produced in Northern Sumatra is sold in the following manner samples are exhibited at an auction place called Frascati, in Amsterdam Buyers from all over the world examine the samples and submit sealed bids for certain lots. At a given time, the bids are opened and the lot is sold to the highest bidder Tea is sold on the local Batavia market and also at auction in Amsterdam. Sugar is sold entirely by a selling organisation of sugar-growers called United Java Sugar Producers in Soerabaia, which fixes the price. Most of the rubber is sold on the exchanges at London and Amsterdam Coffee is sold on the local markets in Batavia and Soerabaia or on the exchanges, especially in London and Amsterdam. The price of pepper and copra is largely fixed by the market in New York or London The special market for coffee is Amsterdam The price of tin produced by private companies depends primarily on the London market.

3. *Apportionment of Net Profits.*

96. It is impossible to lay down a general rule in connection with the apportionment of part of the net profits of the branch to the deficitary parent, or *vice versa.*

When an enterprise operates at a total loss, no profit will be allocated to the Indian branch if, for instance, the enterprise consists only of a buying establishment outside N.E.I., and a selling organisation in this country. If, however, there is only one buying establishment outside this country, but several selling establishments in N.E.I. and various other countries, it is quite possible that some profits will be allocated to the East Indian branch, even when the whole enterprise has been working at a loss. This is perfectly logical in view of the fact that possibilities for making profits vary considerably in the different markets. In cases like these, the only way to arrive at satisfactory conclusions is to make an exhaustive analysis of the business itself and a careful comparison with similar enterprises carrying on their business in this country. The above problem is still in its initial stages of development.

97. When the enterprises concerned possess only a wholesale buying organisation within N.E.I., whose profit is calculated by considering a certain commission on the buying as East Indian profit because a more reliable method is lacking, it is conceivable that a certain amount of profit is assessed as having been realised in this country, while the total result of the enterprise would be negative. This gives an example of the undesirable consequences to which this system may lead.

98. With regard to foreign enterprises carrying on agricultural or mining activities in this country, which manufacture the raw products into finished articles and sell them in foreign countries, the East Indian profit can justly be taxed where the business in its entirety is working at a total loss on account of losses sustained in the manufacture abroad of the raw material, or in the sale abroad of the finished product. The East Indian profit would be delimited by the price obtainable for the raw product in the world markets.

(d) Apportionment between Parent Enterprise and Subsidiaries.

99. The present trend of the practice is to determine, as much as possible, the profits made by the subsidiary as if the latter existed independently of the parent company. This has always been done where the parties concerned have maintained separate accounts for the " dummy " and have declared as its profits the full profits of agricultural or mining enterprises. In many cases, however, serious problems have been presented by the fact that the book-keeping of the parent company does not treat the " dummy " as a separate entity, and represents the holding company as the exploiter. Sometimes, from an economic viewpoint the subsidiary enjoys no independent existence, and is, in fact, entirely merged with the parent company.

100. The fiscal authorities are not bound by any settled rule, and if the intention to evade taxation is plain, they have the right to assess the parent company, notwithstanding the representations which the parties concerned may make. Such cases will, however, always remain exceptional, as the authorities are able, in most instances, to respect the legal fiction and still make the necessary corrections in order to arrive at a fair assessment.

101. The word " dummy " has a special significance in N.E.I., resulting from the fact that the agrarian and mining laws forbid companies, organised elsewhere than in the Netherlands or N.E.I., to acquire long lease rights, or mining concessions, or even prospecting licences. Consequently, foreign (not Dutch) companies can only carry on agricultural or mining enterprises in this country through the intermediary of a representative, which, as a rule, is a subsidiary company organised in the Netherlands or in N.E.I. The subsidiary, as a rule, has little capital and holds the long lease titles, etc. The fiscal administration of N.E.I. has always adhered to the point of view that these subsidiary companies are the exploiters of the land or concessions concerned, and are therefore

assessable on the income derived from such properties. If companies take an unfair advantage of this viewpoint, it may be necessary to go a step further, and treat part of the income allotted to the holding company as taxable profits. It will then be necessary for the administration to take into account the profits of the holding company in order to arrive at a proper valuation of the profits of the subsidiary.

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

(a) Industrial and Commercial Enterprises.

1. *Selling Establishments.*

Local Establishments selling in National Markets.

102. When a foreign enterprise purchases goods abroad and sells them in N.E.I., it is exceedingly difficult to define what should be considered as the East Indian profit of the enterprise.

The administration prefers that goods purchased abroad be invoiced to the N.E.I. establishment at the original cost to the enterprise ; the invoice price should therefore not include a part of head-office expenses or a part of the profits to be realised on sale here. The fiscal administration will determine the amount of the deduction to be allowed from the East Indian profit in respect of head-office expenses, and also the amount of the profit realised here which is to be allocated to the purchasing office as its profit.

If the invoice price is above original cost, the administration will require information as to the basis on which it is computed. Several companies send the original invoices showing the price they paid for the goods shipped to the East Indian offices, so that the examination of the book-keeping here gives a complete insight into the state of affairs. Nevertheless, there remains the problem of determining how much of the profit is to be allocated to the branch in this country.

103. It is not fair to start from the idea that all the profits are made on the selling, so that only the expenses of the establishments abroad are deducted. This conception prevailed here formerly, and found many adherents because of its simplicity in throwing the entire profit to the place of sale. Owing to a better insight into these matters, however, the principle of apportioning profits has been adopted.

As a rule, the buying of goods for importation into N.E.I. requires a good deal of experience and commercial judgment, especially when it involves an enormous variety of merchandise. A part of the profits should decidedly be allocated to this buying. For the greater number of import enterprises an allocation on the basis of 25 per cent for the buying and 75 per cent for the selling in this country may be accepted as fair and reasonable. Of course every taxpayer may prove that the circumstances of his own business justify a divergence from this standard.

When a monopoly article is involved, there is a tendency on the part of the fiscal authorities to allocate a larger part — for instance, 90 per cent — of the profits to East India. The reason for this is that, once the agency for these articles has been obtained, the buying is done more or less automatically, being limited chiefly to the passing on of orders from East India.

104. When the foreign company manufactures its own goods, the chief question is whether only a fraction of the output is sold in N.E.I. or whether the products are manufactured exclusively or primarily for sale in N.E.I. If only a part of the products are sold in N.E.I., the calculation of the "selling price" from the factory to the export department of the enterprise should be carefully examined. The price at which the export department invoices to the local sales branch is subject to the same verification as that described above in connection with an enterprise buying abroad for sale in East India. Furthermore, the authorities may request information as to the prices at which the same goods have been invoiced to dealers or branches in other countries, or, if necessary, they may make a comparison with the profits of local competitors. If a company has virtually a

world monopoly of a given product which it markets itself, the taxpayer often fixes the East Indian profits at a certain percentage of the selling price, which may be accepted by the tax authorities after a careful examination of the accounts.

105. When a manufacturing company produces articles especially for N.E.I., it usually markets them here itself through a sales branch, or through a subsidiary company, which, in fact, is nothing more than a sales department of the company. In this case, the profits realised should be fixed at a fraction of the total net profits, and it seems just to allocate to each of the two parts of the enterprise one-half of the profits, although here, also, the particular nature of the business may justify a different percentage. Usually, the taxpayer will show a tendency to put a lower value on the sales profits, and a higher one on the manufacturing profits. On the contrary, the authorities are inclined to put a considerably higher value on the sales. This tendency is the result of the economic development of these recent years, during which sales have become a factor of paramount importance in view of the widespread over-production.

If the sales branch in N.E.I. markets not only goods which have been manufactured by the foreign enterprise, but also goods which have been purchased (for example, to complete its line), the authorities would attempt to segregate the two categories and allocate the profits of each in accordance with what has been said above

Local Establishments selling abroad.

106. Although the establishments referred to here are of rare occurrence, the N.E.I. administration looks upon the activities of the branch established in this country which sells its goods in a third country, where the parent company has no permanent establishment, as selling transactions carried out in this country. If the head office established abroad is able to prove that the sales in neighbouring countries should be attributed entirely or partly to its activities, the administration would take these circumstances into consideration in fixing the profits of the local branch.

2. *Manufacturing Establishments.*

107. In the case of agricultural enterprises, the production of the raw material entails, as a rule, considerable manufacturing processes, and for the finished " raw " product universal market prices exist. The same is true of the products of mining enterprises in N.E.I. Consequently, when a foreign enterprise produces the raw material here and sells it on any of the world exchanges, the entire profit is regarded as taxable in N.E.I. If the foreign enterprise uses its raw material in manufacturing at a factory in another country, the world market price for the raw material is used to delimit the profit allocable to N.E.I. However, N E.I. is not a real industrial country, so that this question of determining manufacturing profits is of no practical importance here. As the wage standard for the native labourer is very low, it is not at all impossible that eventually more and more industries will be established here There can be no doubt that, in this case, a profit would be allocated to the local manufacturing establishment in accordance with the same principles as are applied in apportioning profits between a foreign manufacturing establishment and a local sales establishment (see paragraphs 104 and 105).

3. *Processing Establishments*

108. Processing establishments have seldom, if ever, come to the attention of the fiscal administration. In principle, however, if materials have undergone some kind of manufacturing process in this country, a certain part of the net profit will be allocated to the establishment where the processing took place

4. *Buying Establishments.*

109. Simultaneously with the swing to the viewpoint that the circumstances of purchasing abroad may contribute to the profit realised on the sale of imported goods in N.E.I., the opinion on the taxation of the foreign export houses also underwent a change. There are several foreign enterprises whose activities in N.E.I. are restricted exclusively to buying raw materials for manufacture or retail sale by the principal establishment abroad. These enterprises were exempted formerly, especially when they went in for wholesale buying — for instance, from the large-scale producers (or their agents) of such products as copra, tea, rubber and sugar. According to the ideas now prevailing, there is no reason for this exemption. In the absence of more accurate information concerning the wholesale buying of raw materials for a world concern, it may be sufficient to treat as East Indian profit an amount equal to the usual commission on the purchases that would be paid to an independent purchasing agent, especially when the buying transactions were effected by a subsidiary company, which is substantially in the position of a commission agent. In such case no assessment would be made on the parent company itself. This method of calculating the East Indian profit for the buying establishment, without taking into consideration the results obtained by the whole concern, may not be entirely satisfactory. But there does not seem to be any immediate prospect of a change in view of the difficulties in getting a true insight into the total profit of the foreign concern and the influence of the various business factors.

110. When the concern specialises in buying the products of small native farmers, very often an extensive buying organisation is required, entailing intricate financial transactions (the " advance system "). In such cases, the buying is such an important factor in the making of profits, and the selling abroad is, as a rule, such a very simple transaction, that more than half is to be put down as East Indian profits. But here, as elsewhere, the peculiarities inherent in a specified enterprise may call for special decisions on the part of the authorities. As an example, the business of buying pepper may be taken. There are a few foreign pepper dealers, who not only buy their pepper in the local market in Batavia, but also have their local buying agents in different places in South Sumatra, and, by giving advances to local growers or smaller buying agents, ensure themselves of the quantity of pepper needed for their trade. Such a buying organisation involves considerable risk and expenditure, requires a knowledge of the country, the people and the local markets, and is obviously a much more important factor in the enterprise than the office in London or New York, which sells the pepper on the produce exchange.

111. Difficulties arise especially when the enterprise does not confine itself to real buying and selling of products, but goes in for speculative transactions. The verification of the allocation of profits as made by the taxpayers themselves (for instance, for the purpose of calculating a bonus to the East Indian manager or staff) is exceedingly difficult in those cases, because it is generally impossible to trace the results of certain transactions, on account of the impossibility of putting purchases over against corresponding sales. As a last resort, the East Indian profit will have to be computed by means of valuation.

112. As a general rule, we may say that, for foreign concerns, which carry on wholesale buying in this country of products of industries, which products are again sold wholesale abroad, the profits are considered to have been made in the ratio of 50 per cent within and 50 per cent outside N.E.I. This method of apportionment is applied to the total net profit derived from the transactions carried on partly within and partly without the country, without taking cognisance of any specific commissions or charges made by establishments abroad against the buying establishment within N.E.I. as compensation for sales activities, management or other services rendered to it. The application of this method is, of course, subject to modifications in order to take into account the particular circumstances of a specified enterprise.

113. When the products have to undergo some sort of manufacturing process in N.E.I., the nature of this process will be the deciding factor in determining whether more than 50 per cent is

to be allocated to this country. In one case [1] the taxpayer, a foreign company purchasing and preparing tobacco in N.E.I., had valued its local profits at half of the total net profits. Seeing that the business of this taxpayer consisted in buying within N.E.I. territory wet and half-dried tobacco, curing such tobacco, packing and exporting the finished product and selling it wholesale in Europe, the fiscal authorities moved that even the entire profit might be considered as East Indian profit. The Court of Tax Appeals, however, judged that, as the principal management for the buying, all the selling and the general financial management and the book-keeping were established in Europe, all of which were doing work of considerable influence in the making of profits, it would be a fair division to regard two-thirds of the net profit as East Indian profit.

114. On the other hand, it will be inadmissible to fix the East Indian profit at half of the net results of the foreign enterprise if the latter subjects these products, bought wholesale, to an additional manufacturing process in the foreign country, or sells them to the public at its own retail establishments. In such cases a certain part of the profits must be allocated either to the manufacturing process or to the retail sales.

5. *Research or Statistical Establishments, Display Rooms, etc.*

115. The mere existence of these establishments in N E.I. presents, as a rule, no grounds for taxation, unless direct selling transactions take place on the premises. When a foreign corporation has a sales establishment in this country, it is felt that any profits attributable indirectly to the existence of a display room or a statistical establishment will appear in the books of the selling establishment, and, consequently, will be included in its assessment. Should it be necessary to determine the East Indian profit by fractional apportionment, the existence of such establishments would be considered as justification for increasing the East Indian proportion.

(b) Banking Enterprises.

116. The problem of the allocation of profit in the banking business is exceedingly difficult, and opinions differ greatly. In practice, the banks working in this country maintain separate accounts reflecting the profits of the local branch, subject to correction by the authorities. Until now, practically no difficulties have arisen in connection with the allocation of items of gross income. Thus, the gross income of a N.E.I. branch includes income from lending to individuals or companies in N.E.I., discounting bills in N.E.I., effecting collections or rendering other services in N.E.I., as well as rents from property situated in N.E.I., and profits from a business conducted in N.E.I. The principal difficulty experienced relates to the allocation of deductible interest. No deduction is allowed for interest on the bank's own capital, whether that capital is used by the head office or is used by the branch in N.E.I. or a branch elsewhere. On the contrary, interest on deposits is a deductible expense. It is the theory of the administration that the money from deposits becomes mingled with the capital of the bank itself, and therefore loses its character. The combined funds flow from one establishment of the bank to another in accordance with the need for it in making loans. When an establishment advances money to another, it charges interest. For tax purposes, however (or for purposes of determining the profitableness of the various establishments), only the interest on deposits is deductible. As it is impossible to ascertain how much of every advance is out of deposits and how much is out of capital, the authorities presume that the proportion of deposits to capital is the same in every part of the enterprise. Consequently, the tax authorities allow as a deduction from the East Indian profits the same proportion of interest paid here to depositors as total deposits bear to total capital.

[1] Court of Tax Appeals judgment of September 13th, 1926, No. 21, concerning the war tax on profits.

117. The taxpayers frequently object to the theory of the administration on the grounds that the amounts deposited in the N.E.I. branch often exceed, in fact, the amounts loaned by the branch, and, therefore, the above-described limitation should not be applied to the interest actually paid by the local branch to its depositors. To such arguments the administration replies that it is impossible to say that income from loans is earned solely by the use of deposits. Amounts deposited become mingled with the capital. Depositors will not put their money in a bank unless it has sufficient capital to assure them of the safe return of their money when wanted. Consequently, it is presumed that earnings should be attributed to capital and deposits in the ratio of their respective amounts. This ratio is the same in all the branches of the business (with the possible exception of banks of issue and banks working in countries with abnormally high or low rates of interest). The ratio between the capital and deposits of the N.E I. branch is therefore presumed by the authorities to be the same as the proportion between the company's entire capital and deposits, regardless of the amount of capital allotted to the local branch in the books of the parent bank, and this proportion limits the amount of interest on deposits that may be deducted. Another argument in favour of the views of the administration is that the computing of the so-called East Indian capital by the taxpayers themselves may be exceedingly arbitrary. As certain taxpayers object to these views, they may eventually be tested before the Court of Tax Appeals.

118. Where the head office of a foreign bank lends money to the head office of a foreign company for use in its business or exploitation in N.E.I , the interest on such loan is generally allocated by the authorities to the bank's branch in N E I., even though the bank itself may not do so.

(c) Insurance Enterprises.

119. In general the local branches of foreign insurance companies are taxed on the basis of their separate accounts, subject of course to verification, unless they elect to be taxed by the fractional method described in paragraph 33.

(d) Transport Enterprises.

120. The geographical situation of the N.E.I. makes it a matter of course that, by these enterprises, we can only mean those engaged in shipping and air transport. As from January 1st, 1933, non-resident shipping and air-transport enterprises are exempt on profits derived from freight and passenger service between foreign countries and N E I., but not from inter-island transportation (see paragraphs 18 and 31).

121. The principle on which the calculation of the profits of foreign shipping companies has been based in the past is that 50 per cent of the profits made by transport by land and water from country A to country B is allowed for each country. Therefore, the formula for the East Indian profits is :

$$\text{N.E.I net profit} = \frac{\text{Inter island freight and passage money, plus half freight and passage money to and from N.E.I.}}{\text{Total amount of freight and passage money}} \times \text{total net profit}$$

Notwithstanding the opposition of the principal shipping companies, the Court of Tax Appeals has always upheld this formula, which has been accepted by the foreign companies whose interests in the levies in this country are not so great.

(e) Power, Light and Gas Enterprises.

122. In view of the geographical situation of the N.E.I., these foreign enterprises are of no importance. Foreign companies, exploiting such industries in this country and also abroad,

can always arrange their book-keeping in such a manner that the profits made by the industries established in this country can be calculated or computed without any trouble. The only possible difficulties might arise from the distribution of overhead expenses and calculation of interest.

(f) Telegraph and Telephone Enterprises.

123. Only the cable companies are of importance here, as practically the whole of the telephone service is exploited by the Government. The N.E.I. net profits of a cable company are calculated by apportioning the total net profit in the ratio of gross receipts.

(g) Mining Enterprises.

124. As a general rule, mining enterprises in N.E I. present few difficulties, as their operations do not extend abroad.

Local oil industries give rise to serious problems, however, because they are merely a part of world concerns, and the determination of the sale price is very difficult. Until now, the basis of calculation of the production profits of the concerns producing here and selling abroad has been the so-called " gulf price " of oil. The oil sold in N.E.I. is entirely produced here.

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

125. Enterprises having their centre of management in N.E.I. and branches or subsidiaries abroad are of very rare occurrence; a systematic examination of the questions similar to those treated in connection with foreign enterprises is therefore superfluous.

126. It should, however, be stated that the same principles for the allocation of profits as those described in connection with foreign enterprises would be applied for local enterprises with branches or subsidiaries abroad

C. HOLDING COMPANIES.

127. *Local Holding Company controlling One or More Subsidiaries abroad.* — There are no holding companies established in N.E.I. which control foreign subsidiary companies, but, if they existed, they would be taxable on their dividends or other income received from foreign subsidiaries (see paragraph 63).

128. *Local Subsidiary controlled by a Foreign Holding Company.* — No tax is imposed on dividends paid by a local subsidiary to a foreign holding company (see paragraphs 32 and 42). Profits diverted from a subsidiary to a foreign parent may be taxed as described in paragraph 96.

Annex.

TABLE OF TARIFFS.

I INCOME-TAX. [1]
(On Individuals and Partnerships.)

Taxable income between	and	Tax corresponding to the first figure of the "income" column	Tax applicable to the portion of income included between the two figures of the "income" column		
(In florin)		(In florins)	(In florins)		
				For each whole amount of	exceeding
120	560	1.20	0.20	10	120
560	1,200	10	0.25	10	560
1,200	2,000	26	1.50	50	1,200
2,000	2,800	50	3.50	100	2,000
2,800	3,600	78	4.—	100	2,800
3,600	4,400	110	4.50	100	3,600
4,400	5,200	146	5.—	100	4,400
5,200	6,000	186	5.50	100	5,200
6,000	8,000	230	6.—	100	6,000
8,000	10,000	350	7.	100	8,000
10,000	14,000	490	8.—	100	10,000
14,000	18,000	810	9.	100	14,000
18,000	22,000	1,170	10.—	100	18,000
22,000	26,000	1,570	11.—	100	22,000
26,000	30,000	2,010	12.—	100	26,000
30,000	34,000	2,490	13.—	100	30,000
34,000	38,000	3,010	14.—	100	34,000
38,000	43,000	3,570	15.—	100	38,000
43,000	48,000	4,320	16.—	100	43,000
48,000	54,000	5,120	17.—	100	48,000
54,000	60,000	6,140	18.—	100	54,000
60,000	66,000	7,220	19.—	100	60,000
66,000	74,000	8,360	20.—	100	66,000
74,000	82,000	9,960	21.—	100	74,000
82,000	90,000	11,640	22.—	100	82,000
90,000	100,000	13,400	23.—	100	90,000
100,000	110,000	15,700	24.—	100	100,000
110,000	120,000	18,100	25.—	100	110,000
120,000	130,000	20,600	26.—	100	120,000
130,000	140,000	23,200	27.—	100	130,000
140,000	150,000	25,900	28.—	100	140,000
150,000	160,000	28,700	29.—	100	150,000
160,000	175,000	31,600	30.—	100	160,000
175,000	190,000	36,100	31.—	100	175,000
190,000	and above	40,750	32.—	100	190,000

[1] Figures in force for the tax year 1933, in virtue of Article 27 of the Income Tax Ordinance, 1932.

II. Company Tax.

Basic rate : 10 florins on each full 100 florins of the taxable net profit. [1]
Annual surcharge [2] : 40 per cent of the basic rate.

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[1] Article 11 of the Company Tax Ordinance.
[2] Figure in force for the tax year 1932

UNION OF SOUTH AFRICA

BY

A. F. CORBETT,

Commissioner for Inland Revenue.

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PART I. — GENERAL DESCRIPTION OF INCOME-TAX SYSTEM.[1]

1. The tax takes the form of a *normal tax* and *supertax*. To this has been added for the current financial year, as a form of emergency taxation, a *surtax* upon one class of income, " fixed interest " — that is, interest derived from investment securities. [2]

2. Up to the 1932-33 financial year, the *normal tax* was imposed under three sets of rates:

(a) In the case of companies whose principal business was the mining for gold or diamonds, at a flat rate of three shillings in the pound (15 per cent);

(b) In the case of all other companies, at a flat rate of two shillings and sixpence in the pound (12½ per cent);

(c) In the case of persons other than companies, at the rate in the pound of one shilling and as many two-thousandths of a penny as there were pounds in the amount chargeable.

3. For the 1932-33 financial year, the rate for gold-mining companies has been increased to four shillings in the pound.

4. The amount upon which the tax is levied in each of these classes is the net amount, after the allowance of the deductions and abatements permitted by the statute, of the income derived by the taxable entity from sources within the Union or deemed for the purposes of the statute to be so derived. A more detailed examination of the nature of the income so charged will be given under the heading " Taxable Income " below.

5. *Supertax* is levied upon the net amount chargeable under the statute at a rate in the pound of one shilling and as many five-hundredths of one penny as there are pounds in the amount so chargeable.

6. The amount subject to supertax is built up on the basis of the taxable income determined for normal tax purposes, the determination for those purposes being final and conclusive as far as supertax is concerned. To the amount so determined are added:

(a) Dividends derived from public companies in so far as they have been derived from

---

[1] Legislation in force on December 31st, 1932.

[2] The following figures, taken from the 1931-32 budget accounts, will illustrate the relative importance of the income-tax in the Union's budget:

Income-tax: £6,000,000; other taxes (Customs, excise, tax on natives, death duties, stamp duties, etc.): £12,000,000; Post, Telegraph, Telephone, services rendered, public estate, miscellaneous: £9,000,000. Total, £27,000,000.

Income-tax yield can be analysed so as to show the yield under the classes taxed at different rates; Gold and diamond mining companies produced £1,750,000; other companies, £1,550,000; individuals, £1,750,000; supertax, £950,000.

sources within the Union, including liquidation dividends, to the extent that they represent the distribution of profits ;

(b) The nominal value of bonus shares awarded to any taxpayer by way of capitalising the profits of a company of which such taxpayer was a shareholder ;

(c) Any allocation to the taxpayer from the undistributed profits of a private company, where, in the opinion of the taxing authority, an inadequate distribution has been made.

7. Supertax is chargeable in the case of all persons other than public companies ; thus, individuals, estates, trusts and private companies are brought within the charge. The inclusion of private companies dates from the present financial year only, and has been rendered necessary by the use of incorporation under the Companies Act as a means for evading this form of taxation. For this purpose, however, a restricted meaning has been placed upon the term " private company ". It is limited to companies in which :

(a) Shares representing not less than 90 per cent of the share capital of the company are held or controlled by not more than any five shareholders ; or

(b) Shares representing not less than 51 per cent of the share capital are held or controlled by one person ; or

(c) Not less than 75 per cent of the working capital has been supplied by one person.

8. From these classes of companies (which may, of course, overlap) there are excluded :

(a) A company in which shares representing not less than 80 per cent of the share capital are held or controlled by a public company or public companies ;

(b) A company which has distributed as dividends during the year of assessment an amount not less than 75 per cent of the amount which would otherwise constitute its income subject to supertax for that year ;

(c) A company whose sole or principal business is mining for gold, to the extent that its profits are derived from that source.

9. Companies so excluded are public companies for the purposes of the tax, and their distributions of dividends are liable for taxation in the hands of the recipients ; whereas the distributions by private companies, as so defined, are free from taxation in the hands of the recipients, irrespective of whether the distributing company has actually been charged with supertax or not and without regard to the rate of tax to which it may have been liable if so chargeable. This provision, which admittedly will be productive of anomalies, has been adopted with a view to the simplification of administration.

10. The *surtax*, introduced by the Income-Tax Act No. 28, of 1932, picks out for special taxation " fixed interest ", which is defined by a restrictive definition which specifies the several forms of interest which are to be included in the term. The following are the classes of interest so included :

(a) Interest derived from stocks and securities (other than Treasury Bills) issued by the Government of the Union or of any colony now included in the Union or by any local authority within the Union ;

(b) Interest derived by residents in the Union from stocks and securities issued by other Governments where such interest is exempted from taxation under the laws of the State of issue in the case of persons non-resident in that State ;

(c) Interest derived from debentures or debenture bonds ;

(d) Interest derived from mortgage bonds or notarial bonds registered in any deeds registry of the Union, other than covering bonds given to secure fluctuating liabilities ;

(e) Interest derived from fixed deposits ;

(f) Interest derived from deposits for purposes of investment with any person or institution.

11. Save in the case of life assurance companies, the charge is limited to such items of interest of the specified classes as would fall for assessment under the normal tax provisions. Where, therefore, a particular class of interest is exempted from normal tax (as, for example, interest on deposits in the Post Office Savings Bank) or interest is exempted in the hands of certain persons (as, for example, interest on Government stocks held by persons who are neither resident nor carry on business in the Union), no liability for surtax will arise.

12. Life assurance companies, both mutual and non-mutual, are excluded from these exemptions. They are made specifically liable to the surtax. These companies are brought within the scope of the surtax for no other reason than the necessity for revenue. They are the largest individual recipients of " fixed interest " in the Union.

13. The rate of tax is progressive according to the rate of interest charged under the security by which it is produced. The scale is as follows :

Where the rate of interest charged :	Per cent
Does not exceed 5 per cent per annum, the rate of tax is	5
Exceeds 5 per cent but does not exceed 6 per cent, the rate of tax is	6
Exceeds 6 per cent but does not exceed 7 per cent, the rate of tax is	7
Exceeds 7 per cent but does not exceed 8 per cent, the rate of tax is	8
Exceeds 8 per cent but does not exceed 9 per cent, the rate of tax is	9
Exceeds 9 per cent, the rate of tax is	10

14. Where two or more securities yielding different rates of interest are held by one taxpayer, the rate applicable is determined by expressing the sum of the amounts of surtax calculated at the rate appropriate in each case upon the gross interest derived from each security as a percentage of the sum of the gross interest derived from all the securities.

1. TAXPAYERS.

(a) INDIVIDUAL.

15. Neither nationality, domicile, nor residence affect the liability of individuals, save in a few special instances. The general basis of the tax is source within the Union, and, provided that the income arises from such a source, the recipient is liable whatever may be his nationality, domicile or residence. Conversely, Union nationality, domicile or residence does not create liability in respect of income derived from sources outside the Union.

16. The exceptions to this rule are as follows :

(1) Extensions of the charge :

Interest on stocks or securities issued by other Governments is liable in the hands of a person ordinarily resident or carrying on business in the Union if such interest is not chargeable with income-tax in the country of origin by reason of the recipient not being domiciled or resident therein (Section 9 (4), Income-Tax Act No. 40, of 1925, as amended by Act 36, of 1926).

(2) Restrictions of the charge :

(a) Interest from Union Government stocks and securities (including Treasury Bills), and the stocks and securities issued by the Governments of the colonies now included in the Union or by local authorities in the Union, is exempt from taxation if the recipient is neither ordinarily resident nor carries on business within the Union (Section 10 (1) *(h)* of Income-Tax Act No. 40, of 1925, as amended by Act 36, of 1926).

(b) Dividends distributed by companies from profits earned in the Union are exempt in the hands of persons not ordinarily resident nor carrying on business in the Union, provided such dividends are neither paid nor payable in the Union (Section 33, Income-Tax Act No. 40, of 1925).

(b) Partnerships.

17. While persons carrying on business in partnership are required to make a joint return as partners in respect of such business (Section 37 (15), Income-Tax Act No. 40, of 1925), each partner is assessable separately (Section 46 (7), *ibid.)*. His *pro rata* share of the profits of the partnership business, determined as though the taxable income of the partnership were being ascertained, is taken into account in the calculation of his individual taxable amount, income from other sources being added and losses under other heads being set off in the final determination. In calculating the share of profit derived from the partnership business by any partner, any salary drawn by him from the business or interest credited to him on the capital invested by him in the business is treated as a portion of his share of profit.

18. To meet the difficulty that, while his liability for income-tax is personal to a partner, his only asset may be his interest in the partnership business, provision is made under Section 66 (2) of the Income-Tax Act No. 40, of 1925, that the tax due and payable by a partner in any business may be recovered from the assets of the partnership in so far as it is referable to the share of profits derived by him from the partnership business. To determine how much is so referable, the section provides that a proportion of the tax due by him shall be taken in the ratio that his share of the partnership profits bears to his total taxable income from all sources. To guard against the liability of one partner becoming a charge upon his fellow partners, further provision is made that the amount recovered from the partnership assets shall not exceed the interest of the partner concerned in the partnership assets.

(c) Companies.

19. The term " Company " is defined in Section 72 of the Income-Tax Act No. 40, of 1925, as " any association incorporated or registered under any law in force in any part of the Union and any such association which, though incorporated or registered outside the Union, carries on business or has an office or place of business therein ".

Thus, to fall within the scope of the charge upon companies, a company must be :

(a) Registered under a statute in force in the Union ; or

(b) Carrying on business in the Union ; or

(c) Having an office or place of business in the Union.

But these conditions, while determining whether a company falls within the scope of the taxing statute, do not in themselves create any liability for taxation. For any such liability to arise, there must be a taxable amount accrued to such a company from sources within the Union and so rendered taxable by the Statute.

20. Of the three conditions, *(a)* and *(c)* are purely questions of fact. Condition *(b)*, while also a question of fact, must be determined from a consideration of the actual operations of the company during the year of assessment. It will be observed that, to be liable, a company must itself conduct business operations within the confines of the Union. To trade *with* the Union, either directly or through an agent resident in the Union, is not sufficient to bring it within the charge. The operations must be those of the company itself. The nature and extent of operations which will constitute such carrying on of business were discussed in the case of Joel *v.* Commissioner for Inland Revenue (1922, W.L.D. 29).

It is not essential that the real centre of management should be within the Union. The existence of a branch office is sufficient to bring a company within condition *(c)*.

2. TAXABLE INCOME.

21. For the purposes of this study, national income is taken to be income derived from sources within the Union, and foreign income is taken to be income derived from sources outside the Union.

22. By the terms of the Income-Tax Act No. 40, of 1925, the income-tax of the Union is imposed only upon income derived from sources within the Union, or, by the terms of the Act, deemed to be so derived. In treating certain classes of income as derived from sources deemed to be within the Union, the system of taxation brings within the scope of the tax and treats as national income certain items which might be regarded more properly as foreign income. The heads of income so treated are :

(a) Remuneration received for services rendered outside the Union, when the services are rendered to the Government of the Union or any local authority within the Union under contract with such Government or local authority ;

(b) Interest upon any stocks or securities issued by the Government of any other State (including Dominions of the British Commonwealth and British colonies or dependencies) when received by residents in the Union, who are exempt from taxation on such interest by the country of origin by reason of their non-residence in that country.

23. For the determination of the " national " taxable income or income derived from sources within the Union, the net is widely spread. " Taxable income " in terms of the Income-tax Act is determined by a process of elimination from " gross income ", and " gross income " is defined in relation to any taxpayer as his total receipts and accruals, whether in cash or otherwise, other than receipts of a capital nature, and, in addition to this general provision, there are enumerated certain specified forms of receipt which, though doubtful in nature or definitely of a capital nature, are to be included for statutory purposes in income. These special additions are :

(a) Annuities (including that portion of the annuity which represents return of capital);

(b) Gratuitous receipts for services rendered ;

(c) Commutations of amounts due under a contract of service ;

(d) Premiums received for the occupation of premises or the use of machinery ;

(e) The annual value of quarters, board, residence or other advantages granted in respect of employment ;

(f) Any surplus on the realisation of capital assets over the redemption allowances made in respect of those assets (in the case of mining operations only).

24. The deciding factor in the limitation of the scope of the tax is the capital nature of any receipt, and it is in the application of this dividing-line that the bulk of controversy in applying the statute arises. The characteristics of a receipt of a capital nature have been dealt with in a series of decisions of the Supreme Court of the Union, of which the principal are the following : In Commissioner of Taxes *v.* Booysens Estates Limited (1918, A.D. 576), it was held that, in the absence of evidence that the respondent company had been formed for the purposes of trading in mining properties, the profit realised by the company on the disposal of its properties was a receipt of a capital nature and not income. In Stephan *v.* Commissioner for Inland Revenue (1919, W.L.D. 1), it was held that the profits realised in the salvage of the contents of a single vessel constituted income, inasmuch as the venture required systematic organisation on business lines, notwithstanding that such operations, by reason of lack of opportunity, were and could only be of an isolated character. In Deary *v.* Deputy Commissioner for Inland Revenue (1920, C.P.D. 541), the seller of a business allowed the purchase price to remain unpaid, but secured under a bond on the assets of the business, with the proviso, however, that, so long as it remained unpaid, one-fourth of the profits of the business should be paid over to him. It was held that, notwithstanding that the payment was described as " for and in consideration of his goodwill ", the share of the annual profits so received by the seller constituted income, and was not a receipt of a capital nature. In Commissioner for Inland Revenue *v.* Lunnon (1924, A.D. 94 ; 1 S.A. Tax Cases, 7), a payment made to an ex-director of a company after his resignation from office was held to be of a capital nature. In Commissioner for Inland Revenue *v.* George Forest Timber Company Limited (1924, A.D. 516 ; 1 S.A. Tax Cases, 20), the profits realised by the sale of timber cut from a natural forest were held to be income, and the diminution of the value of the forest by the cutting was held not to be an allowable deduction.

In Overseas Trust Corporation Limited *v.* Commissioner for Inland Revenue (1926, A.D. 444 ; 2 S.A. Tax Cases, 71), an investment company which had acquired shares in companies in liquidation was held to have earned income and not a receipt of a capital nature when realising a profit on the distribution of the assets of the liquidated companies. In Commissioner for Inland Revenue *v.* Lydenburg Platinum Limited (1929, A.D. 137 ; 4 S.A. Tax Cases, 8), it was held that a company which had been originally formed for carrying on mining operations but had abandoned mining and proceeded to purchase large additional properties of a speculative mining value realised income and not an accretion of capital on the disposal of the properties so acquired.

25. The question of source also was dealt with in the Overseas Trust Corporation case *(supra)* when it was held that profit resulting from the employment of capital in the Union was derived from a source within the Union, notwithstanding that the assets acquired by the use of the capital might be situated outside the Union or disposed of to persons outside the Union through agents employed for that purpose in foreign countries. In this decision, the court followed a previous judgment in Commissioner of Taxes *v.* Dunn and Company Limited (1918, A.D. 607), in which it held that interest earned by an English company on advances on open account for the purchase of goods in England for despatch to a South African business firm was derived from a source in England, where the capital was employed in making the purchases. In a later case, a novel written in the Union by a novelist ordinarily resident in the Union was held to have produced income from Union sources, notwithstanding that it was published outside the Union under a contract negotiated outside the Union (Millin *v.* Commissioner for Inland Revenue, 1928, A.D. 207; 3 S.A. Tax Cases, 170).

3. ASSESSMENT OF TAX.

(a) Computation of Taxable Income and Abatements.

26. " Taxable income " is determined by eliminating from " gross income ", firstly, all amounts exempted from the tax ; and, secondly, the deductions and set-offs permitted under the statute.

General Provisions.

27. *Exemptions.* — The exemptions provided are (Section 10, Income-Tax Act No. 40, of 1925) :

(1) Revenues of *(a)* the Government of the Union ; *(b)* the provincial administrations of the Union ; *(c)* other States (including British Dominions and colonies and other possessions), when derived from sources within the Union, save such revenues derived by such British State, colony or possession as is derived from any trade carried on within the Union ; *(d)* local authorities within the Union. [1]

(2) Any receipts or accruals whatsoever of *(a)* building societies ; *(b)* friendly societies ; *(c)* trade unions ; *(d)* pension, superannuation or provident funds of a permanent nature ; *(e)* ecclesiastical, charitable or educational institutions of a public character.

(3) All receipts and accruals of mutual life assurance societies, in so far as they arise from the business of life assurance and the granting of annuities.

(4) The receipts and accruals, other than receipts and accruals from investments of *(a)* amateur sporting bodies ; *(b)* associations, registered and unregistered, which do not derive profit out of transactions with persons other than their members ;

(5) The salaries and other emoluments paid to *(a)* the Governor-General and his personal staff ; *(b)* officials of other States (including British States, colonies and possessions), provided that the persons employed as officials are not ordinarily resident in the Union ;

(6) The following specific forms of income : *(a)* war pensions ; *(b)* awards under the Miners' Phthisis Acts of the Union ; *(c)* interest derived by persons not ordinarily resident nor carrying on business in the Union from stocks and securities of the Government of the Union of any colony now included in the Union, or of any local authority in the Union ; *(d)* interest on any loan issued by the Government of the Union free of tax [2] ; *(e)* interest on : Post Office Savings Bank deposits, Post Office Savings Bank certificates, Union Loan certificates, Building Society contributory shares ; *(f)* dividends from companies which fall within the scope of the normal tax provisions ; *(g)* profits derived from gold-mining leases granted by the State in which the liability for taxation was commuted in the rental charged [3].

28. *Deductions.* — For the purposes of the deductions, each " trade " carried on by the taxpayer is dealt with separately. " Trade " is defined as covering practically every activity for the pursuit of gain. The deductions allowed in terms of the Act are (Section 11, Income-Tax Act No. 40, of 1925) :

(1) Generally, *(a)* expenditure and losses incurred in the Union in the production of the

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[1] " Local authority " is defined in Section 72 of the Income-Tax Act as meaning " any divisional council, rural council, municipal council, town council, village council, town board, local board, village management board, health committee, school board, district council, the Transkeian General Council, the Pondoland General Council, any additional, local or general council established under the Native Affairs Act No. 20, of 1923, and the Rand Water Board ".

[2] All such loans have now been redeemed.

[3] Only one lease was issued on these terms.

income, other than expenditure and losses of a capital nature ; *(b)* so much of such expenditure incurred outside the Union as the Commissioner for Inland Revenue in his discretion may allow.

(2) Specifically, *(a)* the cost of repairs to income-producing property and to machinery, implements and other articles used in the income-producing trade or business ; *(b)* an allowance for the diminution in value by reason of wear and tear of machinery, implements and other articles used in the income-producing trade or business (no wear-and-tear allowance is permissible in respect of buildings and other structures of a permanent nature) ; *(c)* an allowance, calculated over the period of the lease, in respect of any premium paid for the lease of property or machinery ; *(d)* an allowance for bad and doubtful debts (bad debts must be proved to be so to the satisfaction of the Commissioner and doubtful debts when so established are to be valued by the Commissioner) ; *(e)* compulsory pension fund contributions ; *(f)* an obsolescence allowance in respect of income-producing assets other than fixed property (see *(a)* above) — this allowance can only be claimed on the scrapping of the asset in question and is limited to the difference between the cost price to the taxpayer and the sum of any allowances made to him under point *(a)* and the price realised by the scrapped asset (if any).

29. Instead of the allowances for wear and tear, lease premiums and obsolescence, enumerated under *(b)*, *(c)* and *(f)* above, mining concerns are allowed a redemption allowance in respect of expenditure upon equipment and development, calculated over the life of the mine in respect of which the expenditure has been incurred (Sections 11 (2) *(f)* and 23, Income-Tax Act).

30. *Losses.* -- The amounts allowed to be set off against the taxable income as determined after the above eliminations and deductions are :

(a) As against the taxable income derived from any particular trade, any assessed loss incurred by the taxpayer during the same year in carrying on any other trade, and

(b) As against the total taxable income from all trades and other sources, any balance of assessed loss from his transactions taken as a whole brought forward from the previous year of assessment.

31. No losses incurred prior to July 1st, 1915, when the present form of income-tax was introduced, may be claimed as a set-off, but, apart from this restriction, there is no limit in period for the losses on income account which can be carried forward.

32. *Capital Expenses.* -- The restriction of the expenditure and losses admissible as deductions to those other than of a capital nature balances the corresponding limitation of income. As in the case of income, the phrase has called for judicial interpretation. In Randfontein Estates and Gold Mining Company Limited *v.* Commissioner of Taxes (1917, T.P.D. 278), expenditure on prospecting the properties of the company was held to be of a capital nature ; so, in Lockie Brothers Limited *v.* Commissioner for Inland Revenue (1922, T.P.D. 42), were losses due to the withdrawal of sums by a fraudulent manager under the guise of fictitious purchases of trading stock. In the George Forest Timber Company Limited *v.* Commissioner for Inland Revenue (1924, A.D. 516 ; 1 S.A. Tax Cases, 20), the cost of acquiring a natural forest for the purpose of felling the trees and converting the resulting timber into a saleable product was held to be within the restriction, as was also the cost of building deviations to an existing railway track in Rhodesian Railways *v.* Commissioner for Taxes for Southern Rhodesia (1925, A.D. 438 ; 1 S.A. Tax Cases, 133), under an Act of Southern Rhodesia which takes over the provisions of the Union Act. In Baikie *v.* Commissioner for Inland Revenue (1931, A.D. 496 ; 5 S.A. Tax Cases, 173), the expenditure on acquiring a wattle plantation, when purchased with the land upon which it was growing, was held to be of a capital nature, though the bark and timber, produce of the plantation when felled, would constitute a receipt of income by the farmer purchasing the property.

Special Provisions applicable to Particular Trades.

33. In addition to the general provisions specified above, the Union income-tax system makes special provision for the determination of the taxable income derivable from :

(a) Farming operations ; *(b)* mining operations ; *(c)* foreign shipping enterprise ; *(d)* the operation in the Union of submarine cables or wireless communications ; *(e)* insurance business.

Of these heads, *(c)*, *(d)* and *(e)* will be dealt with under Part III of this report. Heads *(a)* and *(b)* deal with purely national enterprises.

34. (a) *Farming Operations* (Section 15, Income-Tax Act No. 40, of 1925). — In so far as their returns relate to income derived from farming operations, taxpayers are given an option whether there shall be included in the determination of the taxable income derived from those operations the value of the live-stock and produce held by them at the beginning and end of each year of assessment.

35. If the taxpayer decides against including these items, he must account in any year of assessment for the full amount realised by any disposals of live-stock and produce during the year of assessment, though the Commissioner is empowered to make an allowance for any *initial* capital included in the realisation, and, in such an allowance, the capital held in live-stock or produce on the date prior to the first imposition of income-tax in the Union (June 30th, 1913) is to be regarded as the initial capital of any taxpayer who was farming at that date.

36. This method of return is largely favoured by the farming class who, for the most part, keep very inadequate records of their transactions and prefer to take the risk of a heavy assessment in the event of a large realisation rather than maintain full records of their stock year by year.

37. If the taxpayer decides to include live-stock and produce on hand in his returns, he is allowed to select standard values for the various classes of his live-stock, thus simplifying his returns to an enumeration of each class. The values are intended to be constant from year to year, but power is given to the Commissioner to adjust values to general economic conditions, and this power has been exercised during periods of catastrophic falls in values, such as that now prevailing.

38. Both classes of farmers are given a special privilege over other taxpayers in that they are allowed to claim as deductions the cost of certain capital improvements such as dipping tanks, dams, water-furrows, boreholes and pumping-plants, fences, the eradication of noxious plants, the prevention of soil erosion, the erection of buildings used in connection with farming operations other than those used for domestic purposes, and the establishment of orchards and vineyards.

39. (b) *Mining Operations* (Sections 23 and 24 Income-Tax Act No. 40, of 1925). — In addition to other items of expenditure allowed generally, but in substitution for the allowances in respect of wear-and-tear on capital assets, diminution of the value of leaseholds, and scrapping, there is allowed in the determination of taxable income from mining operations an annual redemption allowance in respect of capital expenditure incurred in the development and equipment of the mine and its administration prior to production or during any period of non-production.

40. The allowance is determined by dividing the sum of the unredeemed expenditure at the close of the year of assessment by the number of years of life attributed to the mine.

The life is automatically reviewed every third year, but can be reconsidered at the instance of either the taxpayer or the Commissioner whenever any material alteration takes place in the circumstances of the mine.

The determination of the life is made by the Government Mining Engineer, subject to review by the special court for hearing income-tax appeals in the case of dispute.

(b) Computation of Tax and Abatements.

41. When the taxable income has been determined, certain abatements are allowed in calculating the taxable amount — that is, the amount upon which the tax payable is actually calculated (Section 14, Income-Tax Act No. 40, of 1925).

42. The abatements differ in the case of companies and persons other than companies. In the former case, it is limited to an allowance of £300, which is reduced by £1 for each £1 by which the taxable income exceeds £300. Thus a taxable income of £301 produces a taxable amount of £2.

43. Persons other than companies, in which class are included all unincorporated entities such as trusts, clubs, etc., are allowed a more extended abatement which is made up of a series of allowances, which are applicable according to the circumstances of the taxpayer. The allowances consist of :

(a) A sum of £300 ;

(b) A sum not exceeding £50 in respect of insurance premiums (the policies may cover death, accident or sickness, but must insure either the taxpayer, his wife or minor children) ;

(c) A sum not exceeding £10 in respect of subscriptions to benefit and friendly societies ;

(d) A sum of £75 in respect of each unmarried child or step-child, who having been alive during the year of assessment was (or would have been, had it survived) under the age of twenty-one years on the last day of the year of assessment ;

(e) A sum of £30 for each dependent (a dependent is defined as any person incapacitated by old age, infirmity or any other reason satisfactory to the Commissioner from maintaining himself, or any child (other than the child or step-child of the taxpayer (for whom provision is made under the children's abatement)) under the age of twenty-one years on the last day of the year of assessment to whose maintenance during the year of assessment the taxpayer has contributed in cash or otherwise to an amount not less than £30).

44. The abatement made up of the sum of these allowances is, however, subject to reduction, in the case of married persons, by £1 for every completed £10 by which the taxable income of the taxpayer exceeds £600, and, in the case of unmarried persons, by £1 for every completed £1 by which the taxable income of the taxpayer exceeds £300. For the purpose of calculating these deductions, a married person includes a widow or widower or a divorced person who maintained during any portion of the year of assessment a child qualified for the children's abatement.

45. In the determination of the supertax, special provisions are made both for the allowance of deductions and the provision of abatements. In respect of those items of the income subject to supertax other than the taxable income as determined for normal tax purposes, the cost of production within the Union (other than any costs of a capital nature) is allowed as a deduction. Moreover, when a taxpayer, instead of a taxable income for normal tax purposes, has an assessed loss, he is entitled to set off that loss against the other items of his income subject to supertax — as, for example, dividends — so as to avoid an anomaly of a heavy payment of supertax when a loss may have been suffered over the whole transactions of the year.

46. To determine the taxable amount subject to supertax, an abatement is applied to the income so subject. This abatement starts at the rate of £2,500, but is reduced by £1 for each £1

that the income exceeds that sum. Thus, an income subject to supertax of £2,502 produces an amount so subject of £4, and the whole abatement is absorbed and disappears at £5,000.

47. Under the provisions imposing the new surtax on " fixed interest ", deductions can be made of expenses, including interest paid out, incurred in the earning of the interest taxed, and an abatement is provided which is based, not on the amount of interest subject to the tax, but on the taxable income and dividends accruing to the recipient of the interest. Where the sum of the taxable income and dividends does not exceed £300, any fixed interest is wholly exempt ; where the sum of the taxable income and dividends exceeds £300, the amount of such interest taxable is limited to the amount of that excess. Thus a taxpayer in receipt of fixed interest amounting to £80, whose taxable income and dividends together amounted to £350, would pay surtax on £50 and not on £80.

4. COLLECTION OF TAX.

48. All forms of tax under the Union income-tax system are collected by direct payment. There is no collection at the source. Returns are obtained from the recipients of the income taxable and assessments are made upon them directly, which are required to be paid at the Revenue Offices of the Government of the Union.

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

1. Definition and General Principles.

49. For the purposes of this part, a foreign enterprise is defined as one which has its real centre of management outside the Union of South Africa. By enterprise is meant a business concern organised for the purposes of making profit.

50. A foreign enterprise, whether belonging to an individual, partnership or a company, is liable to the Union income-tax if, and only if, it derives from sources within the Union income within the definition of that term as contained in the Income-Tax Act of the Union (Act No. 40, of 1925). Certain items of income are deemed to be derived from sources within the Union which would not naturally fall within that description (see Part I, paragraph 21 *et seq.)*.

51. Generally, it may be said that the existence or non-existence within the Union of a business establishment of any foreign enterprise does not affect the liability of such an enterprise for tax in respect of any income arising from sources within the Union, though the absence of such an establishment may materially affect the issue whether any particular income does arise from such sources. The exception to this general principle is the provision in respect of dividends *(vide infra)*.

2. Taxation of Certain Kinds of Income.

(a) *Dividends.*

52. Dividends derived from companies which fall within the scope of the normal tax provisions are exempt from normal tax in the hands of the shareholders who receive them, but are liable to supertax. Supertax is chargeable in the case of all persons other than public companies (for the differentiation between public companies and other companies for this purpose, see Part I, paragraphs 7 to 9). But from this liability for supertax upon dividends, a special exemption is granted to *individuals* who are not ordinarily resident nor carrying on business in the Union, provided that the dividends to which they are entitled are not paid nor payable within the Union (Section 33, Income-Tax Act No. 40, of 1925). Thus a foreign enterprise belonging to a single individual or to two or more individuals in partnership (a partnership has not, under the law of the Union, a separate entity ; the partners are regarded as several individuals carrying on business in association) will not be liable for supertax on dividends received from companies earning profits in the Union if *(a)* the centre of management of the business is not in the Union, *(b)* the business has not within

the Union an establishment in which business operations of the enterprise are conducted, *(c)* the dividends are not paid to some persons in the Union, *(d)* the dividends are not required by the terms of the memorandum of association of the company to be paid to some person within the Union.

53. Dividends accruing to foreign enterprises belonging to private companies, as defined by the amendment to Section 27, Income-Tax Act No. 40, of 1925, introduced by Section 5 of Act 28, of 1932 (see Part I, paragraphs 7-9), are now liable to supertax, irrespective of the residence of the private company, the locality of its business operations or the place of payment of the dividends.

54. Dividends payable to public companies do not attract liability for any taxation.

55. The levy of supertax is by direct assessment upon the taxpayer. Where the taxpayer, however, is absent from the Union, the taxing authority can appoint any person as his agent, or, if he is a shareholder in a company, can appoint as such agent the company in which he holds shares. When an agent has been so appointed, the Commissioner has as full rights of recovery against any property under the control of the agent as he would have against property in the possession of the taxpayer.

(b) *Interest.*

56. Interest arising from sources within the Union is primarily liable for both normal tax and supertax without differentiation between different classes of recipients. To this general rule, there is an exception in the case of interest received from stocks and securities issued by the Government of the Union (including the stocks and securities issued by the Governments of the several colonies now included in the Union) or any local authorities in the Union (see Part I, paragraph 16 (2)). Such interest is exempt if received by a person not ordinarily resident nor carrying on business in the Union. " Person ", in this context, means any entity, whether individual, company or other association of persons.

57. Interest arising from debenture bonds and secured or unsecured loans is taxable without any differentiation, but, in this connection, reference should be made to the case quoted in Part I, paragraph 25, that of Commissioner of Taxes *v.* W. Dunn and Company Limited, in which it was held that interest charged by a foreign enterprise on an open account with a Union enterprise did not arise from a source within the Union when the account represented purchases made in London on behalf of the Union enterprise. It was held that the interest did not arise from a loan made to the Union business, but from the employment by the London enterprise of its capital in London.

(c) *Directors' Percentages.*

58. Percentages, whether of profits or dividends, paid to directors of companies in consideration of their services are treated as remuneration for those services and classed with salaries and fees.

(d) *Royalties for the Use of Patents, Copyrights, Trade Marks, Secret Processes and Formulæ and Similar Income.*

59. Amounts received for the use of patents, copyrights, trade marks, secret processes and formulæ are only taxable in the hands of foreign enterprises if those enterprises carry on business in the Union and the amounts received arise from contracts entered into within the Union. If the contract is entered into elsewhere, or through an independent agent, no liability would arise. There is no differentiation in other respects in connection with this type of income.

(e) *Rents, Mining Royalties and Similar Income.*

60. Rents, mining royalties and other similar income arising from immovable property situated in the Union are chargeable with tax in the hands of the recipients without any differentiation. Upon them, a foreign enterprise will be liable under any circumstances.

(f) *Gain derived from the Purchase and Sale of Real Estate, Securities and Personal Property.*

61. *Real Estate.* — Profits derived from the purchase and sale of real estate are chargeable only if the transaction is one which is entered upon as an operation of business for the purpose of making profit. Moreover, for the profit so earned to fall within the scope of the tax, the contract of sale producing the profit must have been carried through as an incident of business conducted within the Union. Consequently, it would be impracticable for liability in such a case to be incurred by a foreign enterprise unless that enterprise had within the Union an establishment capable of carrying through such a transaction and did, in fact, carry it through at that establishment. Thus the sale of a South African property in London by a London company dealing in real estate would not attract liability, notwithstanding that the company had a branch office in Johannesburg. On the other hand, a deal effected in Johannesburg would bring into existence liability, irrespective of the locality in which was situated the asset dealt with.

62. *Securities and Personal Property.* — Similar provisions govern the sales of securities and personal property. The deciding factor is the place where the transaction is carried through which is productive of the profit, not the *situs* of the thing sold nor the place of residence or business of the purchaser.

(g) *Salaries, Wages, Commissions and Other Remuneration for Services.*

63. Remuneration for services rendered is taxable in the hands of foreign enterprises (including in the term individuals whose principal place of business is outside the Union of South Africa) only in so far as it represents payment for services rendered within the Union. But a mere casual absence from the Union in the course of carrying out duties which are usually to be performed in the Union is not regarded as taking a proportionate part of the remuneration out of the charge. Thus an employee in a Union business would be regarded as liable upon his salary for the whole period, notwithstanding that he was sent to do work beyond the confines of the Union in the course of the duties of his employment. This principle is also applied to directors' fees. The services of a director are presumed to be rendered at the real centre of management of the company. If that is in the Union, the presumption is that the remuneration received for those services arises from a source within the Union. Under that presumption, the rendering of casual or incidental services elsewhere would not change the liability. But the presumption can be rebutted. If it is established that it is the function of a director in his capacity as such to render services outside the Union, no liability would arise in respect of his remuneration for those services.

(h) *Income from a Trust.*

64. In so far as the income from a trust arises from sources in the Union, it is liable for taxation notwithstanding that the beneficiaries may be " foreigners ". In determining the source of the trust income, the actual derivation of the component parts of that income is taken into consideration, without regard to the constitution of the trust itself. The fact that a trust is constituted under South African law would not impress the character of income derived from a source within the Union upon income received by the trust from sources outside the Union.

65. The basis of the assessment of a trust depends upon its terms. The trustee is responsible for accounting for its income, but, in so doing, he acts only as the representative of any beneficiaries

who may have a vested interest in the income of the trust. If such beneficiaries exist, the amounts accruing to them are regarded as portions of their individual incomes to be assessed in conjunction with any income derived by them from other sources. In assessing the trust, these amounts are treated as outgoings and the trust as an entity in itself is liable for taxation only on the balance that remains. If, however, the ultimate beneficiaries in the trust have no immediate interest, then the trust stands chargeable as an entity on the whole income.

66. Special provisions are made in respect of trusts created by parents on behalf of their children. The income of such trusts is taxed as a portion of the income of the parent creating the trust (Section 9 (3), Act 40, of 1925, as amended by Section 4, Act 28, of 1932). In this connection, it should be noted that the income of a wife is aggregated with that of the husband for taxation purposes (Section 9 (2), Act 40, of 1925).

67. For the purposes of the surtax introduced by the Income-Tax Act, 1932 (Act 28, of 1932), special provisions are made in respect of the charge for surtax upon " fixed interest " derived by trusts. (For the meaning of the term " fixed interest ", reference may be made to Part I, paragraph 10.) Notwithstanding that the income of the trust may be distributable amongst beneficiaries, the interest received by the trust is chargeable with surtax in the hands of the trustee as a single sum. This provision, which must produce anomalies in the incidence of the tax, has been adopted in order to simplify the administration of the tax in such cases.

(i) *Profits from the Carrying-on of a Business or Industry.*

68. Sales effected by a foreign enterprise through a *local commission agent or broker* do not attract Union taxation. A special provision taxing the profits arising from such sales was introduced into the Income-Tax Act of 1925, but the Section (Section 18, Act 40, of 1925) was repealed with retrospective effect by the Income-Tax Act of the following year, Act 36, of 1926.

69. Where a *local dealer or distributor* buys and sells for his own account goods supplied by a foreign enterprise, the Union tax falls only on the profit made by the local dealer, and no liability attaches to the profit made by the foreign enterprise in the supply of goods to the dealer, notwithstanding that the latter may have the exclusive right to handle those goods in the Union.

70. Where the goods of a foreign enterprise are sold through a *travelling salesman* who has no power to complete a contract, the profit will not be liable for taxation if the contract of sale is completed outside the Union ; if he is empowered to complete a contract, the profit resulting from any contract completed in the Union will be liable for taxation.

71. Sales effected in the Union by a *local agent with a power of attorney* will attract taxation.

72. Sales effected in the Union by an *agent* out of *stocks belonging to a foreign enterprise* will attract taxation.

73. Income derived from business conducted by a *permanent establishment* within the Union of a foreign enterprise will be liable for taxation in so far as that income is derived from sources within the Union. The business of such establishment is, for the purpose of the Union tax, on the same footing as any national enterprise conducted in the Union.

B. NATIONAL ENTERPRISES.

74. A national enterprise is regarded as one which has the real centre of its management within the Union.

75. As the income-tax system of the Union restricts the charge to income derived from sources within the Union, a national enterprise is not liable for taxation on income derived from sources outside the Union, save in the few cases in which income is deemed to be derived from sources within the Union, though, on general principles, it would not be so regarded. Those cases are:

(a) Income arising from services rendered or work or labour done outside the Union for the Government of the Union or any provincial or local authority in the Union, where such services are rendered or work or labour done in accordance with a contract of employment entered into with that Government or other authority ;

(b) Interest received on stocks or securities issued by any Government outside the Union, if such interest is not chargeable with income-tax in such country of origin by reason of the recipient not being domiciled or resident therein.

76. In view of the restricted nature of the liability of a national enterprise in respect of income from foreign sources, it is unnecessary to deal specifically with the various kinds of income which a national enterprise may derive from abroad.

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

I. GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

77. Branches and subsidiary companies are dealt with on different principles. Subsidiary companies are separate juristic entities and are treated as separate taxable units, subject, of course, to such special consideration of those items of their accounts as may be affected by their subordinate positions. A branch of a foreign enterprise, on the other hand, is treated as a business carrying on operations elsewhere as well as in the Union and falls under the provisions made for such cases.

78. Where the business of any person extends beyond the Union, the Income-Tax Act (Section 19 of Act 40, of 1925) provides that the taxable income of the Union portion of the business shall be determined on an assets-to-assets basis — that is to say, the Union taxable income shall be such proportion of the taxable income of the business as a whole (as determined in accordance with the principles of the Union Income-Tax Law) as the assets in the Union bear to the total assets of the business. This enactment is, however, subject to the proviso that, if accounts satisfactory to the Commissioner can be furnished, the Commissioner or the taxpayer may claim that the actual taxable income derived from sources within the Union or loss incurred within the Union shall be assessed in terms of the statute.

79. In actual practice, the terms of the proviso are employed in the majority of cases, and the main provision has become, save in the case of banking enterprises, merely a last resort when other methods fail. It is necessarily crude in its results and produces many anomalies. On the other hand, few businesses are unable to produce branch accounts, and these accounts, when taken in conjunction with the powers of the Commissioner to allow such expenditure incurred outside the Union in the production of the income as he may think fit (Section 11 (2) *(b)*, Act 40, of 1925), provide a satisfactory basis of assessment.

(a) Book-keeping and Accounting Requirements.

80. The form of return of income is prescribed by the Commissioner under statutory authority (Section 38, Act 40, of 1925), and that prescribed only provides for the disclosure of the taxable income (that is, the net income) derived from the several activities scheduled on the return. But the regulations issued under statutory authority (Section 74 (1) *(c)*, Act 40, of 1925) provide that any return rendered under the Act shall be accompanied by all such balance-sheets, trading accounts, profit-and-loss accounts and other accounts of whatsoever nature as are necessary to support the information contained in the return. Provision is also made that all such accounts shall be authenticated by the signature of the taxpayer and the person who has prepared them on his behalf.

The last provision fixes the responsibility in the case of fraudulent or inadequate returns.

81. In addition to these provisions, the Commissioner is given power (Section 37 (10), Act 40, of 1925) to call for fuller and further returns as he may think them necessary and to require information to be given by any person who is in a position to give it (Section 40 (3), *ibid.)*. He is also empowered to call for the production of books and other records (Section 41, *ibid.)*.

82. Where the income to be assessed is that of a branch of a foreign enterprise, the accounts and information to be supplied are those of the business as a whole unless adequate branch accounts can be supplied.

(b) Methods of Allocation.

1. *Method of Separate Accounting.*

83. As stated above (paragraphs 77 and 78), the income of a subsidiary company is determined on the basis of its accounts and that of a branch business upon its accounts, if these are available and are satisfactory to the Commissioner. But, in accepting these accounts, the dependent nature of the subsidiary company or branch is borne in mind, and the deductions claimed are reviewed from that point of view. As far as the price of goods invoiced to the branch or subsidiary company is concerned, the practice is to accept the invoice figures as declared for Customs purposes. It is considered that the liability for those duties upon the gross value of the importations is sufficient protection against excessive loading of the price to the subsidiary or branch, as it must impose a heavier burden than a tax upon profits.

84. Charges of interest and payments for services rendered or for the use of patent rights or secret formulæ are dealt with differently in the cases of branches and subsidiary companies. Such charges as between a branch and the head office would be disallowed as internal charges, unless it was established that they represented an allocation to the branch of charges borne by the head office on behalf of the business as a whole (see 3, S.A. Tax Cases, 328 ; Income-Tax Case No. 103). In the latter event, they would be allowed if the Commissioner was satisfied that the allocation was fair and reasonable, having regard to the relative activities of the branch and the rest of the business. Similar charges made in the accounts of a subsidiary company would be allowed, provided that the Commissioner was satisfied as to the genuineness of the charges. While the separate existence of the companies is accepted, the allowance of such a claim is still governed by the Commissioner's discretionary powers under Section 11 (2) *(b)* of the Income-Tax Act (No. 40, of 1925).

2. *Other Methods of Apportionment.*

85. The method of applying a percentage to turnover is provided by the Income-Tax Act in the case of foreign shipping companies and all businesses dealing with messages sent by submarine cable or wireless apparatus. In both cases, however, the alternative method of assessment on accounts covering the local business is provided for. In the case of insurance companies, a fractional method of apportionment is provided. These cases will be dealt with in greater detail under paragraphs 101 to 107 and 109.

86. Where a fractional method of apportionment is adopted [1], the entire income of the concern has to be taken into account in order to determine the fraction which is to represent the Union taxable income. For this purpose the accounts of the business as a whole are called for and are reviewed as though an assessment were being made on the accounts, any information required for the elucidation of the accounts being called for from the branch officials, who are under the jurisdiction of the Union courts. If the information is not available and the items in the accounts

[1] See paragraphs 79 and 87.

are not capable of ready explanation, resort is had to the provisions of the Act giving the Commissioner power to raise estimated assessments.

3. *Requirements for Selection and Relative Value of the Various Methods.*

87. Inasmuch as the decision whether any local accounts submitted can be accepted as satisfactory is vested in the Commissioner, whose discretion in this matter cannot be questioned, the option as to which form of assessment is to be adopted can be said to be with the Administration, but it cannot compel the submission of local accounts. If a foreign enterprise prefers to submit to an arbitrary apportionment on an assets basis or to a percentage calculation in the case of a shipping or cable or wireless business, the Administration must accept the position. But, as previously stated (paragraph 79), the majority of businesses of any importance furnish satisfactory local accounts and the apportionment cases constitute a small minority.

Every encouragement is given to the submission of local accounts, which are considered the most satisfactory basis for securing a fair assessment. In so far as such an account deals only with transactions completed in the Union, it will give a true reflection of the income from Union sources and the wide discretionary powers given to the administration in the allowance of expenditure incurred outside the Union makes it difficult for claims for such expenditure to be used as a means of evasion. If the claim is suspect, it can be disallowed and, so long as the Commissioner has exercised his discretion fairly and honestly, it cannot be reviewed. Any basis of apportionment must produce a rough and ready result, and an apportionment on the basis of assets must be inadequate in the case of a business whose earnings bear little or no relation to the local situation of its assets. Moreover, that local situation raises questions of difficulty in connection with movables, such as stock-in-trade and cash assets. In every way, a basis of apportionment is to be deprecated unless no other method of assessment is practicable.

(c) Apportionment between Branch and Parent Enterprises.

1. *Apportionment of Gross Profits of Local Branch to Real Centre of Management.*

88. In assessing the profits realised by a local branch of a foreign enterprise, the taxable income derived from the operations of that branch only are taken into account, as those alone can fall within the charge as being derived from sources within the Union. No portion of the profit derived from those operations can be attributable to the real centre of management, inasmuch as the internal charges between that centre and the branch are not allowed, save in so far as they represent expenditure incurred by the centre of management on behalf of the branch.

2. *Apportionment of Expenses of Real Centre of Management to Branch.*

Interest Charges.

89. If the enterprise as a whole has a general debt, whether secured or unsecured, which has been incurred for the purposes of the whole enterprise, a proportionate part of the interest paid is admitted as a charge against the branch profits. The proportion to be so allowed is determined on different principles, according as the indebtedness is or is not secured by a debenture issue. In the event of there being a debenture issue, secured by a bond on the assets of the enterprise as a whole, the apportionment is made on an assets basis, as, in such a case, the indebtedness is definitely linked to the assets of the business ; the amount of interest to be allowed against the Union branch is then determined by the proportion of the assets located in the Union. In the case of an unsecured indebtedness, the amount of interest charged out in the accounts of the branch is scrutinised in

relation to the relative volume of the branch operations, and its acceptance as an allowable deduction depends on the reasonableness of the claim.

General Overhead.

90. Similarly, if it is established that other overhead expenses incurred at the real centre of management of an enterprise are sufficiently linked with the profit-earning operations conducted in the Union, an allowance of such proportion of those expenses as seems fair and reasonable is made. No general principle can be laid down governing such an allocation. Each case is determined in accordance with its facts.

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

91. In view of the restriction of the Union tax to income derived from sources within the Union, the business operations of the local branch of a foreign enterprise are alone taken into consideration, without regard to the results of the operations of the same enterprise outside the Union. The taxation to be paid on Union profits, or the loss to be allowed in respect of Union transactions, is not, therefore, affected in any way by losses or profits made by the parent branch or by the enterprise as a whole.

(d) APPORTIONMENT BETWEEN PARENT ENTERPRISE AND SUBSIDIARIES.

92. As previously stated (see paragraph 77), the separate juristic entity of a subsidiary company is recognised under all circumstances and it is assessed as a separate tax-paying unit, subject to the proviso that, in view of the intimate relations existing between it and the parent company, any charges in favour of the parent company, when the latter is a foreign enterprise, receive a meticulous scrutiny and are only allowed subject to the discretionary powers entrusted to the administration.

II APPLICATION OF THE METHODS OF ALLOCATION IN SPECIFIC CASES.

(a) INDUSTRIAL AND COMMERCIAL ENTERPRISES.

1. *Selling Establishments.*

Local Establishments selling in National Market.

93. Where a foreign enterprise sells through a permanent establishment in the Union, the profit of the local establishment is determined as though the branch were a separate establishment and the cost of the goods sold is taken at the price at which they are invoiced to the Union establishment and declared for Customs duty purposes. While it is appreciated that this permits of the goods being loaded with a profit in favour of the foreign branches of the enterprise, experience has not indicated any satisfactory method of meeting the position without creating many difficulties, including raising questions of double taxation. The safeguard to revenue generally lies, as mentioned before, in the Customs duties.

Local Establishments selling abroad.

94. If a Union branch of a foreign enterprise effects sales in a third State — as, for example, Rhodesia — the liability of resulting profit for Union taxation would depend upon the facts of the sales. If orders were taken in Rhodesia and the sales were confirmed by the Union branch, then the resulting profits would form part of the taxable income of the Union branch, as the sale would have been effected in the Union. So also would be the position if the Union branch effected the sales

directly to the Rhodesian customer, and, in either case, the liability would not be affected by the fact that the goods sold might be delivered direct to the Rhodesian customer from another branch of the enterprise. But, if the sales were effected outright in Rhodesia and delivery only was made from the stocks held by the Union branch, the resulting profit would be outside the scope of the Union tax and no liability would arise.

2. *Manufacturing Establishments.*

95. If a manufacturing establishment in the Union sells its products directly to customers outside the Union, the whole proceeds are regarded as arising from a source within the Union, notwithstanding that the sales may be effected through agents in the countries in which the customers are resident. As the primary function of a manufacturing establishment is to dispose of the wares manufactured, the profit arising from the manufacture and disposal is regarded as being derived from the business of manufacturing as carried on in the Union. If, however, a manufacturing establishment in the Union maintains a retail establishment in another country at which the goods manufactured by it are sold by retail, then a manufacturing profit only would be regarded as having arisen from Union sources, as the retail profits would have arisen from sales actually effected by the enterprise in a branch situated outside the Union. The manufacturing profit would be determined by valuing the output transferred to the retail branch at prevailing wholesale prices within the Union.

3. *Processing Establishments.*

96. No profit is ascribed to processing establishments, the operations of which are regarded as too remote from the actual realisation of the goods to justify any allocation of the profits resulting from such realisation.

4. *Buying Establishments.*

97. The purchase of goods in the Union by a foreign enterprise through a local establishment does not render the foreign enterprise liable for taxation on any presumed profit. Nor is the position altered if the purchases are made from a local subsidiary company. In such a case, however, the subsidiary company would be liable on the profit, if any, made by it on the sales effected.

5. *Research or Statistical Establishments, Display Rooms, etc.*

98. If a foreign enterprise has within the Union an establishment which does not directly engage in profit-making transactions, no profits are ascribed to that establishment, notwithstanding that its maintenance may result in the increase of the profits earned by the enterprise elsewhere.

(b) Banking Enterprises.

99. Of the foreign banking enterprises which carry on business in the Union, two are assessed on accounts which set out the operations of the banks within the Union and permit of the taxable income derived from Union sources to be determined, while the third is assessed upon the assets-to-assets basis. On this basis the taxable income or assessed loss of such an enterprise for the purposes of the Union tax is a sum which bears the same proportion to the total net profits or loss from all sources, as the case may be, when calculated in the manner provided under the Union Income-Tax Act for the determination of taxable income or assessed loss, as the assets of the enterprise in the Union bear to the total assets of the enterprise. This method of assessment produces a less inaccurate result in the case of banking enterprises which have their assets distributed in the countries in which they operate.

100. The banks which furnish local accounts are permitted to charge against Union earnings a proportion of the overhead expenses incurred in connection with the head office situated overseas.

(c) Insurance Enterprises.

101. Special provisions are made for the assessment of insurance companies (see First Schedule to Act 40, of 1925, as amended by Acts 23, of 1927, and 30, of 1931). Distinctions are drawn between *(a)* mutual and non-mutual concerns and *(b)* between life assurance (including the granting of annuities) and other forms of insurance.

102. *Mutual* companies are chargeable upon income derived from investments only, and are exempt, save in respect of surtax (see Part I, paragraph 12), even from such a charge in respect of investments relating to their " life " business — that is to say, investments included in their life funds.

103. As regards business other than " life " business, the taxable income of a mutual company is determined by first taking a proportion of the receipts or accruals arising from all investments in respect of the branches of insurance business other than life business in the ratio that the premiums received in the Union for those branches of insurance bear to the total premiums from all sources received by the company for those branches and, secondly, by deducting from the amount so ascertained an allowance for expenses of management ; this allowance is fixed by taking a proportion of the total management expenses, other than commissions, in the ratio that the portion of the investment income from which it is to be deducted bears to the whole investment income of the company. For the purposes of this determination, the yield from all such investments, wheresoever located, is taken, so that the position may arise where a company is chargeable with Union tax upon investment income, notwithstanding that it may have no investments within the Union.

104. *Non-mutual* companies are chargeable :

(a) In respect of " life " business, on a proportion of the dividends distributed to shareholders during the year of assessment out of profits earned by the life business carried on. This proportion is determined by the ratio which the sum represented by the premiums received in the Union for life assurance when added to the annuity payments made in the Union during that period bears to the sum represented by the premiums received from all sources when added to all payments made in respect of annuities. Where the business of the company extends to other branches of insurance, the proportion of the dividend distributed which is to be attributed to the life business is determined by taking the ratio of the profits earned by the life business during the period since the preceding distribution of a dividend to the profits earned from all branches of insurance during that period.

(b) In respect of other branches of insurance, on a taxable income determined by charging against the premiums and other amounts received in the Union from carrying on the business of insurance the actual losses and expenses incurred in the Union in respect of that business. In this determination, premiums paid for re-insurance are deductible from the premiums received, but the losses incurred are required to be reduced by the amount of any re-insurances received. Further, no provision may be made for unearned premiums.

(d) Transport Enterprises.

105. Special provisions are made for the assessment of foreign enterprises carrying on shipping business in the Union (Section 16, Income-Tax Act, No. 40, of 1925). The primary method of assessment is upon a taxable income determined by taking 10 per cent of all amounts paid in respect

of passengers, live-stock, mails and goods shipped in the Union. Provision is, however, made for assessment on the ordinary basis, where accounts satisfactory to the Commissioner can be rendered.

106. For some years, the 10 per cent basis was applied throughout, as no shipping companies were able to comply with the requirements of the administration as to accounts. From the nature of the business carried on by them, any accounts purporting to deal with the transactions of a shipping company in the Union involved approximations and estimations under most of the heads of expenditure. As the result, however, of later negotiations, arrangements have been made with the majority of the foreign enterprises carrying on business in the Union, whereby a certificate from the taxing authority exercising jurisdiction over the profits of the enterprise as a whole indicating the rate of profit earned by it upon turnover is accepted as indicating, for the purposes of Union taxation, the rate of profit applicable to the turnover derived from transactions in the Union. Subject to such adjustments as may be rendered necessary by the provisions of the taxing measure under which the rate of profit has been determined, the certificate, together with the statements of the Union turnover, is accepted as an amount satisfactorily disclosing the taxable income derived from the business conducted in the Union.

107. The assessment of tramp steamers, save where such vessels belong to a regular line, is still made on the percentage basis, and the Act gives special powers to secure payment of the assessments where the tramp owner has no recognised agent in the Union other than the master of the ship.

(e) Power, Light and Gas Enterprises.

108. There are no special provisions dealing with enterprises of this sort, nor, in fact, do any foreign enterprises carry on business of this nature in the Union.

(f) Telegraph and Telephone Enterprises.

109. All inland communications are in the hands of the Government of the Union. Submarine cables and wireless communications to places outside the Union are assessed, whether foreign or national enterprises, on a percentage basis, the taxable income being a sum equal to 5 per cent of the gross takings in respect of any messages transmitted from any office in the Union (Section 17, Act 40, of 1925).

(g) Mining Enterprises.

110. Mining enterprises conducted in the Union by foreign enterprises are assessed in the same way as those conducted by national enterprises, subject to the allowance of such expenditure incurred outside the Union as the Commissioner may, in his discretion, allow.

111. The system of assessment of the profit arising from mining operations requires the rendering of accounts for each mining unit, as the redemption allowances depend upon the life of the mine. Consequently, no difficulty is experienced in determining the taxable income of such an enterprise as derived from sources within the Union. As in the case of manufacturers (paragraph 95), the whole of the sale price of the product is required to be brought into account as derived from a source within the Union, irrespective of the place where the product is disposed of.

No examples have yet occurred of a mining property overlapping the borders of the Union, which would be the only case in which any system of allocation would be rendered necessary.

For details of the basis upon which mining operations are assessed, reference may be made to Part I, paragraphs 29, 39 and 40.

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

112. By applying the principle of taxing only income derived from sources within the Union, income arising from business operations carried on outside the Union is automatically eliminated.

113. No attempt is made to allocate to the real centre of management, when that is within the Union, any portion of the profit made by operations elsewhere, where those are carried through to completion outside the Union. But, if any transactions of the enterprise are carried through at the centre of management, taxable income would arise from them, notwithstanding that they concerned matters or events outside the Union. For example, a whaling company with its head office and control within the Union carried out whaling operations in the south seas, those operations being based on an island outside the borders of the Union. The whales were captured on the high seas, and the oil was rendered down on a floating factory moored at the island base. When the floating factory was fully laden, it proceeded direct to Europe, where the oil was sold by an employee of the company, who had there a permanent establishment. It was held that the profit arising from the manufacture and disposal of the oil arose from sources outside the Union. But, when one of the floating factories was lost at sea and the company recovered, under a policy of insurance entered into at the real centre of management in the Union, the value of the oil carried by the factory, it was held that the proceeds of the policy were derived from Union sources, as flowing from the contract of insurance entered into within the Union (3, S.A. Tax Cases, 136, decision of special court for hearing income-tax appeals).

C. TRUSTS AND HOLDING COMPANIES.

114. The basis of source in the determination of income and the treatment of each company as a separate taxation unit simplifies the position under the Union system, as far as holding and subsidiary companies are concerned.

Where the holding company carries on business in the Union, the Union taxation falls only on those of its operations that bring into existence income from Union sources. The profits therefore of foreign subsidiary companies which such a holding company may control are outside the field of the Union taxation. So also, when a subsidiary company carries on operations in the Union under the control of a foreign company, the operations of the subsidiary company only fall within the scope of the Union taxing measure.

Annex.

TABLE OF TARIFFS. [1]

I. NORMAL TAX.

TAXPAYERS	Rate of Tax in each £1 of Taxable Amount
Gold mining companies	4 sh.
Diamond mining companies	3 "
Other companies	2 " and 6 pence
Persons other than companies	1 " and 1/2000th of one penny

II. SUPERTAX.

(Applicable to all persons other than public companies.)

1 sh. and 1/500th of one penny for each £1 of amount subject to supertax.

III. SURTAX.

(Applicable to " fixed interest " only.)

RATE OF TAXABLE INTEREST	Rate of tax applicable to the amount subject to surtax
Interest not exceeding 5 %	5 %
Exceeding 5 % but not exceeding 6 %	6 %
Exceeding 6 % but not exceeding 7 %	7 %
Exceeding 7 % but not exceeding 8 %	8 %
Exceeding 8 % but not exceeding 9 %	9 %
Exceeding 9 %	10 %

[1] Income Tax Act 1932 (No. 28 of 1932). (Note : the administration of the taxes is governed by Act 40 of 1925 as amended.)

MASSACHUSETTS

(United States of America)

BY

HENRY F. LONG

Commissioner of Corporations and Taxation.

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PART I. — GENERAL DESCRIPTION OF INCOME-TAX SYSTEM.[1]

The Massachusetts income-tax [2] applies only to resident individuals and resident members of partnerships. It is a classified tax, the rate being 6 per cent on interest and dividends, 3 per cent on gains from the sale of intangible property, 1½ per cent on business income and 1½ per cent on annuities.

A corporate excise-tax is levied on manufacturing and business corporations, foreign or domestic. " Public Service Corporations " are almost without exception Massachusetts corporations, and are subject to a special tax regime. In the case of domestic manufacturing and business corporations, the excise-tax is levied on corporate excess as well as on income derived from business carried on in Massachusetts ; foreign corporations pay tax only on the basis of income and upon corporate excess from their Massachusetts activities.

The excise-tax rate on income is 2½ per cent, but the tax is subject, in the case of domestic corporations, to a minimum tax of one-twentieth of 1 per cent on gross receipts assignable to Massachusetts and one-twentieth of 1 per cent on the value of the capital stock ; and, in the case of foreign corporations, to a minimum tax of one-twentieth of 1 per cent of such proportion of the capital stock owned by the foreign corporation as the value of the assets employed in business in Massachusetts bears to the total value of all assets.

1. TAXPAYERS.

(a) Individuals.

The income-tax law applies to every individual who is an inhabitant of Massachusetts and to all taxable income received while such individual is an inhabitant. An " inhabitant " is a person whose domicile or legal residence is within the Commonwealth, and mere physical presence or absence is not the deciding factor. An individual who is not an inhabitant is not liable to any tax, even though he derives all his income from Massachusetts and spends all his working hours in that State.

A domicile, once acquired, continues, even during physical absence, until a new domicile is acquired. If a person moves into Massachusetts during the fiscal year, he includes in his return all income received after acquiring domicile. Persons intending to remove their domicile from Massachusetts during the fiscal year must file returns and pay tax before leaving.

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[1] Legislation in force on March 15th, 1933.

[2] The income-tax, which is levied only on resident individuals, yielded, in 1930, $31,786,014, or 10.14 per cent of total tax revenue.

The corporate excise-tax, which is a levy on both corporate excess and income, yielded, in 1930, $15,263,303, or 4.87 per cent of total State revenue. Of this amount, domestic business and manufacturing corporations paid $11,425,417 and similar foreign corporations paid $3,837,888.

The principal levy is the local property-tax, based upon the value of real estate and certain types of tangible personal property.

(b) PARTNERSHIPS.

An inhabitant of Massachusetts who carries on business in partnership would be taxed on his share of the income of the partnership which is taxable — namely, the same proportion of its income, wherever derived, as the interest of the Massachusetts partners bears to the total interest. The income of non-domiciled partners is not taxable.

(c) CORPORATIONS.

For purpose of corporate excise-tax, corporations are classified as (1) domestic business and manufacturing corporations and (2) foreign business and manufacturing corporations. The first category includes every corporation established under the general or special laws of Massachusetts for the purpose of carrying on business for profit, but not those organised under such laws for carrying on any kind of banking, insurance, rail transportation business, nor telegraph and telephone companies, gas, electric light, heat or power companies, nor other public service corporations. The category of foreign corporations includes companies organised under laws other than those of Massachusetts, for purposes for which a "business" corporation may be organised in Massachusetts, provided such foreign corporation *(a)* has a usual place of business in Massachusetts or *(b)* is engaged in Massachusetts, permanently or temporarily, and with or without a usual place of business therein, in the construction, erection, alteration or repair of a building, bridge, railroad, railway or structure of any kind.

2. TAXABLE INCOME.

The taxable income of inhabitants of Massachusetts includes only :

(1) Remuneration for services rendered during the previous year whenever and wherever earned, retirement allowances and pensions paid for past services, and profits from carrying on a business ;

(2) Life annuities ;

(3) Net gains from purchases or sales of stocks, bonds and other intangible property irrespective of where the transaction takes place ; and

(4) Certain interest and dividends.

Taxable interest includes practically all interest, the more important exceptions being the following : interest from savings banks in Massachusetts and from banks in certain States with which this State has reciprocal arrangements ; interest from the savings departments of trust companies (but that from the savings department of a national bank is liable to tax) ; interest on mortgages secured exclusively on Massachusetts real estate, provided the amount of the mortgage does not exceed the assessed value of the property ; interest from Federal obligations and from obligations of the State of Massachusetts and its municipalities (but interest on the obligations of another State is taxable).

Taxable dividends include dividends from foreign corporations, but not dividends from Massachusetts corporations.

The taxable income of a corporation is that part of the total net income of the domestic or foreign corporation, determined for purposes of Federal income-tax (plus interest on bonds of other States and municipalities outside Massachusetts, and losses of previous years excluded from the Federal return), which is allocable to Massachusetts, as described in Part III of this report.

Generally speaking, there is relatively little trouble in allocating net income to Massachusetts.

Ninety per cent of claims for abatement are made on corporate excess [1] and only ten per cent on account of income-tax.

The corporate excess tax and income-tax are added together and form the basis of assessment under the corporation excise-tax. They are compared with the minimum tax to see if the latter in particular cases may be higher, but the yield from the minimum tax is relatively small.

3 and 4. ASSESSMENT AND COLLECTION OF TAXES.

Individual income-tax returns are made on or before March 1st for income received in the previous calendar year.

Corporation returns are made during the first ten days of April and show the income for the taxable year, which is defined to be the year last due to be returned to the Federal Government.

After the return is filed, it is examined and, if complete, is forwarded to the assessor to assess. A separate computation sheet is made, upon which are set down the figures to serve as the basis of assessment. The tax is then placed on a warrant sheet and is signed by the Commissioner. This sheet is forwarded to the collector and the bills are sent to the corporation. The statute provides that they shall be sent as soon as possible after the first Monday of August. In practice, they are sent on September 20th and are not due for payment until October 20th. Corporations have sixty days in which to make application to the Commission for a revision of the assessment. If the Commission renders a decision that is not satisfactory, an appeal may be taken to the "Board of Tax Appeals" from which there is no appeal on points of fact, but an appeal can be made to the supreme court of Massachusetts on questions of law.

The greater part of the taxes are paid between September 20th and October 20th. The filing of an application for abatement does not constitute a stay for collection.

Individuals can make a provisional payment, but they are not obliged to do so. As in the case of corporations, the bulk of the taxes are collected during October.

In the case of foreign corporations, the tax payments are due at the same time as those of domestic corporations. There is a provision in the case of a sale of assets that the tax may become due at once. This applies more especially when the foreign corporation starts removing its assets preliminary to withdrawal.

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[1] Corporate excess is supposed to be based entirely upon property. Its value may, however, be dependent in part upon earnings or income. There is a distinction between corporate excess in the case of a domestic corporation, and that of a foreign corporation. In the case of the domestic corporation, the starting-point is the value of the shares of stock, and deduction is then made of the value of the equity in Massachusetts real estate, the value of machinery in Massachusetts, the value of certain types of securities, of tangible property situated in another State or country and a certain proportion of cash and accounts receivable which may be attributable to an office outside Massachusetts. The starting-point in the case of a foreign corporation is also the value of the shares of stock, but an apportionment is then made on the basis of the value of the assets employed in Massachusetts as compared with the value of all assets; from the resulting figure is deducted the value of the equity in Massachusetts real estate, Massachusetts machinery and certain types of securities. The problem is to determine what assets are employed in Massachusetts. In the case of tangible property within the State, such property is said to be employed in Massachusetts. The rule prescribes that that proportion of an intangible asset will be deemed to be employed in Massachusetts which corresponds to the proportion between income in Massachusetts and total income (Rule 2505).

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

The term " foreign " enterprise, as used herein, includes only a business enterprise conducted by a corporation organised outside Massachusetts (non-resident individuals being exempt). The excise-tax is imposed on foreign corporations for the privilege of having a place of business under the protection of the laws of Massachusetts and with the financial, commercial and other advantages flowing therefrom, measured by the property and net income fairly attributable to business done in the State. The excise is measured by two factors: (1) the value of the corporate excess employed within the Commonwealth, and (2) the net income derived from the business within the Commonwealth (Alpha Portland Cement Company *v.* Commonwealth of Massachusetts (1924), 268 U.S. 203).

The normal basis of assessment for foreign corporations is the net income shown in the return made to the Federal Government, plus certain items excluded from the Federal return — *e.g.*, interest on bonds of municipalities outside Massachusetts — or allowed as deductions therefrom — *e.g.*, net losses of previous years. In the event of the Federal Government's return being changed, the foreign corporation is required to notify Massachusetts of the change thus made. This may result in an additional tax or in a refund. Foreign corporations doing business only in Massachusetts are taxable on the whole of their income ; those having establishments outside are taxable on the part of their income allocated to Massachusetts. In other words, there are no special taxes on specific classes of income derived from Massachusetts sources. The tax is an excise for the privilege of having a place of business in Massachusetts and is not on income, but is measured by income allocable to Massachusetts, as described in Part III.

The primary reason for liability to Massachusetts corporation excise-tax is the possession of a usual place of business in that State, but in no instance is the foreign corporation taxable if the business is purely interstate commerce (Alpha Portland Cement Company *v.* Commonwealth of Massachusetts (1924), 268 U.S. 203).

The term " usual place of business " implies that there must be some place that can be designated a place of business. Soliciting orders without any other business activity would not constitute having a place of business, but, if there is warehousing of goods, coupled with business activity, a usual place of business would be deemed to be established. As a rule, it consists of a factory or sales office.

In this connection, an example may be given of a silk company which had an office in Massachusetts, where salesmen solicited business and took orders. These orders were transmitted for confirmation to the home office. The salesmen had samples, but never sold out of any stock in Massachusetts. It was held that the company was not subject to the excise.

If orders were filled out of a stock and delivery made to a customer in Massachusetts, it would, on the other hand, constitute intrastate business and so be liable to tax. It would make no difference whether confirmation of the order came from inside or outside Massachusetts.

In the light of these principles, the business of the foreign corporation would probably be regarded as interstate and not taxable if it marketed its products through a commission agent or broker, sold to a local dealer or distributor, or solicited business through a travelling salesman. If the foreign corporation, however, provided a local agent with a stock of goods, the foreign corporation retaining title to these goods, but the agent selling and acting in a general capacity, an attempt would be made to hold the corporation for tax. Similarly, if the agent were an employee in an office of the foreign company and empowered to act for his company, the company would be liable to tax.

Ownership of a permanent establishment, such as a sales office or factory, would imply a usual place of business in Massachusetts, and liability to tax would arise.

B. NATIONAL ENTERPRISES.

A national enterprise may be defined as an enterprise belonging either to individuals residing in Massachusetts, whether doing business singly or in partnership, or to a corporation organised under the laws of Massachusetts.

An individual residing in Massachusetts would be taxable on the whole of his business income, as defined in the Statute, even though the income might be derived in part from business transacted outside Massachusetts.

Individuals carrying on business in partnership would be taxed on the same proportion of the income of the partnership, wherever derived, as the interests of the Massachusetts partners bear to the total interests.

Corporations would be taxed merely on that portion of the total income determined for Federal income-tax purposes which is allocable to Massachusetts.

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

I. GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

(a) Book-keeping and Accounting Requirements.

There are no specific requirements laid down by the Statute. An auditor can be sent out to examine the books and a demand can be made that the enterprise produce the books and records, but in practice this is rarely done.

(b) Methods of Allocation.

If there is separate accounting and it appears to reflect fairly the income of the business in Massachusetts, it is accepted. If it does not appear to reflect Massachusetts income fairly, the parent corporation must file a return of its total income. The proportion which the Massachusetts income bears to the total, as shown by the return, is taken as the basis of the tax, which is computed by employing an " allocating percentage ".

If there is doubt of the honesty of the return made by the corporation, the income of the parent is checked with the return filed with the Federal Government. But, as it is easy to ascertain the net income returned to the Federal Government, it is assumed that the foreign corporation does not falsify its returns to Massachusetts.

A foreign corporation carrying on business outside Massachusetts may, by notification to the Commissioner, on or before the date when the tax return is due, refuse to accept the statutory allocating method, but it must nevertheless submit the prescribed form of return within the usual filing time. Moreover, such corporation, and every such corporation organised outside the United States which is required to return to the Federal Government only income from sources in the United States, must, on or before May 10th, file with the Commissioner a detailed statement of its annual net income derived from business carried on within the Commonwealth, according to such method as it desires to submit for the consideration of the Commissioner, together with an explanation of that method. The alternative method proposed by the taxpayer is scrutinised by the tax authorities, and, if it seems clear that the income is truly reflected, such method will be accepted.

If the statement does not clearly show that the corporation is entitled to the method proposed, the authorities revert to the statutory method and require data to be given in the prescribed manner, whether the corporation has supplied data for the alternative method or not. Upon making a demand for abatement, the corporation is permitted to give a more detailed statement in support of its first claim. No particular method is laid down as an alternative. It may be the use of only one or two of the factors in the formula, or some " rule of thumb " mutually acceptable to the tax-collector and the taxpayer.

1. *Method of Fractional Apportionment.*

The statutory method of allocation consists in first allocating in their entirety certain items of the adjusted total income declared for Federal tax purposes, and apportioning the remainder by applying a prescribed apportionment fraction. In the case of a foreign corporation having a regular place of business without as well as within Massachusetts, the following items of income are allocable in their entirety to Massachusetts :

(a) Gains from the sale of capital assets, if such assets consist of real estate or tangible personal property situated in Massachusetts ;

(b) Interest received from any corporation organised under the laws of Massachusetts, or from any association, partnership or trust, having transferable shares and having its principal place of business in Massachusetts, or from any inhabitant of Massachusetts, except interest received on deposits in trust companies or in national banks doing business in Massachusetts.

On the other hand, the following classes of income of foreign corporations shall not be allocated in any part to Massachusetts :

(a) Interest other than that described above as allocable in its entirety to Massachusetts ;

(b) Dividends ;

(c) Cains from the sale of the capital assets other than those described above as allocable in their entirety to Massachusetts.

Capital assets shall not be deemed to include stock-in-trade sold in the ordinary course of business. For purposes of allocation, expenses may not be deducted from income allocable in its entirety. Such income is taxable, subject to the machinery deduction, to the extent that the corporation had income without deduction by reason of a Federal net loss (Rules and Regulations, Sections 4002 to 4006). The machinery deduction is obtained by multiplying the total income allocable to Massachusetts by the ratio of the average fair cash value of machinery owned and used in manufacture in Massachusetts to the average value of the total assets employed in Massachusetts.

After deduction of the classes of income which are allocable in their entirety, the remainder of the income is apportioned by means of the " allocating percentage ", which is determined, under Table A of the return for foreign corporations, as follows :

		Divide *(a)* by *(b)* to obtain decimal.	Carry out decimal at least six places.
1.	*(a)* Average value (actual) of tangible property in Massachusetts	.....	
	(b) Average value (actual) of all tangible property	..... =	.....
2.	*(a)* Wages, salaries, etc., assignable to Massachusetts	.....	
	(b) Total wages, salaries, etc.	..... =	.....
3.	*(a)* Gross receipts assignable to Massachusetts	.....	
	(b) Gross receipts from all business	..... =	.....
4.	Total of Items 1, 2 and 3 — divide by 3 [1]		.....
5.	Allocating percentage (express in decimal)		.....

Items 1, 2 and 3 are fractional and are to be reduced to decimals by dividing *(a)* by *(b)*, and the result should be set down in the outer column. These decimals should then be added and an

[1] If only two of above proportions apply, substitute 2 ; if only one applies, substitute 1.

average obtained, which is known as the " allocating percentage ". The instructions for computing the percentage are given below :

" *Item* 1. — If monthly inventories have been taken, these should be used in determining the average value. For example : The total of monthly inventories divided by 12 should give the average value for the year. If monthly inventories have not been taken, inventories as at the beginning and end of the year accounted for may be used, provided the stock-in-trade and other tangible property of the corporation have remained substantially constant during the year. Distinguish between tangible property and intangible. Do not include intangible property such as stocks, bonds, notes, bills receivable, goodwill and the like. Note that 1*(a)* applies to tangible property in Massachusetts and 1 *(b)* to all tangible property. In supporting Schedule 1*(a)* state the method used.

" *Item* 2.— Include under *(a)* all wages, salaries, commission or other remuneration to employees except such as is paid to employees chiefly situated at, connected with, or sent out from premises for the transaction of business which are owned or rented by the corporation outside Massachusetts. An employee is one who works for and under the control of his employer. The mode of payment, while a circumstance to be considered in determining the question whether or not a person is an employee, is not decisive. An " employee " may include a travelling salesman, even though paid on a commission basis. The term does not include an independent agent or a contractor or a corporation. Include under *(b)* all the wages, salaries, commission or other remuneration of employees.

" *Item* 3. — Include under *(a)* the following : (1) All sales, except those negotiated or effected on behalf of the corporation by agents chiefly situated at, connected with, or sent out from, premises for the transaction of business which are owned or rented by the corporation outside Massachusetts. Include under sales, remuneration for personal services. (2) Rentals or royalties from property situated or from patents used in Massachusetts. Include under *(b)* all sales, rentals or royalties.

" *Items* 1, 2 *and* 3.— If both numerator and denominator of a fraction are "none", the proportion is to be deemed inapplicable. If the numerator is " none " but the denominator is any amount greater than " none ", insert " none " against the item in the outer column. For example : $\frac{0}{50{,}000}$ (0 ÷ 50,000) = 0. If the numerator and denominator are identical, insert 1 in the outer column. For example : $\frac{10{,}000}{10{,}000}$ (10,000 ÷ 10,000) = 1. "

2. Discussion of the Factors of Allocation.

The starting-point is the Federal income-tax figure, with certain additions. The net income having been determined, this amount is allocated by application of the three factors. If one-tenth of the business of the corporation is done in Massachusetts, it is assumed that one-tenth of the profit is derived from that State. The factors are calculated to reflect the extent of business activity, and hence the amount that is earned in that jurisdiction.

The three factors of the statutory formula are real or personal tangible property, pay-roll and gross receipts.

In any method of allocation, the Administration would try to determine where the income is made and from what source it is derived. The question arises as to what factors produce income.

It is true that, in the case of a corporation that manufactures and sells, the initial step is certainly one of purchase. A corporation once contended to the Commission that practically all its profits were derived from outside Massachusetts because, although the factory and sales branch were in that State, the brains of the corporation were in New York, and in the particular case most of the

profits were made by skill in the purchase of raw materials. It is admitted that good management of a business contributes to its ultimate profit. Efficiency in the management of a factory may reduce costs and make the margin of profit greater. Wise advertising may facilitate the sale of the product, efficient salesmanship may make the demand for it greater, and, in general, there are many factors that go to make up profit.

All business, however, implies the application of human faculties to capital to produce a profit. For that reason, it is held by the Commission that the pay-roll is significant, because the pay-roll compensates the exercise of human faculties. In general, men are paid according to their worth, and it is fair to say the pay-roll represents the compensation of human faculties exercised in a particular jurisdiction.

There is, further, the return that ought to flow automatically from capital, and it is fair to include as one of its elements *tangible property*.

If we include the sales factor in addition to the wage factor, some duplication may result. Where equal weight is given to tangible property, pay-roll and sales, irrespective of the character of the business, in particular instances an unduly large amount may be attributed to the sales activities, but it is believed that this will not ordinarily result.

On the other hand, if a single factor be adopted, a much more distorted result is probable. In support of this argument, the case of a company in Connecticut may be considered. The Company contended that 80 per cent of its profit was attributable to its sales activities. The State of Connecticut taxed it on something like 49 per cent of its profits, and the sole factor applied was that of tangible property. It is probably true that a distinction ought to be drawn between a corporation which sells a specialised product, such as a typewriter, and resorts largely to advertising to increase its sales, and a corporation which sells a staple article.

The most questionable of the factors contained in the formula is probably the receipts factor, but the practical operation of the law cannot be said to have produced any misleading results. It has been fairly generally acquiesced in, and there has been no great evasion of the tax.

When the factors are well balanced, the formula usually results in a fair tax, but the importance of each factor naturally varies from business to business.

Certain kinds of corporate activities will not require as much tangible property as others. This remark applies also to the pay-roll. A business that turns over its product many times during the year is very likely to show a big figure for gross receipts, and the percentage of the pay-roll may be less than where the turnover is not so frequent. There are also corporations, like personal service corporations, where very little in the way of tangible property is ever found. Again, the handling of hardware or things of that character may represent a very substantial amount of tangible property, as in the case of a real estate corporation. Further, in some other kinds of corporations, the pay-roll might be very small for the reason that the product sold would be so bulky that a very small number of objects might be sold during the year, even though the receipts were considerable. This would be true, for example, of steel bridges, steamships or locomotives. At the other extreme are women's shoes, confectionery, restaurant businesses, department stores and even hotels. If, in any such case, the results of the formula are inequitable, the taxpayer may propose an assessment on an alternative basis.

3. *Requirements for Selection of Methods and Relative Value of the Various Methods.*

A corporation which carries on business partly in Massachusetts has the option of refusing to accept the statutory method of allocation by filing a notice prior to a day stipulated in the Statute. The corporation then submits an alternative method, which is considered by the Commissioner. In the last analysis, it is the duty of the Commissioner to determine the income derived from business carried on in Massachusetts, and it may be that he will reject the alternative method proposed by the corporation as not indicating as correctly as does the statutory method the amount earned in Massachusetts ; or he may in such circumstances determine the amount in some other manner.

Unless, however, the corporation refuses to accept the statutory method of allocation, the

Commissioner is bound to follow it, and, under the Statute as it exists to-day, he has no option permitting him of his own volition to set aside the statutory method in the event of his considering that it does not allocate to Massachusetts the full amount of income derived therefrom.

As far as a subsidiary corporation is concerned, the question is one of determining the true earnings of the corporation, eliminating payments to the parent corporation in excess of the true value of the property or services given therefor. How this determination is to be arrived at by the Commissioner is not set forth in the Statute, although there is a provision which relieves a subsidiary corporation from a minimum tax if it volunteers to file a statement from which any such excessive payments have been eliminated. Where corporations do not furnish such a statement, it is the practice to apply the method of consolidating accounts. In general, this method involves principles of allocation similar to those prescribed by the Statute for the allocation of the income of a corporation operating through a Massachusetts branch.

More detailed rules have never been laid down for cases where either a corporation objects to the amount of income allocated to Massachusetts by the statutory rule, or, in the case of a parent and subsidiary, where the so-called consolidated method is objected to because it allocates too large an income to Massachusetts. Each case is dealt with in the light of its own particular circumstances. As already mentioned, such cases are relatively few in number. As a rule, separate accounting has been requested (when a corporation objects to the statutory method or where objection is taken to the consolidated method by a subsidiary) in connection with the maintenance of a sales organisation in Massachusetts, the manufacturing activities being entirely outside that State. In such cases, the question arises as to what actual profit is derived from the sale of goods in Massachusetts. This usually involves a division of the profits resulting from those sales between the producing activities and the sales activities.

Where it can be established that goods are invoiced to a subsidiary corporation or a branch at actual manufacturing cost and the expenses of maintenance of the branch have absorbed all the difference between the price at which the goods are invoiced to the branch office and the sales price, there can be little or no question of division.

Where goods are invoiced to the branch at a price in excess of manufacturing cost a difference in opinion is more than likely to arise. If the article is a staple product, market conditions and quotations can be resorted to to test the fairness of the price charged to the branch office; but in these days, when so many articles are distinctive, bearing a trade mark or trade-name, market conditions are not available, for there is no other article of precisely the same brand. In such cases, the gross profit has to be apportioned more or less arbitrarily between manufacturing cost and selling price by the branch office. In a very few cases adjustments have been made by apportioning to the producing end of the business two-thirds of the profits and to the sales end one-third, but this can by no means be fairly laid down as a rule for general application. A comparison of expenditure might be helpful in making a fair apportionment, but very few cases in Massachusetts have been settled on the basis of separate accounting, and no case is recalled where any reference to expenditure has been resorted to in connection with adjustment.

In the case of a foreign corporation with diversified interests, but selling only one of its products in Massachusetts, the corporation has in a few instances split up its profits and shown what the profit is from the sale of that particular product. If the tax authorities were of opinion that the profits were thus truly reflected, such an arrangement would be agreed to, and the factors would not be applied to the general income. In practice, it has been found that a corporation will make this request when the profits made in Massachusetts are lower then the profits made elsewhere.

The tax system in Massachusetts does not consist of an income-tax strictly speaking, but is an excise, and it was the intention of the legislature to levy a fair tax on the business activities carried on in Massachusetts and to measure the extent of these activities, whether they were profitable or not. It is felt that no hardship is imposed in applying the statutory method. Particularly in the case of a domestic corporation, it is probably more sound to adhere to the statutory method than to adopt separate accounting.

The factors applied bear a distinct relation to the business activities carried on in Massachusetts. For each particular type of business the factors must be made to conform to that limited part of the business (how much tangible property, etc.) which relates to Massachusetts.

The question really is, whether or not, as a matter of sound fiscal policy, the success or failure of a corporation to make money ought to have a bearing on the measure of a pure excise-tax. The fundamental virtue of adhering to a hard and fast rule of allocation, conceived with the greatest degree of fairness possible, is that, in the final result, not more than 100 per cent of the income will be subject to tax.

The statutory method is applied in 95 per cent of the cases involving foreign corporations carrying on business in Massachusetts. For the other 5 per cent, no hard and fast rule is laid down ; the method adopted depends on circumstances.

Where separate accounting has been accepted, it has usually been in self-defence. If the corporation does not accept the statutory method, the burden of proof is upon it to show that, by separate accounting, it can satisfy the Commission that true profits are reflected.

The method of separate accounting is seldom employed, and it has to be substantiated by evidence to show that intra-company transactions have been so conducted as to allocate a fair profit to Massachusetts.

The verification of the accounts of a foreign corporation is extremely difficult, and, in the case of international business, the tax authorities are at the mercy of the corporation, as it is impossible to send auditors long distances to check accounts.

(c) Apportionment between Branch and Parent Enterprise.

1. *Apportionment of Gross Profits of Branch to Real Centre of Management abroad.*

This question has been dealt with extensively in discussing the statutory method.

In cases where separate accounting is used, the principle is recognised that, where a foreign corporation with its real centre of management abroad has a sales branch or factory in Massachusetts, no allowance will be made for the profits attributable to the direction exercised in another State, although an allocation of overhead for the expenses of the office will be accepted.

2. *Apportionment of Expenses of Real Centre of Management to Branch.*

Interest Charges. — A corporation would have the interest charges on debt distributed over its business wherever located. In the event of a large part of the property being outside the Commonwealth, and therefore not lending itself to taxation, and only a small part in the Commonwealth — say, roughly, ninety per cent out and ten per cent in — Massachusetts would allow only ten per cent off the debt. This, of course, is not a definite rule, but is the practice in such cases.

General Overhead. — Similarly, the overhead expenses of foreign enterprises are distributable over the whole organisation. It is, of course, again to be understood that Massachusetts takes the net income as returned to the Federal Government. Before this net income is found, many of these overhead charges have already been eliminated from the consideration of Massachusetts as the result of deductions allowed by the Federal Government. If these overhead expenses or charges are reflected in the balance-sheet, the authorities, failing a better plan, adopt the formula used in the allocation of net income and apply it to the allocation of " net worth ", or as it is called in Massachusetts " corporate excess ".

(3) *Apportionment of Net Profits of Branch to Deficitary Parent and* vice versa.

In general, when the Massachusetts establishment operates so as to show a net profit and the enterprise as a whole shows a net loss, Massachusetts does not tax, because the corporation is

taxed as a unit and not in respect of its business in Massachusetts. There is, however, a minimum tax provided so that, in any event, if any business is done, even at a loss, Massachusetts collects a minimum tax of one-twentieth of one per cent of the gross receipts attributable to Massachusetts.

The reverse is equally true : if profits are made by the corporation outside Massachusetts, Massachusetts takes its proportionate share of the net income of the corporate unit under the formula, even though the Massachusetts activities may be conducted at a loss.

The question of net income or net loss, as to a given unit of activity, is largely a matter of accounting. A business, in order to be successful, must have many activities that do not show their value, except as they may be reflected in increasing sales or decreasing costs. It is to be assumed that all business activities of a corporation are adopted for the sole purpose of making net income. This being so, the State in which any of these activities are carried on is entitled to a fair share in the total net income for the purpose of taxation. It is necessary to find a measure of allocation which allots a fair share for a given jurisdiction to tax. Massachusetts has found that property, pay-roll and gross receipts represent the best formula to start with, but there may be other formulæ for particular lines of business, where weight would be given to advertising, manufacturing, administration, selling, buying or processing. The result, however, would probably not ensure any greater fairness than the three-factor method used in Massachusetts. There the practice is to apply the formula universally in the first instance, for the tax bills must go out promptly after receipt of the tax return. The formula is ordinarily departed from only when the corporation applies for an abatement of its tax and presents more detailed figures than were possible in the tax return. In the case, however, of a few corporations, whose set-up is well known, the tax is adjusted without the use of classification or formula before the tax bill goes out ; it is, of course, impossible to treat many in this way, as Massachusetts, after collecting its corporate taxes, distributes them to the cities and towns to meet their current liabilities.

If a corporation maintained in Massachusetts for years a branch which, according to its books, made no profit, but the maintenance of this branch enabled the foreign corporation to maintain a larger output, the Commission would not go so far as to claim tax on an indirect profit. In one case, a shoe company sold through a branch in Massachusetts. It brought evidence to show that the shoes were manufactured at one price and sold at another and that the actual expense of maintaining the branch was the difference between the two figures. No attempt had been made to invoice the goods with any profit above the actual cost of manufacture. It may be that in that case the increase in volume tended to reduce costs in general. Although, in this particular instance, the Commission did not refuse to set aside the provisions of the Statute, it is not often possible to determine the actual cost price.

(d) Apportionment between Parent Enterprise and Subsidiaries.

What has been said about the methods of allocating income applies to the allocation of the income of a separate corporate entity, but does not apply where there is a subsidiary corporation in Massachusetts. In other words, what has been said relates purely to the allocation of the income of what is admittedly a single corporation subject to taxation in Massachusetts. An entirely distinct problem arises in connection with the taxation of subsidiary corporations.

In the great majority of such cases it is probably true that the income disclosed to Massachusetts by the subsidiary corporation is more or less artificially regulated and manipulated through the control of the parent organisation. It is, of course, usually less than the Massachusetts authorities would assess it at if there were no absorption of profit by arrangement between the companies. It is the practice in such cases to ask for a copy of the return jointly filed by the parent and subsidiary corporation with the Federal authorities. The factors are then applied to the consolidated income with a view to establishing the presumable amount of the consolidated earnings attributable to the activities of the subsidiary. This ascertained, and if the subsidiary carries on business, not only in Massachusetts, but elsewhere, the allocation factors are again applied to determine the portion

of the income derived from Massachusetts activities. This method is sometimes referred to briefly as the "consolidated method". The information obtained, however, is based entirely on presumption. If it can be established through an analysis of inter-company transactions that this method allocates too large an income to Massachusetts, it is set aside and such an amount as on the facts appears to be the true income earned in Massachusetts is substituted. In the great majority of cases, however, the consolidated method appears to have produced equitable results. In view of the fact, too, that it would often be exceedingly difficult to analyse inter-company transactions and agree upon what would have been a fair arrangement as between the subsidiary and the parent, the tax has in almost every case been finally settled upon the basis of the consolidated method.

To illustrate the difficulties inherent in any attempt to substitute for the more or less arbitrary arrangement which, in fact, may exist between parent and subsidiary an arrangement upon a basis likely to obtain as between independent parties, we may take the case of a parent corporation manufacturing a distinctive product which it invoices to a subsidiary corporation, and which the latter under the arrangement between the two companies sells at so small a gross profit that its expenses may absorb that profit. How can a fair price for the parent to charge the subsidiary be determined ? The product is a distinctive one, and there is therefore no market quotation for it. This being so, the price that would have obtained as between independent parties is very largely a matter of conjecture, about which the administering authority and the taxpayer can argue and differ in opinion, perhaps finally settling the point by compromise rather than entering into protracted litigation. For this reason, no doubt, many corporations accept the so-called consolidated method where it appears to produce an equitable result.

II APPLICATION OF THE METHODS OF ALLOCATION IN SPECIFIC CASES.

(a) Industrial and Commercial Enterprises.

Before individuals or companies can be taxed, they must be subject to jurisdiction. The method of allocation adopted in Massachusetts recognises three sources of profit—buying, manufacturing and selling. It is impossible to indicate their respective importance. A formula based on buying expense, selling expense and manufacturing expense would very likely give the same result as the formula now adopted. There must be some method of allocation, even if it be an arbitrary one. Under separate accounting, it is left to the corporation to make its own apportionment.

In principle, the activities of buying, manufacturing, processing, the maintenance of establishments and management go to make up the ultimate profit and, in theory, they should be allocated according to the parts they play. The Massachusetts formula does, in fact, attribute a certain weight to each of these factors, but does not go so far as to determine what weight should be attributed to each.

The greater part of selling profit, it can be asserted, is due to skill in buying, as, for example, in the business of horse-dealing in New England. Buying profit depends on three factors: (1) integrity or the advantage in the market a man's credit gives him over an unknown buyer ; (2) financial ability ; and (3) the use to which a purchaser puts the article bought.

1. *Selling Establishments.*

In the case of a sales establishment in Massachusetts, there is no doubt that the profit arises in that State.

In the case of a corporation manufacturing in another country and selling in Massachusetts, a certain manufacturing profit will be allocated to the manufacturing establishment. The Commission would try to discover whether the corporation was invoicing at a cost above that of manufacturing. If this was impossible to determine, some arbitrary method would be employed,

such as attributing two-thirds to manufacturing and one-third to sales, or a compromise would be effected in order to avoid litigation.

Under separate accounting, the question arises: What should expenses figure at in order to obtain for tax purposes a fair profit? As a rule, the expenses of manufacturing greatly outweigh selling expenses. The difficulty is to isolate a particular cost. For example, the product sold may be a by-product of another industry, as in the case of leather. In estimating its cost, we have to go back to the price at which a corporation — say, in the beef trade — sold hides. In order to determine the final cost of the leather, the expenses of the various stages have to be added up, and these would greatly outweigh the cost of selling. It is generally felt that, on this basis, the jurisdiction in which the sale took place would not get its fair share of profit if only the actual expenses of selling were allocated to it and that, in order to arrive at a proper figure, there should be some apportionment of the whole expenses.

Where manufacturing and selling elements enter into play, an estimate of manufacturing activities and sales activities would be a more rational basis of apportionment of actual profits than a comparison with other corporations, since, if the latter procedure were adopted, an undue profit might be allocated to manufacturing.

When the statutory method of allocation is used, some manufacturing profit is allowed for in applying the formula. When an alternative method is employed, a certain deduction from the eventual profit is often allowed for manufacturing costs. The authorities try to look at each case on its own merits and to consider the psychological advantage of making the taxpayer feel that his case has been given due and fair consideration by the Commonwealth.

In the case of enterprises purchasing abroad and selling in Massachusetts, the income derived from buying abroad and selling in that State would be apportioned according to the three-factor method. The formula would ascribe little profit to buying, however, unless buying expenses were heavy. If the assessment were made by an alternative method, some recognition would possibly be paid to a buying profit as distinct from pure commission. In the case, however, of a single corporation, there is no passing on of the title to the goods, so the question would not arise. In the case of sales by a subsidiary, when the title to the merchandise is retained by the foreign corporation, these sales would be taxed in Massachusetts.

In practically no case has a trading corporation buying abroad and selling in Massachusetts refused to accept the statutory method and thereby imposed on the tax authorities the necessity of fixing a buying profit.

In the difficult task of estimating a buying profit, it might be possible to apply the theory that a man tends to receive remuneration representing his worth to the corporation that employs him. Although a part of buying profit is due to luck, part will be due to skill in forecasting the market and, although the remuneration paid to the buyer may be too much or too little, it does serve to some extent as a measure.

No profit from buying is realised until a sale is made, and the amount of such profit not only depends on the state of the market when the raw material was bought, but also on the state of the market when the finished product is sold. There is, therefore, the element of time to be considered, and this may be as long as five years — as, for example, in the case of cotton. Such a profit might not be reflected in the accounts for several years, but the expenses of buying the raw material would appear the year the purchase was made. The true state of affairs could only be reflected by a corporation starting anew each year and concluding all its transactions in that year. This does not happen, and the Commission has had to adopt a method which can be accepted as fair by all concerned. This has meant the adoption of a yardstick that will apply to an average corporation concluding all its transactions within the calendar year.

In addition to a buying profit, there is a buying loss, since a foreign corporation can sell to its subsidiary at a higher price than it normally could.

In the case of an enterprise both manufacturing and purchasing abroad and selling in Massachusetts, there is usually no separation of profits; but the factors of tangible property, gross

receipts and pay-roll would be applied to the total income, and the profits would be allocated according to the result of the formula.

Although the formula as applied may be a hardship on the corporation in one year, it may be an advantage in another, and the fairness of the burden imposed must be judged over a number of years.

2. *Manufacturing Establishments.*

Enterprises manufacturing in Massachusetts and selling outside the State would have most of their tangible property and make most of their payments in Massachusetts, while deriving their receipts from sales outside. The maintenance of the sales office outside Massachusetts would reduce the amount attributable to this State by application of the formula.

3. *Processing Establishments.*

The profits made by a corporation engaged in processing would be taxed in the same way as those of any corporation earning business income, but no particular account would be taken of the value of the article processed or of the fact that the processing within Massachusetts had increased the value of the merchandise.

4. *Buying Establishments.*

If a corporation merely bought in Massachusetts and carried on no other activity within the State, the tax would be comparatively small, the wage factor alone allocating any income to the State.

5. *Research or Statistical Establishments, Display Rooms.*

As regards a service establishment, such as a laboratory for the carrying out of experiments, the particular circumstances of each case would have to be considered. The expenditure of large sums for experimental purposes would probably not be taken into account, the Commission holding that, if these experiments proved successful, there would, in the future, be a larger revenue for taxation purposes. Tax would not be imposed where the foreign corporation maintained a display room, but made no sales there.

Although it is true that these activities go to make up a profit in the final analysis, it is also true that, when separated from the whole, a particular activity such as a service establishment cannot be said to make a profit. What is true of the whole need not be true of each of its parts taken separately. According to the principle of law in Massachusetts, profits are only taxed if they are derived from business activities within the State. Therefore, while the fact of merely buying in Massachusetts or having there a research laboratory would be recognised as contributing to the final profit, these functions would not be considered as business activities subject to tax. In defining what constitutes business it is very difficult to draw a dividing-line. Broadly speaking, a corporation that lets its name be known in Massachusetts can be said to be doing business there, and it is a question of expediency where the line should be drawn.

In the preceding cases it is of course, very difficult to get a proper tax determination. Ordinarily, however, a corporation is successful or unsuccessful in these enterprises, and the accumulated experience of year after year finally furnishes a rule of tax settlement on which the State and the corporation can agree. These kinds of cases indicate that the Massachusetts formula will not work in every case and justify the provision in Massachusetts law that, where the formula does not work, some other method of determining tax can be used. Obviously, no single formula would apply to all the cases put under question II. The questions asked show clearly how impossible it is to provide a yardstick which will measure with accuracy every tax burden of every corporation. Any such

formula would probably result in very arbitrary and unfair exaction. Tax administration, being about forty per cent law and sixty per cent good judgment, suggests that a formula or any other method of apportionment should not be too harsh or too rigid and might well provide for reciprocal action as between taxing jurisdictions. The net income should be subject to the formula in the first instance; or, if this is inapplicable, be adjusted on some fair method of determination, which could vary according to the set-up of the particular corporation.

(b) Banking Enterprises.

Only national banks and Massachusetts incorporated banks can do business in Massachusetts. They are taxed on net income, the Federal return of net income being the base; there are then added to it the same items of income as in the case of foreign and domestic business corporations. Banks are treated in the same manner as business corporations in respect of all these questions.

(c) Insurance Enterprises.

Massachusetts taxes insurance companies on net premiums and reserves, so that the matter of allocation does not arise. Credit, however, is allowed for return premiums and for reinsurance, together with retaliatory provisions respecting the insurance tax laws of other States.

(d) Transport Enterprises.

Railway and like companies are subject to a franchise-tax and not to income-tax. The taxation of railway companies is not unlike the corporate excess tax imposed by Massachusetts upon foreign and domestic business corporations. Shipping companies are subject to a special excise-tax.

(e) Power, Light and Gas Enterprises.

Power, light and gas companies are subject to a franchise-tax, which is based, not on income, but, broadly speaking, on the value of capital stock, less the value of property locally assessable.

(f) Telegraph and Telephone Enterprises.

Telegraph and telephone companies are subject to a franchise-tax, which, broadly speaking, is based on the value of the capital stock less the value of property locally taxable.

(g) Mining Enterprises.

Mining industries are taxed as business corporations.

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

The general method of allocating net income described in connection with foreign corporations is used also for Massachusetts corporations. The items allocable entirely to Massachusetts are interest and dividends, which are included in net income, gains from the sale of intangible capital assets wherever sold, and gains from the sale of tangible personal property and real estate situated in Massachusetts. Other income is apportioned by the allocating percentage previously described. In the event of the formula not working out fairly either from the tax administration's point of view or from that of the corporation, another method of allocation is adopted. In such cases. the formula may be partially used, two factors being employed instead of three, or separate accounting may be

adopted if it reflects the situation fairly. It may, however, be advisable to make some flat tax arrangement. Speaking generally, corporations eventually so arrange their affairs as to receive an even flow of revenue from their various activities, and the accounting adjusts itself so that the amount fairly attributable to Massachusetts can well be measured by sales, tangible property or pay-roll as set out in the formula.

C. HOLDING COMPANIES.

I. National Holding Company controlling one or more Foreign Subsidiaries.

Massachusetts, in taxing its holding companies, gets but little tax, since it has jurisdiction only over the holding company and cannot be said to control at all, or help by governmental aid, the activities which go to make the value of the securities of the corporations held by the holding company. Tax is payable by the holding company on its net income and on its corporate excess, based on as much of the value of its securities as would be reflected in the assets of the holding company's balance-sheet. Speaking generally, the formula previously described is used in these cases and ordinarily reflects a fair tax for Massachusetts.

II. Local Subsidiary Company controlled by a Foreign Holding Company.

No tax is imposed on dividends or interest as such paid to a foreign holding company.

If the local subsidiary of a foreign corporation is conducted at a loss, the real profits being reflected in the parent company, then Massachusetts attempts, without recourse to its formula, to ascribe some portion of the parent corporation's profits to Massachusetts. Sometimes the only way it can be done is to use a consolidated balance-sheet and attribute to the Massachusetts corporation its apparent share of the total.

Annex.

TABLE OF TARIFFS.

I. Income-Tax on Resident Individuals.

Class of income	Rate of tax
Interest and dividends	6 per cent of the taxable income.
Gain from the sale of intangible property	3 ,, ,, ,, ,, ,, ,,
Business income	1.5 ,, ,, ,, ,, ,, ,,
Annuities	1.5 ,, ,, ,, ,, ,, ,,

II. Excise-Tax on Business and Manufacturing Corporations.

Normal tax :

On income :

Domestic and foreign corporations : 2.5 per cent of the taxable income.

On corporate excess :

Domestic corporations : 5 per thousand of corporate excess.
Foreign corporations : 5 per thousand of " corporate excess employed within the Commonwealth ".

Minimum tax :

Domestic and foreign corporations : 1/20 of 1 per cent of the gross receipts assignable to Massachusetts.
Domestic corporations : 1/20 of 1 per cent of the value of the capital stock.
Foreign corporations : 1/20 of 1 per cent of such proportion of the capital stock owned by the corporation as the value of the assets employed in business in Massachusetts bears to the total value of the assets.

STATE OF NEW YORK

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INTRODUCTION.

The New York personal income-tax [1] on individuals, partnerships, estates and trusts is a pure income-tax. Corporations engaged in various types of business are subject to franchise-taxes on the privilege of doing business or operating within the State.

Inasmuch as the purpose of the present statement is to deal with methods of allocating taxable income, it will only deal with the personal income-tax and the taxes which may be measured by income, such as the franchise-tax on business corporations and the tax on financial enterprises. The bases employed for the franchise-taxes on corporations engaged in other types of business are not on *net* income and vary greatly. They are briefly dealt with in an appendix to the present study.

I. PERSONAL INCOME TAX. [2]

PART I. - GENERAL DESCRIPTION. [3]

The personal income-tax of the State of New York was introduced by the Legislature in 1919 (Chapter 627 of the Laws of 1919) and became effective as from January 1st, 1919. The Statute was modelled as far as possible on the Federal Revenue Act of 1918, except so far as it was necessary to adapt the provisions of the Federal Statute to meet State conditions.

TAXPAYERS.

A tax at graduated rates is imposed upon the entire net income from all sources (less personal exemptions) of every resident individual of the State and upon the net income of non-residents of the State from all property owned and from every business, trade, profession or occupation carried on within this State.

The rates of tax have remained stationary at 2 per cent on the first $10,000 of taxable income, 4 per cent on the next $40,000, and 6 per cent on all income in excess of $50,000.

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[1] In the calendar year 1930, the relative revenues from the taxes described herein were as follows : personal income-tax, $81,474,928 ; franchise-tax on business corporations, domestic and foreign, $55,695,702; franchise-tax on State banks, trust companies and financial corporations, $8,051,570. The total of all State and local taxes was $1,140,986,398.

[2] Legislation in force on March 1st, 1933.

[3] By Roy H. Palmer, First Assistant Director, Income-Tax Bureau.

Under the Statute, a " resident " is defined as a natural person domiciled in the State of New York, or maintaining a permanent place of abode within the State, and spending in the aggregate more than seven months of the taxable year there (Section 350). The second part of this definition was intended to fix the status for tax purposes of one who was technically domiciled in another State, but who, maintaining a permanent place of abode in the State of New York and spending the greater portion of a year there, was in fact enjoying the protection of this State to the same extent as one actually domiciled therein. Thus, under the latter part of this definition, an individual might be taxed as a resident in one year and not in the next, depending on whether or not his stay within the State in a given year was greater or less than seven months, as the case might be. The fact that a tax may be imposed in the State of his domicile upon an individual who is considered as resident in the State of New York under Section 350 does not relieve him from liability to this tax.

Partnerships are not taxed as such, but each partnership is required to file for information a return showing the computation of net income from its operations and the distributive shares of the respective partners in the profits. Each individual partner is required in his own return to include his distributive share of the profits of the partnership during the year, whether distributed or not.

Estates and trusts are also required to file returns, and their net income is computed in the same manner as for individuals. In principle, the tax is paid by the trustees and fiduciaries. If, however, the income of an estate or trust is distributable to known beneficiaries, the beneficiaries are required to include in their individual returns their distributive shares of the income of such estate or trust, whether distributed or not.

Taxable Income.

The tax is based upon income for a calendar year. If, however, the taxpayer keeps his books on a basis other than a calendar year, he may report for a fiscal year ending on the last day of any month other than December. The " taxable income " is arrived at by deducting from " gross income " certain allowances in order to arrive at " net income ", from which are then deducted " personal exemptions ".

The term " gross income " does not mean entire income, but is a statutory term defined (Section 359) as including gains, profits and income derived *(a)* from salaries, wages or remuneration for personal service ; *(b)* from professions, vocations, trades, businesses, commerce, sales or dealings in property whether real or personal ; *(c)* interest, rent, dividends, securities or the transaction of business carried on for gain or profit ; or *(d)* gains or profits and income derived from any source whatever. Certain items are exempted, including, for example, proceeds of life-insurance policies paid upon the death of the insured; the value of property acquired by gift, bequest, devise or descent ; interest upon the obligations of the United States or its possessions, etc., or the obligations of the State of New York or of any municipal corporation or political subdivision thereof, and stock dividends.

Gross income as to a resident of the State includes, within the limitations of the definition above stated, income from all sources whether within the State of New York or elsewhere. Thus, a resident is taxed upon the entire profit derived from business, even though the latter is carried on wholly or partly outside the State, and from dividends received from corporations operating entirely without the State and from property owned without the State as well as within.

Gross income, as regards a non-resident taxable under the New York Statute, includes only gross income from sources within the State, and not (1) annuities, (2) interest on bank deposits, (3) interest on bonds, notes or other interest-bearing obligations, (4) dividends — except to the extent to which the same is a part of income from any business, trade, profession or occupation carried on by such non-resident taxpayer in this State.

Thus, a non-resident who owns real property in the State of New York is taxable upon the rents therefrom or upon any profit arising out of the sale thereof ; a non-resident employed within

the State and receiving remuneration for personal service is taxable on the amounts so earned ; a non-resident practising a profession or carrying on a business within the State of New York, either as an individual or as a member of a partnership, is taxable upon his gains or upon profits or income therefrom ; non-resident members of partnerships doing business in this State are likewise taxable upon their distributive shares of the partnership to the extent to which such profits are earned within the State.

Statutory " gross income " having been thus ascertained by such exclusions from entire income, " net income " is arrived at by subtracting therefrom the " deductions " allowed (Section 360), as follows : (1) ordinary and necessary expenses of carrying on trade or business ; (2) interest on indebtedness ; (3) taxes other than income-taxes or special assessments ; (4) losses incurred in trade or business ; (5) losses in transactions entered into for profit ; (6) losses not connected with trade or business if arising from fire, storm, shipwreck or other casualty or from theft ; (7) debts ascertained to be worthless ; (8) allowance for depreciation ; (9) allowance for depletion ; (10) contributions under certain conditions. The following items are not deductible : (1) personal, living or family expenses ; (2) cost of new buildings or improvements ; (3) amounts expended in restoring property or making good depreciation ; (4) premiums on life-insurance policies.

The deductions to which a non-resident is entitled in order to arrive at his net income are the same as are allowed to a resident of the State only in so far, however, as they are connected with net income arising from sources within the State and taxable under New York law. (Losses sustained by non-resident taxpayers in a transaction entered into for profit, though not connected with trade or business, or losses though casualty, are allowed, but only as regards transactions in real property or tangible personal property having an actual *situs* within the State. Deduction also is allowed to a non-resident taxpayer for contributions, but only when made to a corporation or association incorporated by or organised under the laws of this State.)

Before computing the tax on net income, certain personal exemptions are allowed both to residents and to non-residents, according to the status of the taxpayer in the year for which he is reporting. Unmarried persons, or persons not living with their husband or wife, are entitled to a personal exemption of $2,500. Married persons living with their husband or wife, or the head of a family, is entitled to a personal exemption of $4,000. If a husband and wife having separate incomes file separate returns, the exemption may be divided between them as they see fit. An unmarried person who is the head of a family may also have an exemption of $4,000. Taxpayers are also entitled to a further allowance of $400 for each dependent person.

After deduction of the personal exemption, " taxable income " results, which is the basis for the computation of the tax.

Abatement from Non-resident's Tax to prevent Double Taxation. — Non-resident taxpayers who are liable to income-tax in the State or country where they reside in respect of income derived from sources within the State of New York and subject to the personal income-tax are entitled to a credit against this tax in New York for the tax payable to the State or country where they reside. This credit is computed on the basis of the proportion that the income subject to taxation under the New York law bears to their entire income upon which the tax was so payable to such other State or country. This credit is only granted provided that the laws of the State or country where the taxpayers reside grant a substantially similar credit to residents of this State or exempts from taxation the personal incomes of its residents ; further, no credit is allowed against the amount of the tax on any income taxable under the New York law which is exempt from taxation under the laws of the State or country where the taxpayers reside.

Assessment and Collection of Tax.

The tax is self-assessed — *i.e.*, income-tax blanks are furnished to each taxpayer, who prepares his own return of income and deductions, computes his own tax and is required to pay the tax upon

the filing of the return, which is due on April 15th, if on a calendar-year basis, or on the fifteenth day of the fourth month after the close of any fiscal year, if the return is made on a fiscal-year basis. Each return is audited and, if additional tax is found due, an assessment notice is forwarded to the taxpayer, which is payable without interest within ten days, unless the return is negligently prepared or is fraudulent.

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. Foreign Enterprises.

A non-resident conducting an enterprise, singly or in partnership, is taxable on income from certain sources in New York as described below.

Dividends. — Non-residents of the State are not taxable on dividends received from any source, whether the corporation declaring such dividends is situated within or without the State, unless they form part of income from a business carried on within the State of New York. Thus, a non-resident individual employed or carrying on business within the State and receiving taxable income under the Statute is not taxable upon the dividends from stocks owned by him, even in corporations situated in New York State, where his investments are purely personal and have no connection with a business carried on by him within the State. But a non-resident individual, such as a dealer in investment securities, carrying securities purchased in the manner of " stock in trade " for sale to customers, is taxable on dividends received from the stocks thus carried, as being a part of the business income earned within the State. It matters not in such cases whether or not the dividend-paying corporation is situated without the State.

Interest is subject to the same treatment as dividends.

Royalties: Patent and Copyright. — Both patent and copyright royalties are exempt in the hands of either residents or non-residents of the State.

Rents from Real Estate. — A non-resident is taxable on rents derived from real property owned within the State of New York.

Mining Royalties. — Income from mining royalties is held not to be taxable against a non-resident, for the reason that the contract under which the royalties are paid is a kind of personal property having its *situs* in the State of domicile of the owner, and therefore not constituting property owned within the State of New York.

Gain derived from the Sale of Real Estate situated in the State of New York, when received by a non-resident, is subject to tax, even though not connected with business carried on by such non-resident within the State.

Gain derived from the Sale of Securities is not taxable against a non-resident, except when such profit arises out of business carried on within the State of New York, under the same rules as set forth in respect to dividends above. (Likewise losses may not be deducted in such a case except under the same rules and conditions.)

Salaries, Wages and Other Remuneration for Personal Services. — Such income is taxed by withholding at the source, even when earned by a non-resident within the State of New York.

Income from a Trust. — Non-residents are taxable on income derived from property owned or from business carried on within this State by such trusts.

Income from the Carrying-on of a Business. — A very precise definition of what constitutes carrying on business within New York State so as to incur tax liability is given in Article 415 of the Personal Income-Tax Regulations, as amended on July 1st, 1929, which reads as follows :

> " A business, trade, profession or occupation (as distinguished from personal service as employee) is carried on within the State by a non-resident when he occupies, has, maintains or operates desk-room, an office, a shop, a store, a warehouse, a factory, an agency or other place where his affairs are systematically and regularly carried on, notwithstanding the occasional consummation of isolated transactions without the State. This definition is not exclusive. Business is being carried on if it is here with a fair measure of permanency and continuity. A taxpayer may enter into transactions for profit and yet not be engaged in a trade or business. If a taxpayer pursues an undertaking constantly as one relying on his profit therefrom for his income or part thereof, he is carrying on a business or occupation. Thus a " trader " in securities who trades regularly and constantly on his own account, and makes it his business to trade as another makes it his business to run a mercantile establishment, is carrying on a business or occupation. Its regularity or continuity need not be for a long period ; the life of the business is not a material factor. "

In the light of this definition, income from sales made by a non-resident through a regular commission agent or broker is not taxable as a general rule. Income derived by a non-resident from sales made by a travelling salesman is not taxable, provided no office is maintained by the non-resident within the State of New York and the only duties performed by the salesman are selling merchandise. Income from carrying on a trade or business through an agent with power of attorney, the latter operating within the State, would be taxed against the non-resident as though he himself were present and performing the acts in person.

Tax liability arises where a foreign enterprise has an agent who sells out of a stock belonging to it and makes sales through an office maintained by the enterprise. Income from the carrying-on of a trade or business through a permanent establishment, such as an office, shop, store, warehouse, factory or agent, is taxable against the non-resident to the extent of the business allocable to the State of New York.

B. National Enterprises.

A resident individual conducting an enterprise either singly or in partnership is taxable on income from foreign as well as New York sources. The various items of income received are checked in various ways. The Statute requires all individuals, corporations and partnerships maintaining an office or place of business within the State to return to the Tax Commission complete information concerning the amount of all interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable gains, profits and income, except interest coupons payable to bearer, paid to any taxpayer in an amount in excess of the personal exemption to which such taxpayer is entitled. Dividends are not required thus to be reported, probably for the reason that, so many corporations being outside the jurisdiction of the State of New York, any returns of dividends as to an individual taxpayer would be so incomplete as to be valueless. Income derived from a trust is checked from a fiduciary return filed by each trust indicating the distributive share in the income of each beneficiary.

The other methods employed to discover income of all classes are the usual methods of examination of the taxpayer's books and records, the collection of all data and information obtainable from any outside source and analysis of corporate transactions which are known to produce profit to the stockholders.

PART III. - METHODS OF ALLOCATING TAXABLE INCOME.

A. Foreign Enterprises with Local Branches or Subsidiaries.

I. *General Questions and Methods of Apportionment.*

(a) *Book-keeping and Accounting Requirements.*

The net income is required to be computed in accordance with the method of accounting regularly employed by the taxpayer, whether on the calendar-year or fiscal-year basis ; but, if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as, in the opinion of the Tax Commission, does clearly reflect the income.

(b) *Methods of Allocation.*

The Statute further gives the Tax Commission wide powers to make such rules and regulations and to require such facts and information to be reported as it may deem necessary to enforce the provisions of the Statute. Under this authority, the Commission has issued rules and regulations construing the various provisions of the Statute and providing such additional rules for the computation of net income, and for the allocation of income of non-residents as between income earned within and without the State, as is necessary in its judgment for the proper administration of the law. Such rules and regulations have the effect of law unless a court determines that they are not consistent with the provisions of the Personal Income-Tax Law.

No specific method has been prescribed by the Statute for the allocation of income of a non-resident as between income earned within and without the State of New York. It therefore appears that the manner and method of such allocation are left to the discretion of the Commission, which has power to set up rules and regulations for this purpose. The provisions laid down by the Commission are contained in the Personal Income-Tax Regulations, as amended on July 1st, 1929, Articles 455 to 457 and 470, which follow :

> *Article* 455 : *Business carried on wholly within the State.* — The entire net income of a non-resident from a business, trade, profession or occupation, carried on within the State (as " business carried on " is defined in Article 415), and not carried on elsewhere, as so defined, is income from a source within the State of New York and taxable as such.
>
> This is so, even though the non-resident or his representatives travel without the State for the purposes of the trade or business -- that is, for the purpose of buying, selling, financing or performing any duties in connection with the business, and even though sales may be made to, or services performed for, or on behalf of, persons or corporations situated without the State.
>
> *Article* 456 : *Business carried on wholly without the State.* — No part of the net income of a non-resident from a business, trade, profession or occupation carried on without the State of New York (as " business carried on " is defined in Article 415), and not carried on as so defined within this State, is taxable.
>
> This is so, even though the non-resident or his representatives may enter the State for the purpose of buying, selling, financing, or performing any other duty in connection with the business, and even though sales may be made to, or services performed for, or on behalf of, persons or corporations situated within the State.

Article 457 : *Apportionment of Business Income from Business carried on both within and without the State.* — If a non-resident, or a partnership with a non-resident member, carries on business (as " business carried on " is defined in Article 415) both within and without the State, the net business income therefrom must be apportioned so as to allocate to the State of New York a proportion of such income on a fair and equitable basis, in accordance with approved methods of accounting.

If the books of the taxpayer are so kept as regularly to disclose the proportion of his business income which is earned from sources within the State, the return of the taxpayer shall disclose the total income and the part apportioned to the State of New York and the basis upon which such apportionment is made. If such basis is approved by the Tax Commission, the return will be accepted.

If the books of the taxpayer do not disclose the proportion of his net income from sources within the State of New York, his return or, if the basis of apportionment used by him shall not be approved by the Tax Commission, his amended return, shall disclose his net income from business both within and without the State, and the tax will be calculated and collected upon the proportion of his total net income from business which the aggregate of the New York State factors bears to the aggregate of the total factors as herein defined.

The " New York State factors " include the following :

(1) The average of the value of his real property and tangible personal property within the State, *(a)* at the beginning of the tax year and *(b)* at the end of the tax year, but only of property connected with the business.

(2) The total wages, salaries and other personal service remuneration paid during the tax year to employees in connection with the business carried on (as defined in Article 415) within the State.

(3) The gross sales or charges for services performed, by or through an agency (of the kind enumerated in Article 415) situated within the State. The sales or charges to be allocated to New York shall include all sales negotiated or consummated by salesmen, or services performed by other representatives, attached to or sent from offices, or other agencies, situated within the State of New York.

The " total factors " include the following :

(1) The average of the value of all his real property and tangible personal property, *(a)* at the beginning of the tax year and *(b)* at the end of the tax year, both within and without the State, but only of property connected with the business.

(2) The total wages, salaries and other personal service remuneration paid by him during the tax year to employees connected with business, whether within or without the State.

(3) The gross sales, or charges for services performed, whether within or without the State.

" Business income ", as used in this article, excludes profits (or losses) from the sale, exchange or other disposition of real property, and income from rents and royalties, income from these sources being taxable only if the property from which the income was derived was situated within the State of New York, and in such case the entire net income from these sources is taxable.

Article 470 : *Alternative Basis of Apportionment.* — The provisions of Articles 451 to 470 dealing with the apportionment of income of non-residents earned from sources both within

and without the State of New York are designed to allocate to the State of New York, on a fair and equitable basis, a proportion of such income earned from sources both within and without the State. Any non-resident may submit an alternative basis of apportionment with respect to his own income and explain that basis in full in his return. If approved by the Tax Commission, that method will be accepted instead and in place of the one herein prescribed.

Under the above-quoted regulations, the Commission is at liberty to use whichever of the three recognised methods of determining income earned within the State will establish the most fair and equitable basis.

1. *Method of Separate Accounting.* - If the income of the branch office maintained in the State of New York by a non-resident is definitely recorded in separate books of account, so that the operations of such branch office can be clearly indicated, such method will be accepted by the Department. The only method of checking the separate books is by local examination thereof, to see if all items of income attributable to such office are fairly included and if the charges made against such income are reasonable and properly imputed to the branch.

2. *Empirical Methods.* — An empirical method of determining income is only adopted where no other method of arriving at the income of the branch is possible. This would ordinarily be only in cases where the books of the home office were not available and the books of the branch were kept improperly and in such a way that income within the State could not be reflected either on the basis of separate and complete accounts or on the basis of an allocation fraction.

3. *Method of Fractional Apportionment.* — As separate sets of books clearly reflecting income of a branch office within the State are seldom kept under the New York Statute, the income of a non-resident maintaining an office or place of business within the State of New York is ordinarily determined as a fraction of the entire income of the non-resident from such business. In establishing such fraction, the Commission requires that the taxpayer disclose his net income from business within and without the State, and the tax is calculated and collected upon the proportion of his total net income from business which the aggregate of the New York State factors described above bears to the aggregate of the total factors. Any non-resident who feels that this method of apportionment is inequitable may propose an alternative basis of apportionment, which will be applied if accepted by the Commission.

4. *Requirements for Selection of Methods and Relative Value of the Various Methods.* — The Administration can employ whichever method it deems appropriate. The first method, that of complete and separate sets of accounts for the branch and main offices, with proper adjustments for inter-office transactions, is the most practical and most satisfactory from the standpoint of the State. Probably no method can reflect the income earned within the State so accurately. The empirical method is the least satisfactory, for the reason that, to arrive at a percentage to apply against sales or against bank deposits, etc., it is necessary to have more or less accurate comparisons of the business of several other individuals in the same kind of business and doing business under similar conditions. This is difficult, because the statistics on the returns of one year cannot ordinarily be established until the following year. Even then the taxpayer in question, through poor management or owing to peculiar conditions existing in his business, may have sustained losses where all the others with whom comparison is made have realised gains and profits. The fractional method, while practical and used in the majority of cases under the New York law, is faulty and can only be an approximation, which does not always do justice either to the taxpayer or to the State.

(c) *Apportionment between Branch and Parent Enterprise.*

Apportionment of Gross Profits of Branch to Real Centre of Management abroad. — In certain cases where it appears that the State of New York is being attributed more than its fair proportion of the income of the non-resident, an attempt is made to ascribe a certain portion of the profits to the real centre of management in another State, provided it can be done equitably and with justice to the taxpayer and the State.

Apportionment of Expenses of Real Centre of Management to Branch. — When a non-resident carrying on business in his own State or country has a branch office within the State of New York and has incurred a general indebtedness in the operation of the business as a whole, the interest charge on this debt may be distributed between the home office and the branch office in New York. Such distribution is ordinarily made upon the percentage used and derived from the allocation factors described above.

General overhead expenses applicable to both the home office and the branch office are ordinarily entered in the books of the branch office (when separate books are kept) upon such basis as the taxpayer believes to be a fair apportionment. This method is acceptable to the Commission if it is satisfied that the percentage thereof is not excessive. Where the general overhead expenses are not entered in the books of the branch office in New York State, no allowance is made therefor.

Apportionment of Net Profits. — When a non-resident of the State operates a branch office or place of business within the State at a profit, whereas his entire business is operated at a loss, no cognisance is taken of the loss in determining the income of the branch within the State of New York taxable to the non-resident, provided separate books of account are maintained clearly reflecting profit within the State.

If the branch office or place of business operated by a non-resident in this State operates at a loss, whereas a non-resident realises a profit from the operation of his entire business, no portion of such profit would be taxed, provided separate books of account are maintained clearly reflecting the loss within the State.

II. *Application of the Methods of Allocation in Specific Cases.*

1. *Selling Establishments.* — There are no special statutory provisions prescribing allocation of income in the case of non-resident individuals engaged in manufacturing or buying in another country or State and selling through a permanent establishment in the State of New York. Under some decisions and prior rulings, it has been held that, in such case, the entire profit realised through sales in this State is taxable. However, where it is clear that thereby an injustice is done to the taxpayer, exceptions have been made by apportioning under some equitable rule such part of the profit as may properly be attributed to the manufacturing done in another State.

If a non-resident carrying on business in another State with its real centre of management in that State has an office or place of business in the State of New York which makes sales in a third State without having there a permanent place of business, the profits derived from the sales in the third State are ascribed to the New York office and any profit derived therefrom will be taxable in New York.

2 and 3. *Manufacturing and Processing Establishments.* — Upon the theory set forth in the preceding paragraph, a non-resident manufacturing or processing in the State of New York and selling his entire product outside the State would be taxable upon the manufacturing or processing profit, provided it was shown that such profit was clearly chargeable as business done within the State.

4. *Buying Establishments.* — A non-resident continuously buying in the State of New York through a permanent office or place of business, but selling in another State, and having no activity in this State other than buying, would not be taxable.

5. *Research or Statistical Establishments, Display Rooms.* — If a non-resident has an office or place of business in the State of New York which does not directly engage in any profit-making transactions, but through which services are rendered to the business of the non-resident in his home State which contribute indirectly to the realisation of profits *(e.g.,* a statistical bureau, a display room), profits might be ascribed to it depending entirely upon the services rendered. If the activity within the State were merely a room for the display of goods and merchandise, no sales being made within the State, no profits would be taxable under the State law. In the case, however, of a statistical bureau in which the entire business of a non-resident was of the nature of personal service, and personal services were actually rendered within the State of New York as part of the business carried on by the non-resident, tax might be due on a portion of the profits allocable to the State of New York.

B. National Enterprises.

Since under the Personal Income-Tax Law a resident of the State is taxable upon his entire net income from all sources, no allocation or apportionment of the profits made in other States or countries is necessary.

FRANCHISE TAX ON BUSINESS CORPORATIONS.[1]

PART I. — GENERAL DESCRIPTION.

The New York franchise-tax on general business corporations is imposed under Chapter 60, Article 9-A, of the Consolidated Laws of New York, called the "Tax Law", as amended to date.

TAXPAYERS.

In the case of a New York corporation, it is a tax for the privilege of exercising its franchise in New York in a corporate or organised capacity. In the case of a foreign corporation, whether organised in a foreign country or in a State of the United States other than New York, it is a tax for the privilege of doing business in New York. It is therefore not an income-tax in the proper sense of the term, although it may be based on income. Theoretically, this tax is supposed to reach only income attributable to assets within the State, but in fact there is no precise allocation of income to New York sources. The income taken as a basis for the tax is, in general, that part of the net income determined for purposes of United States federal income-tax, plus other items, which is allocated to New York through the employment of an allocation fraction.

The tax imposed on the basis of income is at the rate of 4½ per cent of the entire net income of the corporation, or the portion thereof taxable within the State; but, if the tax so imposed is less than a tax computed on one of the following bases, it is disregarded and the corporation must pay in accordance with the method indicated below which yields the highest tax :

(1) A flatrate of $25 ;

(2) One per thousand upon each dollar of its issued capital stock at its face value, or, if the corporation employs capital outside the State of New York, the tax is computed upon the proportion of its issued capital stock at its face value which its gross assets in New York bear to its gross assets wherever situated ;

(3) Four and a half per cent on a basis obtained as follows : entire net income plus remuneration paid to officers and/or holders of more than 5 per cent of the issued stock, minus $5,000, plus net loss for the reported year, minus 70 per cent of the remainder.

In practice, the Tax Department requires a *qualified* foreign corporation to pay at least the minimum $25 tax, whether or not business is actually transacted.

TAXABLE INCOME.

The tax is paid annually in advance for the year beginning November 1st following the first day of July (date of declaration) in each and every year and is computed by the Tax Commission

[1] By J. J. Merrill, Commissioner, Department of Taxation and Finance.

upon the basis of the corporation's entire net income for its fiscal year or the preceding calendar year. November 1st is the date which determines liability and, if a domestic corporation is in existence on that date, it is liable for the tax in full. Likewise, if the foreign corporation is doing business in New York on November 1st, it is liable for the tax in full and the tax cannot be paid on a pro-rata basis, even though the corporation is dissolved on the following day.

The tax is upon the entire net income, which is presumably the same as the entire net income which such a corporation is required to declare to the United States Treasury, without deduction of:

(1) Items or sums excluded from the definition of gross income in use by any other taxing authority;

(2) Dividends received on stocks;

(3) Taxes paid to the Government of the United States on either profits or net income;

(4) Any specific amount allowed by any other taxing authority;

(5) Losses sustained by the corporation in other fiscal or calendar years, whether deducted by the Government of the United States or not.

Bona-fide gifts to a corporation, other than unpaid salaries or remuneration due to officials, for which no consideration has been given or made by the corporation itself, do not constitute income.

In the case of a corporation organised in a country other than the United States, the entire net income is the entire net income in fact rather than the amount earned in the United States or the amount returned to the United States Treasury Department.

The basis for the tax is determined, as in the case of corporations organised in New York or another American State, by the application of the allocation formula as described below under the heading "Methods of allocating Taxable Income".

For purposes of equitable taxation, the Tax Commission may include or exclude income from any source, provided only that the assets from which the income arises shall be included or excluded, as the case may require, in any segregation of assets for the purpose of computing the tax.

Assessment of Tax.

Every corporation subject to the franchise-tax, including foreign corporations having offices, agents or representatives within New York, shall, annually on or before July 1st, or within thirty days after making its report of its entire net income to the United States Treasury Department for any fiscal or calendar year preceding such first day of July, transmit to the Tax Commission a report on a prescribed form, giving the information concerning the aggregate of assets in New York State and the aggregate of such assets everywhere which is required for the application of the allocation formula described in Part III.

If the corporation has no real or tangible personal property within the State, it must declare the place in which is situated the office where its principal financial concerns within the State are transacted. In any event, the corporation must declare such other facts as the Tax Commission may require for the purpose of computing the tax, or for the purpose of making a comparison with former reports to determine whether or not such reports were erroneous or fraudulent.

Where a corporation carries on its operations exclusively within the State, there is no occasion to segregate assets, and consequently the corporation may waive its rights and shall state only the facts pertaining to its New York activities.

If a taxable corporation owns or controls, either directly or indirectly, substantially all the capital stock of another corporation, or of other corporations, or if a taxable corporation is owned or controlled, either directly or indirectly, by another corporation, it may be required to make a consolidated report showing the combined net income, such assets as are required for computation

of the tax and such other information as the Tax Commission may require, but excluding inter-corporate stock holdings and inter-corporate accounts.

If the Tax Commission suspects that an arrangement has been made to reflect improperly the business done, the segregable assets or the entire net income earned from the business done in New York State, the Tax Commission is authorised and empowered, in such manner as it may determine, to adjust the tax equitably and to eliminate assets, provided only that any income directly traceable thereto be also excluded from the entire net income.

Furthermore, the Tax Commission may permit or require the filing of a combined report where substantially all the capital stock of two or more corporations is owned or controlled by the same interests. The Tax Commission may impose the tax as though the combined net income and segregated assets were those of one corporation, but, in the computation, dividends received from any corporation whose assets, as distinguished from shares of stock, are included in the segregations shall not be included in the net income ; or the Commission may equitably adjust the tax in some other manner.

The computation of the tax is made by the Tax Commission after audit of the return of the corporation. It then serves a notice of assessment.

Collection of Tax.

With the notice of assessment is also served a demand for payment, which is due on or before the January 1st following, or within thirty days of receipt of the notice.

If no return is made by the corporation, the Tax Commission is authorised to establish from any information in its possession an estimate of the net income and of the amount of tax due and to draw up, according to such estimate, an account of the taxes, penalties and interest due to the State from the delinquent corporation. Application for revision may be filed within one year from the date of audit, and the Tax Commission may adjust the tax according to the law and the facts. If it appears that excess of tax has been paid, the corporation will be credited with such amount. The decision of the Tax Commission on such an application for revision may be reviewed upon the law and the facts on appeal to the Supreme Court of New York State. A foreign corporation may, before payment, bring an equity action against the Commission's decision by seeking an injunction from the Federal district court.

PART II — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. Foreign Enterprises.

As has already been indicated, an enterprise belonging to a corporation organised under the laws of a country or State other than New York is liable to the franchise-tax only if it is doing business or is qualified to do business [1] in New York, and then only on the basis of that part of its total net income which is allocated to New York, or on one of the bases for a minimum tax. The net income is " presumably the same " as that upon which the corporation is required to pay tax to the United States ; but the amount thereof as returned to the United States is subject to correction in the event of any fraud, evasion or errors being ascertained by the Commission. If the entire business of the corporation is not transacted within the State, the tax is to be based upon the fraction of such ascertained net income corresponding to the proportion which the aggregate value of specified classes of the assets of the corporation within the State bears to the aggregate value of all classes of assets wherever situated. The classes of assets which enter into the ratio — called the segregated

[1] A corporation is qualified to do business in New York if it files with the Secretary of State a statement and designation of a person on whom process may be served, and it thereupon receives a certificate of authority to do business. It must also pay a fee of $100.

assets — are : real property and tangible personal property ; bills and accounts receivable resulting from the manufacture and sale of merchandise and from services performed ; and shares of stock owned in other corporations, apportionable according to the situation of the physical property represented by such stock.

Even if a foreign corporation has in a given year no net income subject to federal income-tax, it may be liable to the franchise-tax on the part of its total income apportioned to New York through application of the formula. The reason of this is that the levy is not a direct tax upon the allocated income of the corporation in a given year, but a tax levied for the privilege of doing business in one year, and is measured by the allocated income accruing from business done in the preceding year (see New York *v.* Jersawit, 263 U.S., 493, 496).

Consequently, where a foreign company carried on a unitary business of manufacturing and selling goods, in which its profits were earned by a series of transactions beginning with manufacture in a foreign country and ending with sales in New York and other places — the process of manufacturing resulting in no profit until it ended in sales — the State was justified in attributing to New York a fair proportion of the profits earned by the company from such unitary business (Bass, Ratcliff & Gretton, Limited, *v.* State Tax Commission (1924), 266 U.S., 271, 45 Sup. Ct. 82). The Supreme Court, in the decision just cited, states that, the statutory method of apportionment not being shown to be arbitrary or unreasonable, it was right to hold " that the tax imposed for the carrying-on of business in New York is not invalid merely because in the preceding year the business conducted in New York may have yielded no net income. There is no reason why a foreign corporation desiring to continue the carrying-on of business in the State for another year — from which it expects to derive a benefit — should be relieved of a privilege tax because it did not happen to have any profit during the preceding year ".

By reason of the nature of the tax, dividends or interest from New York corporations, rent from real estate in New York or income from any other source in New York are not taxed as such, but only to the extent to which they are included in the part of the entire net income which may be allocated to New York under the allocation fractions.

Although royalties on patents or copyrights issued by the Federal Government may not be subjected to State income-taxes, such income may be included in the income used to measure a franchise-tax such as that of New York (Educational Films Corporation of America *v.* Ward and Others, 1930, 282 U.S., 379, 51 Sup. Ct. 170).

While a State cannot tax directly income from copyrights, these being federal concessions, it may require the income from such copyrights to be included in gross income for determination of the entire net income used as a measure for computing the franchise-tax, which is held to be not directly on income but purely an excise.

Inasmuch as the tax is for the privilege granted rather than for the exercise of the privilege, every domestic corporation in being and every foreign corporation which remains in the State on November 1st is subject to the tax for the full tax year then beginning. Nevertheless, whether or not a corporation is doing business in New York is an important factor and is a question of fact to be determined in accordance with the circumstances of the particular case ; but certain tests are, in practice, employed to determine its status. The principal test is whether the foreign corporation ships into the State goods which come to rest in a warehouse or store before being sold to customers within the State.

The distinction between carrying on business in New York by a foreign corporation and carrying on interstate commerce with New York is not primarily a tax question. [1] Whereas any foreign corporation may carry on interstate business with New York free from tax, it may not, regardless of tax liability, do business in New York without first obtaining from the Secretary of State a certificate of authority.

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[1] If a foreign corporation does business in New York without having obtained a certificate of authority, it cannot enforce its contracts.

In order to carry on intrastate business, the foreign corporation must do more than make a single corporate engagement in an isolated piece of business or an occasional undertaking; it must maintain and carry on business with some continuity of act and purpose, such as might be evidenced by the investment of capital in the State, with the maintenance of an office for the transaction of its business and those incidental circumstances which attest the corporate intent to avail itself of the privilege of carrying on a business. In short, it should appear that it intended to establish a continuous business in the State, and not one of a temporary character (Allison Hill Trust Co. *v.* Sarandrea (1929), 134 Misc. 566, 236 N.Y. Sup. 265).

Even though the foreign corporation may not have qualified to do business, if it does business in New York, it is held subject to the licence- and franchise-taxes, and the assessment of the tax amounts to an assumption by the Tax Commission that the corporation is doing business in New York. It is for the corporation to show proof to the contrary.

In accordance with the above principles, a foreign corporation which secures orders through a broker in New York and accepts them and ships the goods direct to the customer would not be regarded as doing business (Southern Cotton Oil Co. *v.* Roberts (1898), 25 App. Div. 13, 38 N.Y. Sup. 1028).

Further, if a foreign corporation consigns goods to a factor or commission agent in New York, who sells the goods in his own name and collects and accounts for the proceeds, the corporation is not regarded as doing business in New York (Bertha Zinc and Mineral Co. *v.* Clute (1894), 7 Misc. 123, 27 N.Y. Sup. 342).

A foreign corporation is not doing business in New York when it has no place of business, no office and no stock of goods in the State, but merely consigns the goods to merchants for sale, subject to having the contract approved by the corporation in another State. The fact that local dealers sell the goods in their own names under conditional sale agreements and then assign such contracts to the corporation, which retains title until the entire purchase price is paid and collects the instalments through its agents in New York, is a mere incident of interstate commerce (Chase-Hackely Piano Co. *v.* Griffen, 149 N.Y. Sup. 998).

Similarly, the securing of orders through a travelling salesman constitutes interstate commerce.

On the other hand, the carrying-on of business through an agent with a power of attorney, or one who sells out of a stock, or the maintenance of a business establishment for purchasing, manufacturing or selling, constitutes doing business which is taxable.

B. National Enterprises.

A corporation organised in New York is liable to tax for the privilege of exercising its franchise in New York and, when this tax is measured by income, it is imposed only on that part of the total net income allocated to New York, without reference to any particular foreign source of income.

PART III — METHODS OF ALLOCATING TAXABLE INCOME.

A. Foreign Enterprises with Local Branches or Subsidiaries.

I. *General Questions and Methods of Apportionment.*

(a) *Book-keeping and Accounting Requirements*

The law does not prescribe any particular methods of book-keeping, but authorises the Commission to require the taxpayer to disclose such facts as it deems necessary for the proper computation of the tax. This, of course, entails the maintenance of complete accounts evidencing the results of business carried on in New York.

b) *Methods of Allocation.*

The fundamental method of allocation prescribed by the tax law is that of fractional apportionment. This is found in paragraph 214 of Article 9-A, which applies both to foreign and New York corporations transacting business within and without the State. The tax is based upon a proportion of the entire net income, to be determined in accordance with the following rules: the proportion of the entire net income of the corporation upon which the tax shall be based shall be such proportion of the entire net income as the aggregate of certain assets within the State bears to the aggregate of such assets wherever situated.

The aggregate of the New York assets includes :

(1) The average monthly value of real property and tangible personal property within the State.

(2) The average monthly value of bills and accounts receivable arising from *(a)* personal property sold by the corporation from merchandise manufactured by it within the State ; *(b)* personal property owned by the corporation and not manufactured by it within the State, but sold by it or its agents and situated within the State at the time of the receipt of the order ; *(c)* the purchase or sale of, or trading in, goods, wares or merchandise not situated in any place at which the corporation conducted a permanent or continuous business without the State, and where the bills and accounts receivable arose from orders received or accepted by any officer or agent, or at any place of business in the State ; and *(d)* services performed by any officer, agent or representative of the corporation connected with, sent from, or reporting, either directly or indirectly, to any officer located in the State or at any office situated, owned, rented or occupied in the State.

(3) The proportion of the average value of the stocks of other corporations owned by the corporation allocated to the State by the law.

The aggregate of the assets, wherever situated, includes :

(1) The average monthly value of all real property and tangible personal property of the corporation, wherever situated.

(2) The average total monthly value for the fiscal or calendar year of bills and accounts receivable arising from *(a)* personal property sold by the corporation from merchandise manufactured by it within and without the State ; *(b)* the purchase or sale of, or trading in, personal property ; and *(c)* services performed by the corporation, its officers or agents, excluding those bills and accounts receivable which arise in any way from advances or loans.

(3) The average total value of stocks of other corporations owned by the corporation.

The words " tangible personal property ", as used above, mean corporeal personal property, such as machinery, tools, implements, goods, wares and merchandise, but not money, bank deposits, shares of stock, bonds, notes, credits or evidences of an interest in property or evidences of debt.

For purposes of the apportionment formula, real property and tangible personal property are taken at the actual value where situated. The value of share stock of another corporation owned by a taxable corporation is, for purposes of allocation of assets, apportioned in and out of the State in accordance with the value of the physical property in and out of the State represented by such share stock.

If the application of the apportionment formula results in an inequitable assessment, the Tax Commission may include or exclude income from any source, provided that the assets from which the income arises shall be included or excluded, as the case may require, in any segregation of assets

for the purposes of computing the tax. For example, dividends from stock in other corporations, as well as the total value of such stocks, will be excluded, if such other corporations have no physical property in New York State. Recourse to any kind of a method which will assist in computing the tax is authorised by paragraph 11 of Article 9-A. If, in view of the corporation's business and the character and location of its assets, the Tax Commission is of the opinion that the segregation of assets shown by any return does not properly reflect the corporate activity or business done, or the income earned from corporate activity or from business done in New York State, it is authorised and empowered equitably to adjust the tax upon the basis of the corporate activity or the business done within and without the State, rather than upon capital or assets only.

Consequently, the Commissioner in charge of the corporate franchise-tax exercises wide discretionary powers to adjust the tax as he considers most appropriate to the circumstances of the case. He may assess tax on the basis of the separate accounts of the New York establishment, provided he is convinced that they reflect true profits.

(c) *Apportionment between Branch and Parent Enterprise.*

Owing to the essential nature of the apportionment fraction, it is unnecessary to consider such detailed questions as the apportionment of a part of the gross profit of the branch in New York to the real centre of management abroad, or the apportionment of the interest or overhead of the real centre of management abroad to the local branch. Moreover, the formula is never used separately to determine the net profit or loss of the branch or the parent. In any event, if the enterprise as a whole realised a loss, or even if the separate accounts of the branch were taken as the basis of assessment and showed a loss, the minimum tax would be payable.

(d) *Apportionment between Parent Enterprise and Subsidiaries.*

Where substantially all the capital stock of two or more corporations liable to report is owned or controlled by the same interests, the Tax Commission may permit or require the filing of a combined return, and impose the tax as though the combined net income and segregated assets were those of one corporation, as has been previously indicated in Part I under the heading " Assessment of Tax " (Article 9-A, paragraph 9).

Further, where a taxable corporation a substantial portion of whose capital stock is owned, either directly or indirectly, by another corporation acquires and disposes of the products of the latter corporation in such a manner as to create a loss or improper net income, the Tax Commission may require such facts as it deems necessary for the proper computation of the tax, and may, for that purpose, determine the amount which shall be deemed to be the entire net income of the business of such corporation for the calendar or fiscal year. In determining such entire net income, the Tax Commission has regard to the fair profits which, but for any agreement, arrangement or understanding, might be or could have been obtained from dealing in such products, goods or commodities (Article 9-A, paragraph 10).

The same discretionary powers may be invoked by the Commission when the taxable corporation conducts the business, whether under agreement or otherwise, in such a manner as either directly or indirectly to benefit the members or stockholders of the corporation, or any one of them, or any person or persons directly or indirectly interested in such business, by selling its products, or the goods or commodities in which it deals, at less than the fair price which might be obtained therefor.

II. *Application of the Methods of Allocation in Specific Cases.*

Inasmuch as a foreign corporation qualified to do business in New York must pay the corporate franchise-tax, and inasmuch as qualification to do business is, in practice, necessary in every case

where an establishment is maintained in New York, the nature of the establishment is not of primary importance from the point of view of liability. If the foreign corporation in New York State has an establishment at which it sells, manufactures, processes or buys, income will be apportioned to the State in accordance with the working of the formula, and not necessarily with regard to the extent to which the establishment actually contributed to the production of profit. Similarly, the corporation will be taxable even if it maintains a research, statistical or other service establishment which would not itself directly contribute to the realisation of profit. Income might be ascribed to it by the formula, but, if such amount were smaller than the minimum prescribed, the latter would be payable.

B. National Enterprises.

A corporation organised under the laws of New York which has business establishments outside New York in subject to the franchise-tax by application of the allocation formula as described above. If its entire business is transacted within the State, but it derives items of income from abroad, it is taxable on its entire net income as described in Part I.

STATE TAX ON BANKS, TRUST COMPANIES AND DOMESTIC AND FOREIGN FINANCIAL CORPORATIONS.

The present tax on banks, trust companies and domestic and foreign financial corporations was introduced by the Legislature in 1926, the Law becoming Chapter 285 of the Laws of 1926 and taking effect as from March 31st, 1927. The tax on State banks, trust companies and financial corporations is a franchise-tax and is known as Article 9-B of the tax law. The tax on national banks is simply a tax measured by net income and is known as Article 9-C of the tax law. The tax in each case is at the rate of 4½ per cent of entire net income derived from business carried on within New York State.

Returns are required to be filed on or before September 1st of each calendar year, but the tax in each case is measured by the net income of the preceding calendar year. Since, under the banking law, a bank may not maintain branches in the United States, except in the city where its head office is situated, questions of allocation cannot arise in the case of purely banking enterprises.

A foreign financial corporation doing business within New York State has to file an annual return reflecting the entire gross and net income derived by it from business carried on through a permanent establishment or from assets situated in New York State.

If the gross income is derived from business carried on within and without the State, "gross income" means that proportion of income which is derived from business carried on within the State, and the deductions allowed shall be only in the proportion that the gross income derived from business carried on within the State bears to the gross income derived from all sources both within and without the State. This means that the corporation shall report as net income from business carried on in New York State that proportion of its total net income from all sources which its gross income from business carried on in New York State bears to its total gross income from business carried on within and without the State. However, the Commission is given authority to make rules and regulations governing the proper apportionment and allocation of both gross income and deductions, where the business is carried on within and without the State.

Where, in the opinion of the Commission, the branch, agency or subsidiary corporation keeps an independent set of records accurately reflecting its gross and net income from business carried on in New York State, such records will be accepted for the purpose of computing net income.

Where the books of the New York branch or agency are accepted as the basis for determining net income, the interest charge on a debt of the head office is sometimes taken into consideration by apportioning to the New York office or agency part of the interest paid by the head office. This apportionment is usually based on the ratio between the average assets employed within the State and the average of those employed outside.

That part of general overhead which can be shown to have a connection with income from business carried on both within and without the State is distributed according to the ratio between the gross income or gross assets employed or produced within the State and those employed or produced outside.

Insurance Corporations. — Insurance corporations are subject to an annual franchise-tax (1 per cent) on gross premiums (less certain specified deductions) paid during the preceding calendar year for business done at any time in New York (Article 9, section 187).

Transport Corporations. — Corporations engaged in railway, steamship and certain other forms of transport are subject to annual franchise-taxes based upon capital stock within the State and an additional franchise-tax based upon gross earnings within the State (Article 9, section 184).

Power, Light and Gas Corporations. — Such corporations pay an annual franchise-tax on gross earnings within the State and upon a certain proportion of dividends declared or paid in excess of 4 per cent upon the actual amount of paid-up capital employed in the State (Article 9, section 186).

Telephone and Telegraph Corporations. — Such corporations pay the same franchise-taxes as transport corporations.

Holding Corporations. — Corporations whose sole business consists of holding stocks of other corporations for the purpose of controlling the management and affairs of such other corporations pay an annual franchise-tax based on the amount of their capital stock within New York (Article 9, section 188).

STATE OF WISCONSIN
(United States of America)

BY

H. B. REYER, B.A., C.P.A.,

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AND

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PART I. — GENERAL DESCRIPTION OF INCOME-TAX SYSTEM.[1]

The income-tax of Wisconsin is a direct tax at progressive rates, assessed on the taxpayer, and in no instance collected by withholding at the source. It was introduced in 1911 and is now found in the Wisconsin Statutes 1927, Chapter 71, as amended.[2]

1. TAXPAYERS.

(a) INDIVIDUALS.

Liability to assessment depends both on whether the taxpayer is resident within or without the State and upon the source of the income. Every person residing within the State (or his personal representative in case of death) pays tax upon all income from sources within the State and upon such income from sources without as is allocated for tax purposes to residence. Non-residents are liable to tax upon such income from property located or business transacted within the State as is not exempted.

The provision allocating certain items of income for taxation exclusively at source and others exclusively at residence is as follows :

> " Income derived from rentals and royalties from real estate or tangible personal property, or from the operation of any farm, mine or quarry, or from the sale of real property or tangible personal property shall follow the situs of the property from which derived. All other income, including royalties from patents, income derived from personal services, professions and vocations and from land contracts, mortgages, stocks, bonds and securities or from the sale of similar intangible personal property, shall follow the residence of the recipient, except as provided in section 71 095 " (regarding fiduciaries) (Statute 71.02 *(c)*).

(b) PARTNERSHIPS.

In regard to partnerships each individual partner is responsible for the tax on his distributive share of partnership income, whether distributed or not, and the partnership is not taxed as such. Income allocable to residence follows the residence of the individual partners. Income from business or tangible property is taxable if the situs is in Wisconsin, irrespective of where the partners are resident.

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[1] Legislation in force on December 31st, 1932.

[2] The following figures will illustrate the relative importance of income-tax in entire fiscal system and comparative yield : The income-tax of Wisconsin produced in the year ending June 30th, 1931, 11.33 per cent of the total State and local tax revenue — *i.e.*, approximately $20,812,439 out of a total revenue of approximately $183,683,744. The principal levy is the general property-tax yielding $120,855,119. Other levies include various special property and other special taxes ($17,787,691), inheritance taxes ($2,810,216) and motor-vehicle taxes ($21,418,269).

(c) COMPANIES.

The liability of companies depends upon their place of residence and on the source of the income. A corporation is regarded as being resident in the State of Wisconsin if it was incorporated there, or if, though incorporated abroad, it carries on or transacts its principal business there (Wisconsin Statute 71.03 *(e)*). By " principal business " is meant the place where a preponderance of the income is produced and not necessarily the place where the directors meet or the general office is situated. In practice, it has been found that the head office, or real administrative centre, usually coincides with the place where the principal business is located.

2. TAXABLE INCOME.

Under the Wisconsin Income-Tax Act, the term " income" is not restrictive, but includes all gains, profits or income of any kind derived from any source whatever, except certain specified exempted items. The exempted items include, *inter alia*, inheritances and gifts, insurance, except that paid to a partnership or corporation upon the policies on the lives of its officers, partners or employees, and income of insurance companies and steam railroad corporations.

NATIONAL AND FOREIGN INCOME.

In general, if the situs of the source of income is in Wisconsin, it is Wisconsin income ; if the situs is outside, it is foreign income. As has been indicated above, certain classes of income have been allocated to source for taxation purpose, whereas certain others are allocated to the State of residence of the taxpayer. Consequently, if real estate, tangible personal property, a farm, mine or quarry is situated in Wisconsin, the income therefrom is regarded as Wisconsin income. It is important to note that any tangible personal property must have obtained in Wisconsin a definite situs before its sale can constitute a sale within Wisconsin for purposes of income-tax. Otherwise the sale within the State of an article of tangible personal property which has just entered the State or is passing through the State, or has not yet acquired a definite situs therein, is regarded as coming under the category of property in interstate commerce, which is not subject to tax in Wisconsin.

3. ASSESSMENT OF TAX.

With regard to the assessment of the tax, the tax is upon " net income ", meaning " gross income less allowable deductions ". Gross income includes the gross amount of any kind of income from any source whatever. Allowable deductions include dividends from corporations, which are deductible by the stockholder on his personal return, provided that the corporation has paid a tax on 50 per cent or more of its income to Wisconsin.

In the case of business enterprises, assessment is based upon the amount of income less expenses incurred in the production of that income. At present, the tax is computed on the average net income of the three years preceding that in which the tax is assessed. Beginning in 1933, the tax is to be levied on the income of the preceding year. The 1933 tax may be levied on the untaxed income of 1930 and 1931 if that amount is greater than the income of 1932. Starting with the income year 1933, a business loss may be carried forward to the next year, and, if not completely offset, the balance may be carried forward to the year following.

Individuals are allowed credits against the tax in respect of their personal exemptions. The amounts are $8 for a single individual, $17.50 in the case of a married person or head of a family and $4 for each child or dependent.

The rates are progressive and range, for individuals, from 1 per cent on the first $1,000 to 7 per cent in the case of incomes in excess of $12,000 ; and for corporations, from 2 per cent on the first $1,000 to 6 per cent on amounts in excess of $6,000.

4. COLLECTION OF TAX.

The tax is imposed directly on the taxpayer, who is required to submit an annual return on or before March 15th, if income is computed on the calendar year basis and, if computed on the fiscal year basis, the return must be submitted seventy-five days after the close of the fiscal year.

The individual taxpayer merely indicates on his return his items of taxable income and deductions, and the computation of his liability is made by the local tax assessor, who lists the assessment on a roll and delivers the roll and a bill to the collector (county treasurer), the latter forwarding the bill to the taxpayer. Notice of assessment must be served on the taxpayer on the first day of the sixth month following the close of his fiscal or the calendar year and tax is payable in full within thirty days thereafter.

In the case of corporations, the declaration of income is made by the corporation ; the Tax Commission computes the tax, enters the computation on a roll and sends the roll, together with a bill, to the collector (county treasurer), who in turn forwards the bill to the taxpayer. The latter pays the tax within thirty days to the collector.

The initial assessment is made on the basis of the figures submitted by the taxpayer (individual or corporation), but if it is subsequently discovered that the taxpayer has failed to declare the whole income, additional assessments may be made up to a period within seven years after the close of the income-tax year for which the return is made.

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

As has been previously indicated, a foreign enterprise is an enterprise conducted either by individuals residing outside Wisconsin or a corporation organised outside and having its principal business outside Wisconsin, or a corporation organised in Wisconsin but having its principal business outside. A foreign corporation is treated on a plane of equality with a Wisconsin corporation.

A foreign enterprise is taxable only on items of income which are subject to Wisconsin tax because they have their source within the State — namely, rents from real estate and royalties paid in respect of mines situated in Wisconsin, and profits from the sale of real or tangible personalty or from carrying on a business situated in Wisconsin. The foreign enterprise is not taxable on *(a)* dividends, *(b)* interest, *(c)* royalties for use of patents, copyrights, trade marks, secret processes, formulæ and all other income. The sale of stocks or bonds within Wisconsin by a non-resident would be exempt from tax. The method of determining the taxable income from the sale of tangible personal property within the State by foreign enterprises will be treated in detail under Part III in connection with the methods of allocating taxable income.

Salaries, wages, commissions, and other remuneration for services are taxable in Wisconsin, provided the taxpayer resides there.

In the case of income from a trust, the trustee makes the return of all the income of the corpus, but the tax is payable by the beneficiary. The extent to which the beneficiary is taxable depends, as indicated above, on whether or not he is resident in the State.

Income from carrying on a Business or Industry.

The taxation of income from the carrying on of a business or industry depends upon whether the foreign enterprise is carrying on interstate business, which is regulated and taxed only by the Federal Government, or is transacting business within Wisconsin and is therefore subject to the State levy. Enterprises carrying on business within and without Wisconsin are taxable only on such income as is derived from business transacted and property situated within the State (Income-Tax Act 71.02 (3) *(d)*). The test of liability is whether business is transacted within the State rather than whether a certain medium is employed. This is a question of fact within the final determination of the courts. Nevertheless, the following decisions indicate fairly clearly the line of demarcation between interstate and intrastate business :

A reasonable interpretation of a State statute relating to foreign corporations "doing business" within the State does not include the doing of a single act or the making of a single contract, but does include a continuous series of acts by an agent continuously within the State. (International Textbook Company *v.* Pigg (1910), 217 U.S. 91, 30 Sup. Ct. 481, 54 Law Ed. 678, 3 *Am. Fed. Tax Rep.* 2817 ; Loomis *v.* People's Construction Company (1914), C.C.A. 211, Fed. 455.)

Without procuring a licence to transact within the State, any foreign corporation may advance and loan money therein and take, acquire, hold and enforce notes, bonds, mortgages and trust deeds given to represent or secure money so loaned (W.S., section 226.02 (2), paragraph 659).

Foreign corporations placing orders for goods with Wisconsin concerns are not doing business within the State (Southern Flour and Grain Company *v.* McGeehan *et al.* (1911), 144 Wis. 130, 128 N.W. 879 ; Jerome P. Parker Harris Company *v.* Kissel Motor-Car Company (1917), 165 Wis. 518, 163 N.W. 141).

Interstate commerce was being carried on where contracts were made by foreign corporations for the sale of machinery and installation of the same, and when contracts were made for the sale of merchandise, with provision providing for demonstration and inspection (American Slicing Machine Company *v.* Jaworski (1923), 179 Wis. 634,192 N.W. 50 ; Regina Company *v.* Toynbee (1916), 163 Wis. 551,158 N.W. 313 ; Unitype *v.* Schwittay (1919), 168 Wis. 489,170 N.W. 451 ; Greek-American Sponge Company *v.* Richardson Drug Company (1905), 124 Wis. 469,102 N.W. 888).

Similarly, business was not done in Wisconsin when a foreign corporation took security for payment of sales made to Wisconsin residents under a conditional contract, retaining title in the seller until payment (Regina Company *v.* Toynbee (1916), 163 Wis. 551,158 N.W. 313).

Commission Agent or Broker.

In general, interstate commerce is carried on when a foreign corporation sells goods on orders obtained through a broker in Wisconsin, or consigns goods to a factor in that State. A factor is one to whom goods are consigned by another party, called consignor, who retains ownership of the goods as long as they are in the factor's hand. The factor sells the goods to his customers in the State and pays the consignor an agreed price, retaining for himself the difference between that price and the price he is required by contract to pay the consignor. In effect, the factor purchases the goods and resells them to the customer. While the sale of the consignor is interstate business, that of the factor is intrastate business (Duluth Music Company *v.* Clancy (1909), 139 Wis. 189).

Sales to Local Dealer or Distributor.

Foreign corporations selling goods outright to agents within the State are not themselves doing business in Wisconsin (Sanitas Company *v.* Niezorawski (1909), 138 Wis. 377, 120 N.W. 292).

Similarly, a foreign corporation was held not to be doing business in the State when it made contracts for a correspondence course through agents in Wisconsin (International Textbook Company *v.* Pigg (1910), 217 U.S. 91, 30 Sup. Ct. 481, 54 Law Ed. 658, 3 *Am. Fed. Tax Rep.* 2817).

Travelling Salesman.

If a foreign corporation merely solicits business through a travelling salesman or by letter, it is not considered to be doing business, provided the orders are transmitted to the corporation at its domicile and the goods are shipped from there to Wisconsin.

The sale of goods in original packages by a travelling salesman for a foreign corporation is interstate commerce (Greek-American Sponge Company *v.* Richardson Drug Company (1905), 124 Wis. 469, 102 N.W. 888).

A foreign corporation was held to be engaged in interstate commerce when its travelling salesman sold in Wisconsin goods to be shipped to the Wisconsin purchasers from a point outside the State. (Loverin and Browne Company *v.* Travis (1908), 135 Wis. 322, 115 N.W. 829 ; St. Louis Clay Products Company *v.* Christopher (1913), 152 Wis. 603,140 N.W. 351).

Local Agent with a Power of Attorney or selling out of a Stock belonging to the Foreign Enterprise.

If the foreign enterprise gives a power of attorney to a local agent to carry on its business in

Wisconsin and the business is of such a nature as to produce taxable income (*e.g.*, selling goods or services), the enterprise will be liable.

A foreign corporation is doing business in Wisconsin if its local agent has charge of a stock of goods in the State, belonging to the foreign corporation, and delivers them to customers whom he solicits. (Ruling, 6-8-25, Prentice—Hall W.S.T.S. 1925-1926, paragraph 11,046.)

Permanent Establishments.

A foreign corporation having in Wisconsin its own sales office, warehouse, factory or other establishment productive of income is liable to taxation. Some border-line cases are given below :

A foreign corporation is not regarded as doing business within the State if it maintains there a show-room to display merchandise, provided no sales are made therein. No liability is incurred, furthermore, if it ships goods into the State subject to sale upon inspection at a show-room or other convenient place (Greek-American Sponge Company *v.* Richardson Drug Company (1905), 124 Wis. 469,102 N.W. 888).

The holding of meetings of stockholders of a foreign corporation in Wisconsin, even in an office maintained for that purpose, does not constitute doing business nor entail obtaining a license (O.A.G. 1908, page 244, Bradbury *v.* Waukegan and Washington Mining Company (1903), 113 111 App. 600 W.S., section 226.02 (10), paragraph 666).

A contract merely to manufacture outside the State and ship and deliver in Wisconsin, and even to instal in Wisconsin, constitutes interstate commerce, but if the contract provides for the manufacture in Wisconsin of goods stipulated in the contract under a superintendent supplied by the foreign corporation, the latter is transacting business within the State (Loomis *v.* People's Construction Company (1914), C.C.A. 211 Fed. 453).

Similarly, intrastate business is done when a foreign corporation, which sells and supervises the erection of coke-ovens, performs the necessary construction work and purchases supplies and materials therefor. The corporation was held taxable on account of : (1) certain rentals of a shed and typewriter ; (2) materials purchased and sold in Wisconsin : (3) brick stacks ; and (4) salary of engineer and expert brickman (Coppers Co. *v.* Milwaukee (1926), 211 N.W. 147).

B. NATIONAL ENTERPRISES.

For the purpose of this study, the term " national enterprise " is presumed to mean a Wisconsin enterprise — *i.e.*, an enterprise carried on by individuals resident in Wisconsin, singly or in partnership, or by a corporation organised in Wisconsin. It would also include a corporation organised in another State but having its principal business in Wisconsin. Such enterprises are taxable in respect of dividends, interest and other items taxable by reason of residence in Wisconsin, and also income from real estate, mining royalties and the sale of tangible personal property and real estate having their situs in Wisconsin and income from transacting business in Wisconsin.

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

I GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

(a) Book-keeping and Accounting Requirements.

The Tax Commission can require that records be kept, and failure to comply with such a demand is subject to a penalty. No specific method of book-keeping is prescribed. The accounts ordinarily submitted for tax purposes contain the same information as that required by the Federal Government. Supporting evidence is required on certain items such as depreciation, amortisation, bad debts, capital gains or losses, taxes, dividends received, repairs, interest paid, etc. Balance-sheets (based on the books of the enterprise), profit and loss statements, and proof of surplus are required, as well as a statement explaining the difference between the income shown by the books and the income declared on the tax returns. Where it is necessary, the foreign company has to submit to a field audit of the general books of account in order that its return may be verified.

(b) Methods of Allocation.

The provisions of the statute governing the methods of allocation for enterprises engaged in business within and without this State are as follows :

> " 71.02 (3) *(c)*. — For the purposes of taxation, income from mercantile or manufacturing business not requiring apportionment under paragraph 71.02 (3) *(d)* shall follow the situs of the business from which derived. Income derived from rentals and royalties from real estate or tangible personal property, or from the operation of any farm, mine or quarry, or from the sale of real property or tangible personal property shall follow the situs of the property from which derived. All other income, including royalties from patents, [1] income derived from personal services, professions and vocations and from land contracts, mortgages, stocks, bonds and securities or from the sale of similar intangible personal property, shall follow the residence of the recipient, except, as provided in section 71.095."

> " *(d)*.— Persons engaged in business within and without the State shall be taxed only on such income as is derived from business transacted and property located within the State. The amount of such income apportionable to Wisconsin may be determined by an allocation

[1] According to a recent decision of the Supreme Court of the United States, a State cannot tax as income royalties received for the use of patents issued by the United States, because such an imposition would amount to a tax upon the patent right itself and is prohibited by the Federal Constitution (Long *v.* Rockwood (1928), 277 U.S. 142, 48 Sup. Ct. 463). The rule in Long *v.* Rockwood was recently revised by the U.S. Supreme Court in Fox Film Corporation *v.* Doyal (1932).

and separate accounting thereof, when, in the judgment of the Tax Commission, that method will reasonably reflect the income properly assignable to this State, but otherwise in the following manner : There shall first be deducted from the total net income of the taxpayer such part thereof (less related expenses, if any) as follows the situs of the property or the residence of the recipient ; provided that, in the case of income which follows the residence of the recipient, the amount of interest and dividends deductible under this provision shall be limited to the total interest and dividends received in excess of the total interest (or related expenses, if any) paid and allowable as a deduction under section 71.03 during the income year. The remaining net income shall be apportioned to Wisconsin on the basis of the ratio obtained by taking the arithmetical average of the three following ratios :

" 1. The ratio of the tangible property, real, personal and mixed, owned and used by the taxpayer in Wisconsin in connection with his trade or business during the income year, to the total of such property of the taxpayer owned and used by him in connection with his trade or business everywhere. Cash on hand or in bank, shares of stock, notes, bonds, accounts receivable, or other evidence of indebtedness, special privileges, franchises, goodwill or property, the income of which is not taxable or is separately allocated, shall not be considered tangible property nor included in the apportionment.

" 2. In the case of persons engaged in manufacturing or in any form of collecting, assembling, or processing goods and materials within this State, the ratio of the total cost of manufacturing, collecting, assembling or processing within this State to the total cost of manufacturing, or assembling or processing everywhere. The term ' cost of manufacturing, collecting, assembling or processing within this State and everywhere,' as used herein, shall be interpreted in a manner to conform as nearly as may be to the best accounting practice in the trade or business. Unless, in the opinion of the Tax Commission, the peculiar circumstances in any case justify different treatment, this term shall be generally interpreted to include as elements of cost within this State the following :

" *(a)* The total cost of all goods, materials, and supplies used in manufacturing, assembling, or processing within this State, regardless of where purchased ;

" *(b)* The total wages and salaries paid or incurred during the income year in this State in such manufacturing, assembling, or processing activities ;

" *(c)* The total overhead or manufacturing burden properly assignable according to good accounting practice to such manufacturing, assembling, or processing activities within this State.

" 3. In the case of trading, mercantile, or manufacturing concerns, the ratio of the total sales made through or by offices, agencies, or branches located in Wisconsin during the income year to the total net sales made everywhere during said income year.

" Where, in the case of any person engaged in business within and without the State of Wisconsin and entitled to an apportionment of his income as herein provided, it shall be shown, to the satisfaction of the Tax Commission, that the use of any one of the three ratios above provided for gives an unreasonable or inequitable final average ratio, because such person does not employ, to any appreciable extent in his trade or business in producing the income taxed, the factors made use of in obtaining such ratio, this ratio may, with the approval of the Tax Commission, be omitted in obtaining the final average ratio to be applied to the remaining net income.

" As used in this section, the word 'sales' shall extend to and include exchange, and the word ' manufacturing ' shall extend to and include mining and all processes of fabricating or

of curing raw materials. If the income of any such person properly assignable to the State of Wisconsin cannot be ascertained with reasonable certainty by either of the foregoing methods, then the same shall be apportioned and allocated under such rules and regulations as the Tax Commission may prescribe."

Briefly, it is the practice of the Wisconsin Tax Commission first to ascertain whether or not the oreign corporation maintains adequate separate accounts for the activities carried on by ts establishment within Wisconsin. If not satisfied with this separate accounting, the Tax Commissioner applies a general apportionment fraction. When a foreign corporation does not naintain adequate separate accounts and refuses to submit the general accounts necessary for the ıpplication of the apportionment fraction, the authorities are entitled to make a "doomage" or 'stimated assessment based on the best information available This estimated assessment may ılso be made if the foreign corporation refuses to file a return in the formal manner prescribed by he Commission.

If not satisfied with the books of account of the local corporation, the Commission is empowered o ask for all the information it wants. In the case of a foreign corporation selling through a branch n Wisconsin and invoicing to this branch at a wholesale price, the Commission tries to make a comparison with the price at which a corporation would sell the same article to an independent listributor. In cases of doubt, resort is had to apportionment.

If the corporation has a monopoly of the product which it sells through its own branch, the Commission usually resorts to apportionment. Where there is no sound basis of comparison with ales to independent distributors, the tendency is more and more to apply the apportionment raction.

1. *Method of Separate Accounting.*

Persons who report on a separate accounting basis are required to fill in a separate schedule lesignated Form 4C. This is a summarised income statement consisting of three columns : the irst column designated as "Wisconsin business", the second column, "outside business", and the hird column, "total business". This schedule is used for the purpose of comparing different tems of income and expense in order to detect any large variations in the amounts or ratios thereof. Should any large variations occur, they may be due to diversions of income from Wisconsin, or unwarranted loading of expenses against this State, and will be made the subject of office correspondence or field audit, if necessary. The reverse side of Form 4C affords a reconciliation between the books and the tax returns, in the same columnar order, and total book-income is checked against the balance-sheet, which forms a part of the return. In some cases, the administration requires balance-sheets drawn up in the same columnar plan, but it has not as yet become a standard requirement.

2. *Empirical Methods.*

The income of a branch may be determined on the basis of the percentage of turnover, but it would only be used as a last resort due to lack of records. If a company doing business in Wisconsin refuses to file a tax return, the company is assessed on an estimated income, called a "doomage" assessment. The assessments are generally so high that little difficulty is experienced in subsequently getting returns.

3. *Method of Fractional Apportionment.*

By far the larger number of the important corporations which transact a portion of their business or own property in this State are required to file on the apportionment basis. That is to say, they

file a complete return showing the results of the operations of their business everywhere. They are also required to fill in Form 4B, " Apportionment Data ", which supplies the data used for the computation of an apportionment fraction.

The first section of Form 4B is designed to supply the information concerning the " non-apportionable income " — that is, those types of income with a *fixed situs;* such income is first excluded from the total income before applying the apportionment fraction.

The second section of this form provides space for information concerning the amounts of *Tangible Property, Cost of Manufacturing,* and *Sales* pertaining to Wisconsin, and pertaining to the total business everywhere. From the property element must be excluded, of course, property which produces non-apportionable income, such as is reported in the first section of Form 4B.

A separate ratio or percentage is computed for each of the three elements as they apply to Wisconsin, and the arithmetic average of these three ratios is then used as representing the percentage of the total apportionable income attributable to the business activities of the corporation in Wisconsin. To or from the amount of income so apportioned to Wisconsin is added or deducted, as the case may be, any non-apportionable income or loss having a definite situs in Wisconsin. This information is set forth in the upper section of Form 4B. The result thus obtained represents the total income taxable by Wisconsin.

In determining the property factor, property which produces non-apportionable income is eliminated before getting the average of property within and without the State. From the viewpoint of inventories, the tangible property in the apportionment fraction includes raw material, goods in process and finished goods on hand and in the total inventory at the end of the fiscal year. Cost of manufacturing would include such raw materials as went into manufacturing during the year. The schedule of tangible property separates finished goods, goods in process and raw materials merely for comparative purposes. The finished product, until sale, is included in tangible property because, being in the inventory, it is part of tangible property.

The element of cost of manufacturing is to be construed in the light of the best accounting procedure, and includes :

(1) Direct material used ;
(2) Direct labour ;
(3) Manufacturing overhead.

It has been the experience of Wisconsin that manufacturing activities are usually identified with specific units of property and that cost records for such units are usually maintained if separate financial records are not maintained for each unit.

No difficulties arise in computing the cost of manufacturing within and without the State, unless processing is begun in one State and completed in another. Where substantial processing is done in the State of Wisconsin, the Tax Commission has held that all raw material which goes into the processing done in this State is part of the cost of manufacturing in Wisconsin. It would seem, therefore, that any further processing outside the State would include only the direct labour, overhead and such additional material as is used in the further processing of the item. This would also seem to be the rule when the original processing was started outside the State. However, care must be taken not to give undue weight to the original processing outside the State when expensive raw material is used but little additional work is done, after which the item is brought into Wisconsin for the major processing.

The factor of sales includes such sales as would come under the common definition of the term. Ordinarily, it would seem that incidental disposals, such as sales of scrap and the like, would be a reduction of the cost of manufacturing rather than a sales element, for the reason that ordinarily the sales organisation does not come into play in disposing of such products. On the other hand, a sale of a by-product would constitute a sale under the classification, for the reason that it would no doubt be consummated by the selling organisation.

The Wisconsin Tax Commission has held that, wherever the sale is consummated through a regularly established office, that place is the situs of the sale. For example, a Wisconsin corporation which does all its manufacturing in Wisconsin has sales branches in several States of the union. If the managers at the sales branches are able and have the power to consummate a sale without having the approval of the central office, then the Tax Commission holds that the sale is outside the State. On the other hand, in a similar business, if travelling salesmen of the Wisconsin plant merely go out and solicit trade, this is considered a Wisconsin sale. In other words, whether a sale is considered within or without the State depends entirely on whether the Wisconsin company has a regular sales office outside the State and whether the sales office has the power and authority to consummate sales.

Border-line cases must always be determined in view of the circumstances and on the merits of each case ; no uniform rule can be adopted to fit all cases.

4. *Requirements for Selection of Methods and Relative Value of the Various Methods.*

It will be noted from Section 71.02(3)*(d)*, cited on pages 241 *et seq.*, that "the amount of such income apportionable to Wisconsin may be determined by an allocation and separate accounting thereof, when, in the judgment of the Tax Commission, that method will reasonably reflect the income properly assignable to this State, but otherwise in the following manner : . . . "

It appears, therefore, that the separate accounting method should be used if acceptable to the Tax Commission and, if not acceptable, the apportionment method, as outlined in the above section of statute, is the only alternative.

It is Wisconsin's experience that an acceptable method of separate accounting is possible only in a limited number of types of business. The following represent the principal types to which it has been found to be adaptable :

(1) Trading companies ;

(2) Construction companies ;

(3) Manufacturing companies manufacturing a complete product, and maintaining a complete sales organisation therefor within the State.

Trading companies can usually report on a separate basis, because the scope of their activity is, as a rule, limited to the trading area adjacent to the establishment. Usually, the only items of apportionment will be the purchase department expense, if the purchases are made by a central purchasing agent ; allocation of some administrative overhead expense, and perhaps of some nominal accounts, such as federal income-tax payments and interest payments on general loans incurred on behalf of more than one establishment. The operating results of a trading concern are very closely dependent upon the character of the population, the buying habits and resources of the particular territory served, and, for this reason, separate accounting tends to reflect more accurately the true profits earned.

A construction company engaged in construction schemes, such as buildings, dams, concrete roads and bridges, sewers, etc., almost invariably keeps accurate job and construction cost records for each scheme or undertaking, and, with the exception of a few general items of administrative overhead, the costs are applied directly and the profits on each are determined separately from the other. This situation is ideal for separate accounting. It also reflects a more accurate picture of the profits realised than a general apportionment, since the latter tends to average profits over all schemes executed, whereas construction business by its very nature is such that large variations in profits between different projects will and do occur.

We also meet with certain manufacturing concerns which maintain a complete and integrated organisation, incorporating all elements of an independent concern ; that is, owning and employing their own property, performing all their own manufacturing or assembling operations, maintaining

their own sales organisation, doing their own financing, and keeping separate and distinct books of account. A few instances of this occur within this State. Where the establishment is a branch or subsidiary of a larger company employed in the same general line of business, and when such branch or subsidiary is conducted and operated as a distinct and self-sustaining unit, it will lend itself to an accurate separate accounting.

The question will naturally be asked : Why has the Tax Commission found it necessary to require the apportionment method of reporting more generally than the separate accounting method ? The answer is that most of our important foreign corporations are engaged in some form of manufacturing or processing, and, generally, only part of the whole business organisation is maintained in Wisconsin ; the balance is maintained or situated without the State. That is to say, a manufacturing or assembling unit may be situated in Wisconsin, but the general office and sales organisation, together with other manufacturing units, are entirely outside the State. Or the converse may be true. A selling agency or branch may be all that is situated in the State, while the balance of the activities are outside ; or it may happen that only a storage warehouse, either owned or leased, is situated in Wisconsin with no sales department or agency attached thereto. The question then arises : How can you determine, on a separate accounting basis, the profits of one of a number of manufacturing or assembling units independent of the rest of the business, especially when the product is only partially manufactured or assembled in Wisconsin and is then transferred outside the State for completion and sale ?

Or, again, if a selling agency is all that is situated within the State, how can its profit be accurately determined on a separate accounting basis, when the product is such that no definite market price or transfer price from manufacturer to selling agency can be determined ? Or, if the only activity is a storage warehouse within this State, used for convenience in filling orders, on what basis can the profits arising from the use of this storehouse be accounted for separately ? It has been found impracticable, if not impossible, to account separately for any single activity or phase of an interrelated business structure ; in this case, only one method has been found practicable, and that is to take a percentage of the total ultimate net profits realised, the said percentage to be determined by an analysis of the principal elements of the business. Under the statutes of this State, the basic elements of a manufacturing business consist of the tangible property employed in the business, the cost of manufacturing and the sales. Whether these three factors should be given equal weight, as in our computation, or whether relatively different weights should be given, is a matter of opinion. The method used in Wisconsin has proved very satisfactory and many leading manufacturers employing it have expressed their approval and satisfaction with the results.

To summarise : Separate accounting is used in about 50 per cent of cases, involving mostly trading and construction companies and some manufacturing companies whose Wisconsin income can be readily segregated ; the apportionment formula is strictly followed in about 49 per cent of cases, including purely trading companies, for which the factor of manufacturing cost does arise. In the other 1 per cent apportionment is effected on the basis of the factors most appropriate in the circumstances.

Recourse to a " doomage " assessment is usually made only when a corporation refuses to file a return. If notice is sent to the taxpayer that a " doomage " assessment is contemplated, such assessment will not be made provided the taxpayer makes a satisfactory declaration of income within a fixed time-limit — twenty days, unless extended.

(c) Apportionment between Branch and Parent Enterprise.

1. *Apportionment of Gross Profits of Branch to Real Centre of Management abroad.*

The fact of merely having the directors' meeting in another State, or having there the real centre of management, would not be regarded as doing business there, and consequently there would be no occasion to allocate to such centre of management any of the profits realised in Wisconsin. This

same answer applies whether the branch in Wisconsin is the principal business or is of secondary importance to the enterprise as a whole. If a company has a general office in one State and no other property or activities in that State, such as manufacturing and selling, it would seem that no income should be assignable to that State. A situation such as this would, however, seldom exist, since, ordinarily at least, a sales office is connected with the central office.

2. *Apportionment of Expenses of Real Centre of Management to Branch.*

Interest Charges. — Where the local branch of a foreign corporation pays tax on the basis of separate accounts, the Tax Commission allows a deduction of a proportion of the total interest actually paid on general indebtedness. This part is usually determined in the ratio of property in Wisconsin to total property, Wisconsin sales to total sales, or some other factor depending upon the circumstances of the case. The interest must actually be paid to outsiders, and not represent interest arbitrarily imputed to the use of property within the business.

General Overhead. — This is distributed in much the same way as interest. The general overhead may be apportioned to the local branch, the factor of sales being employed more frequently than that of property. If the local branch is taxed by employing an allocation fraction, there is generally no occasion to make a specific allocation for overhead purposes, as it will be automatically included in the fraction, unless the branch is engaged in manufacturing, collecting, assembling or processing, in which case the part of the overhead assignable to activities in Wisconsin may be computed in order to serve as a factor in the allocation fraction.

3. *Apportionment of Net Profits of Branch to Deficitary Parent or* vice versa.

If the branch in Wisconsin is taxed on the basis of its separate accounts, its liability is measured by its profit or loss without regard to the profit or loss of the enterprise as a whole. If, however, the Wisconsin branch should continually show losses and the entire business substantial profits, the Tax Commission would no doubt investigate as to the repeated losses within Wisconsin, and, if it had reason to believe that the loss was not real, it would demand accounts of the head office in order to check the accounts of the branch, and, if necessary, effect an apportionment.

In cases where the local branch is taxed by applying the apportionment fraction, it might result that a part of the profit of the branch would be assigned to the deficitary parent, or *vice versa*, inasmuch as the effect of the fraction is to apportion to the branch its share in the profit or loss of the entire enterprise, in the ratio of the business transacted and property situated within the State to total business and property.

(d) Apportionment between Parent Enterprise and Subsidiaries.

In general, a local corporation, even though controlled by a foreign company, is treated as an independent entity and taxed on the basis of its own accounts. If, however, profits are diverted from the local company to the foreign parent company, then Section 71.25 (1) of the Income Tax Act may be invoked. This provision reads as follows :

> " When any corporation liable to taxation under this act conducts its business in such a manner as either directly or indirectly to benefit the members or stockholders thereof or any person interested in such business, by selling its products or the goods or commodities in which it deals at less than the fair price which might be obtained therefor, or where a corporation a substantial portion of whose capital stock is owned either directly or indirectly by another corporation acquires and disposes of the products of the corporation so owning a substantial portion of its stock in such a manner as to create a loss or improper net income, the Commission

may determine the amount of taxable income of such corporation for the calendar or fiscal year, having due regard to the reasonable profits which, but for such arrangement or understanding, might or could have been obtained from dealing in such products, goods or commodities.

" For the purpose of this chapter, whenever a corporation which is required to file an income-tax return is affiliated with or related to any other corporation through stock ownership by the same interests or as parent or subsidiary corporations, or whose income is regulated through contract or other arrangement, the Tax Commission may require such consolidated statements as in its opinion are necessary in order to determine the taxable income received by any one of the affiliated or related corporations."

One of the principal problems we have encountered is the practice of some of the larger corporations of organising a wholly owned sales corporation in Wisconsin for the purpose of distributing their product. If the only activity of the said corporation in this State consists of selling, and the parent corporation has no property in Wisconsin, and is consequently not licensed to do business there, only the sales corporation will render a report. This report may be either on a separate accounting or on an apportionment basis. However, the profit of the sales corporation is usually limited to a nominal figure by contract or other arrangement made with the parent company without any relation to the fair share of the group's ultimate profits which should be attributed to the sales activity of the business. When the parent manufacturing company is situated in Wisconsin, the reverse situation has been found to exist. The parent will incorporate a subsidiary sales corporation under the laws of another State, transfer its general office to some important city outside Wisconsin and transfer its product to its sales subsidiary at cost of manufacture or at a nominal profit, thereby reducing the income of the Wisconsin corporation and permitting its sales subsidiary to realise all or most of the profit.

Another method which has recently attracted attention is the transferring of patent rights by a Wisconsin manufacturing corporation to a subsidiary corporation organised under the laws of some other State, the purpose being to reduce the income of the Wisconsin manufacturer by large royalty payments to its foreign subsidiary. These three general methods are, in general, the most outstanding ones employed in attempts to remove income from the confines of Wisconsin for income-tax purposes.

Section 71.25 (corporate-tax evasion prevented), above quoted, grants power to the tax authorities to combat various schemes of income-tax evasion. It has been invoked in cases of corporations reporting on a separate accounting basis as well as those reporting on an apportionment basis. In Cliffs Chemical Co. *v.* Tax Commission, 193 Wis. 295 ; 214 N.W. 447, and in Buick Motor Company *v.* City of Milwaukee (U.S. District Court, E.D. Wis.), the corporations were placed on a correct separate accounting basis, which was feasible and practicable in those two instances. In the case of Palmolive Company *v.* Conway (43 Fed. (*2d*) 226), and others, the income of the parent and subsidiary corporations were consolidated and an apportionment fraction determined and applied to the net consolidated income of the two. In the case of Burroughs Adding Machine Co. *v.* Drew *et. al.* (U.S. Dist. Ct., E.D. Wis.), an estimated or " doomage " assessment made by the Tax Commission was sustained because of the refusal of the parent corporation to submit consolidated statements covering the operation of the parent and its subsidiary, which the authorities had demanded in order that the income attributable to the companies' sales activities in this State could be determined.

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

(a) INDUSTRIAL AND COMMERCIAL ENTERPRISES.

1. *Selling Establishments.*

Local Establishments selling in the Wisconsin Market.

The fundamental principle is that when goods are manufactured abroad and sold through an agency or establishment in Wisconsin the assessment is on the basis of the separate accounts of the establishment, provided they show a fair selling profit, and also provided that the fair profit can be arrived at through other than arbitrary methods. A fair selling profit can usually be determined only where there is a well-established market-price for the goods transferred from the foreign manufacturing establishment to the sales branch in Wisconsin. There is seldom an international market, and consequently it is usually necessary, when dealing with this kind of enterprise, to resort to an apportionment fraction.

When an enterprise buys a part of its goods outside and sells in Wisconsin, the Tax Commission recognises that the buying establishment may be considered productive of income. If the method of separate accounting is used, no profit would probably be attributed to that establishment. The statutory allocation formula is not intended primarily for application in the case of enterprises which *buy* abroad and sell in Wisconsin, but rather for those which *manufacture* abroad and sell in Wisconsin. The factors which constitute the fraction of property, cost of manufacture and sales would not permit of much profit being allocated to a purely purchasing establishment. Consequently, the prescribed formula would be abandoned, and the tax authorities would endeavour to formulate another fraction, which would effect a reasonable apportionment to each of the interested establishments.

In substance, although it is recognised that part of the entire profit of an enterprise may be attributed to skill in purchasing, or part to technique in manufacturing, the Tax Commission has not been able to evolve any criteria for fixing the relative profit that should be apportioned to each establishment, and it therefore feels that the application of its formula is the fairest method for effecting such apportionment.

Local Establishments selling abroad.

Where a branch in Wisconsin of a foreign enterprise sends a salesman into neighbouring territory to solicit orders which are filled out of stock at the local branch, the remittances being made to such branch, the profit from such transactions is deemed attributable to the Wisconsin establishment.

When the orders solicited by the salesman from the Wisconsin establishment are filled out of a stock kept in a neighbouring country, it is felt that this business should also be ascribed to the Wisconsin branch.

2. *Manufacturing Establishments.*

When a Wisconsin corporation does all its manufacturing in Wisconsin and sends salesmen to other States to solicit orders, but has no regular sales agency outside the State, the total income of the company is taxable in the State of Wisconsin, as it is considered that all the business is transacted within the State.

If the Wisconsin corporation invoices goods to the foreign sales establishment at the same price as it sells them to independent dealers, it is probable that the tax authorities will accept such a price as determining the profit allocable to the Wisconsin establishment. On the other hand, if no

independent factory price is established, the apportionment fraction will be applied. This is probably an instance where the fraction could be most appropriately employed in apportioning the income between the manufacturing establishment and the foreign sales branch. In a case such as this, it is probable that the formula would result, broadly speaking, in allocating about two-thirds to Wisconsin and one-third to the place of sale abroad, inasmuch as most of the property and all the manufacturing cost would be in Wisconsin, whereas practically all the sales would be outside the State.

3. *Processing Establishments.*

The maintenance of a processing establishment in Wisconsin would be taxable by using the allocation fraction.

4. *Buying Establishments.*

A foreign corporation, which purchases products in Wisconsin and has them shipped direct to its establishment outside, would be doing no business in Wisconsin which would produce taxable income. On the other hand, if a foreign company purchased raw products in Wisconsin and processed them before shipping them, there would be business transacted within the State and taxable income would result. The mere buying, without any of the other elements of business in Wisconsin, would not produce taxable income.

For example, certain companies in the east purchase tobacco in Wisconsin and have it stripped and seasoned in that State, and then store it in a warehouse in Wisconsin until it is needed in the east at the manufacturing establishment. In this case, the assessment would be made by apportionment.

5. *Research or Statistical Establishments, Display Rooms.*

A research bureau would probably be comparable to a manufacturing establishment and the Commission could use the apportionment formula to tax that part of the total profits which this bureau has helped to make. It is doubtful if a statistical bureau would be taxed unless the statistics gathered were sold, and therefore formed an essential part of the business.

It would seem that the maintenance of a mere display room without the consummation of sales within the State would not constitute business within the State.

(b) Banking Enterprises.

As foreign banks are not allowed to establish branches in Wisconsin and as there are no Wisconsin banks with branches in neighbouring States, there is no case for apportionment. It is felt, however, that such enterprises would be taxed on the basis of their separate accounts.

(c) Insurance Companies.

Insurance companies do not pay any income-tax on their operating income, but are subject to a special tax on their gross receipts in lieu of all other taxes.

(d) Transport Enterprises.

Steam railway companies are not taxed on their income, but on an evaluation of their physical property.

Motor-bus lines are taxed like any other industrial concern. The profits of these lines are generally allocated in proportion to the mileage covered within the State.

The income from operating lake vessels are taxed only when they are registered at a Wisconsin port.

There has not yet been any occasion to tax air navigation companies, as they have so far shown losses. They would probably be taxed in proportion to the number of miles flown in Wisconsin.

(e), (f) and *(g)* POWER, LIGHT AND GAS ENTERPRISES, TELEGRAPH AND TELEPHONE ENTERPRISES AND MINING ENTERPRISES.

Such enterprises report their income for taxation purposes in the same way as an industrial corporation. The assets of the public utilities in this State cannot be owned by a foreign corporation. There is no need, therefore, for apportionment or separate accounting to arrive at the income of these companies, for the reason that the total income is taxable. The stock of a public utility may be owned by a foreign corporation, but the Public Service Commission would not allow unjust expenses to be incurred to the disadvantage of the Wisconsin corporation.

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

In general, the same methods of apportionment are employed in taxing a Wisconsin enterprise as have been described in connection with foreign enterprises. If the separate accounting of the Wisconsin establishment is satisfactory, it is employed as a basis of assessment, otherwise the Tax Commission resorts to the allocation fraction.

There is no specific provision regarding allocation to a real centre of management in Wisconsin when all the other operations, such as manufacturing, are carried out in another State. If, in such a case, no business is actually transacted in the State, there will be no taxable profit.

C. HOLDING COMPANIES.

If a Wisconsin company has a foreign subsidiary in the same line of business, or *vice versa*, and there is evidence that, through manipulation, the profits of the Wisconsin company are being diverted to the foreign company, the Tax Commission can force the parent company to file a consolidated return for the parent company and its subsidiaries.

With regard to the case of a holding company which merely holds securities of another company, there is no special legislation. If the holding company is a Wisconsin company, it is taxable on the interest it receives from the foreign company and also of the whole of the dividends, unless 50 per cent of the income of the subsidiary has been subject to tax in Wisconsin, in which case the whole of the dividends is exempt. On the other hand, if the securities of a Wisconsin company are held by a foreign holding company, no liability is incurred by the foreign company in respect of the dividends or interest received, for the reason that the owner of the securities is not resident in the State.

Annex.

INCOME-TAX TARIFF.

(As authorised by Chapter 71 (Income-Tax Law) of the Wisconsin Statutes 1927, amended by Chapter 448 of the same Statutes, 1931) :

Individuals:

Taxable income	Percentage
1 to 1,000	1
1,000 to 2,000	1 ¼
2,000 to 3,000	1 ½
3,000 to 4,000	2
4,000 to 5,000	2 ½
5,000 to 6,000	3
6,000 to 7,000	3 ½
7,000 to 8,000	4
8,000 to 9,000	4 ½
9,000 to 10,000	5
10,000 to 11,000	5 ½
11,000 to 12,000	6
12,000 and up	7

Corporations:

Taxable income	Percentage
1 to 1,000	2
1,000 to 2,000	2 ½
2,000 to 3,000	3
3,000 to 4,000	3 ½
4,000 to 5,000	4
5,000 to 6,000	5
6,000 and up	6

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