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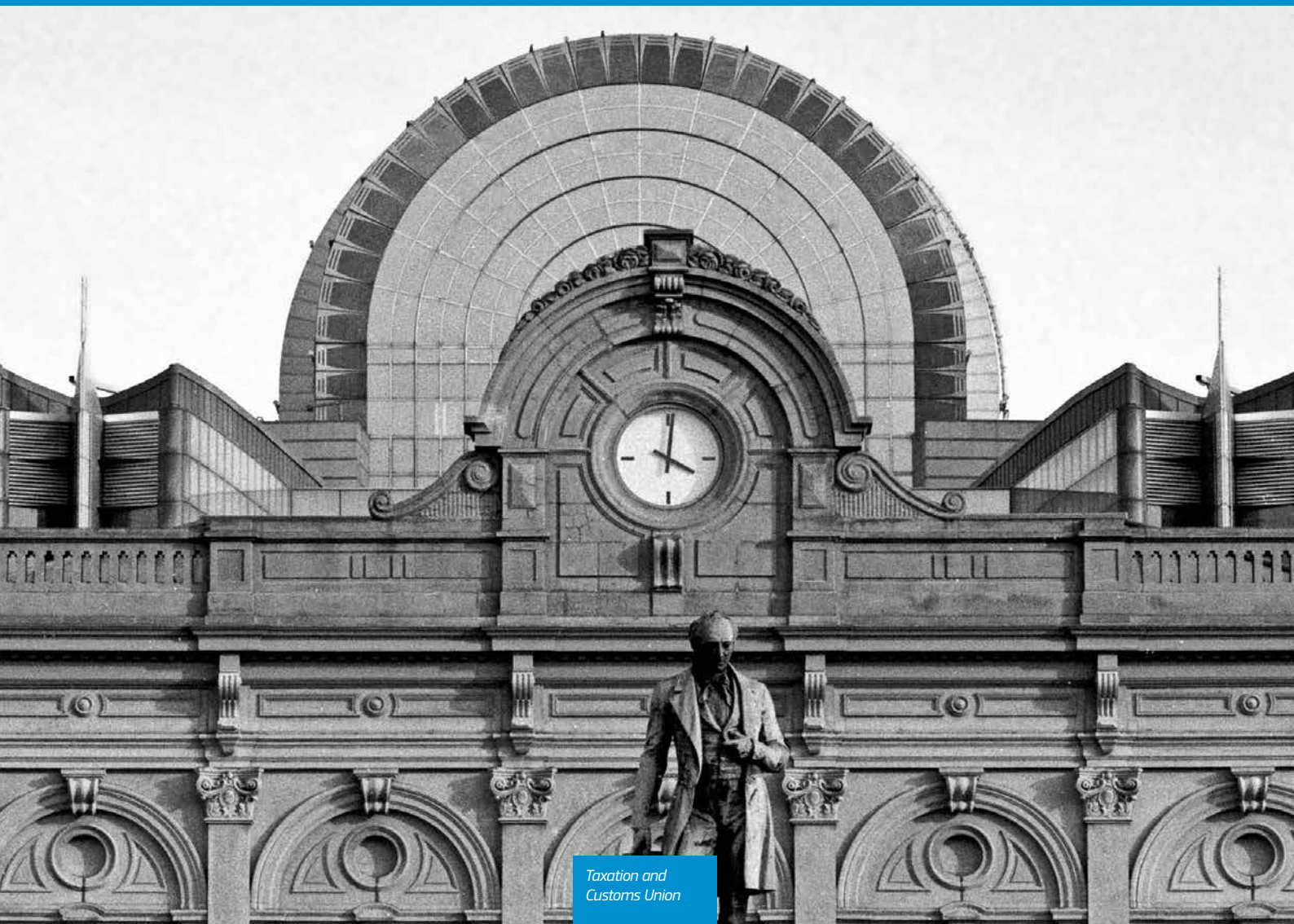
Experiences with cash-flow taxation and prospects

Final report



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Experiences with cash-flow taxation and prospects

Specific Contract No13 TAXUD/2014/DE/310
Based on Framework Contract No TAXUD/2012/CC/117

Final Report
12 May 2015

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Table of Content

List of tables

List of figures

Abbreviations

ACE	Allowance for Corporate Equity
Approx.	Approximately
ATO	Australian Taxation Office
AUD	Australian Dollars
BC	British Columbia
BCMT	British Columbia Mineral Tax
BCMTA	British Columbia Mineral Tax Act
BEPS	Base Erosion and Profit Shifting
BTA	Business Tax Advisory
CAD	Canadian Dollars
CBIT	Comprehensive Business Income Tax
CCCTB	Common Consolidated Corporate Tax Base
CFC	Controlled Foreign Corporation
CFT	Cash-Flow Tax
CFTS	Cash-Flow Tax System
CIT	Corporate Income Tax
DT	Double Taxation
DTC	Double Tax Convention
e.g.	exempli gratia
EC	European Commission
ECJ	European Court of Justice
EE	Estonia
EEC	European Economic Community
et seq.	et sequentia
etc.	et cetera
EU	European Union
EU MS	European Union Member State
EY	Ernst and Young
FAT	Financial Activities Tax
FMV	Fair Market Value
GBP	Great British Pound
GDP	Gross Domestic Product
HU	Hungary
HUF	Hungarian Forint
i.e.	id est
IBFD	International Bureau of Fiscal Documentation
Ibid.	Ibidem
IETU	Impuesto Empresarial a Tasa Única (Business Flat Tax)
IOF	Tax on Financial Operations
IRAP	Regional Tax on Productive Activities
KIVA	Small Business Tax
LNG	Liquefied Natural Gas
METR	Marginal Effective Tax Rate
MNC	Multinational Corporation

MNE	Multinational Enterprise
MRRT	Minerals Resource Rent Tax
MS	Member State
MXN	Mexican Pesos
NCS	Norwegian Continental Shelf
NOK	Norwegian Krones
OECD	Organisation for Economic Co-Operation and Development
OECD-MC	Organisation for Economic Co-Operation and Development Model Convention
OSR	Oil Sands Royalty
par.	paragraph
PE	Permanent Establishment
PL	Poland
PRRT	Petroleum Resource Rent Tax
PRT	Petroleum Revenue Tax
R&D	Research and Development
RFCT	Ring Fence Corporation Tax
SC	Supplementary Charge
SHT	Special Hydrocarbon Tax
SME	Small and Medium Enterprises
TEU	Treaty of the European Union
TFEU	Treaty on the Functioning of the European Union
ToR	Terms of Reference
UK	United Kingdom
US	United States
VAT	Value Added Tax
ZEW	The Centre for European Economic Research

Abstract

The European Commission has requested EY to conduct a study on Cash-flow taxation in EU- and OECD-Member States, to gather information on the design and the impact of the implementation of such a system in practice. This information will be used to evaluate the ability of the system to address issues like the debt-equity bias, the tax neutrality in respect of locational choices and compliance costs.

The study has three main objectives:

- To identify experiences with the adoption of cash-flow taxation, stressing how it was designed, which qualitative and quantitative (administrative or economic) benefits or problems it brought, and how the potential problems identified by the Commission were addressed.
- To identify experiences with proposals and implementations of cash-flow taxation, stressing the main hurdles to adoption (or abandonment) of the proposal and the choices/arguments that led to a specific design of the tax.
- To offer a typology of existing cash-flow taxations and conclude on their optimal design.

Out of 47 examined States, this report identifies three jurisdictions where a (close to) full-fledged CFT was implemented, namely Mexico, Estonia and Macedonia. The other identified CFTs relate to three broad categories: small and medium enterprises, sector specific taxes and gross receipt taxes.

Résumé

La Commission Européenne a mandaté EY pour mener une étude sur l'impôt sur le cash-flow (« CFT » ci-après) dans les Etats-membres de l'UE et de l'OCDE afin d'obtenir des informations sur la forme et l'impact de la mise en place d'un tel système en pratique. Ces informations serviront à évaluer la capacité du système à résoudre des problèmes tels le biais entre le financement des entreprises par la dette ou par les capitaux propres, la neutralité fiscale au regard des choix de localisation et les coûts de conformité.

L'étude comporte trois principaux objectifs :

- Identifier des situations où un impôt sur le cash-flow a été adopté, en soulignant la manière dont il a été conçu, quels avantages ou inconvénients qualitatifs et quantitatifs (administratifs ou économiques) il a entraîné, et comment les problèmes identifiés par la Commission Européenne ont été traités.
- Identifier des situations où un impôt sur le cash-flow a été proposé et mis en place, en soulignant les principaux obstacles à l'adoption (ou à l'abandon) des propositions, ainsi que les choix/arguments ayant conduit à une forme spécifique de l'impôt.
- Offrir une typologie des systèmes d'impôt sur le cash-flow existants, et conclure sur leur forme optimale.

Parmi les 47 Etats examinés, ce rapport identifie trois juridictions dans lesquelles un CFT (presque) complet a été mis en place, à savoir le Mexique, l'Estonie et la

Macédoine. Les autres CFT identifiés relèvent de trois grandes catégories : petites et moyennes entreprises, taxes spécifiques à un secteur et taxes sur les ventes brutes.

1 Mandate

The European Commission (EC) requested a study on cash-flow taxation (CFT) in EU28- and non-EU OECD-countries since 2000 (hereinafter "this report"), to gather information on the impact of the implementation of such a system in practice. This information will be used to evaluate the ability of such system to address issues like the debt-equity bias, tax neutrality in respect of locational choices and compliance costs.

This report identifies experiences with proposals and implementations of Cash-flow taxation, stressing the main hurdles to adoption (or abandonment) of the proposal and the choices/arguments that led to a specific design of the tax. For those countries that have adopted a CFT, this report will identify how it was designed, which qualitative and quantitative (administrative or economic) benefits or problems it brought, and how the potential problems identified by the Commission were addressed. Lastly, this report will offer a typology of existing CFTs and conclude on their optimal design.

The analysis covers now 47 countries that are within the European Union and non-EU OECD Member Countries since the year 2000, as well as non-OECD countries and also discusses systems applying to specific sectors and to small businesses on the following reasons:

A considerable number of countries, which have at a first glance a classical CIT in place, include elements in their tax systems which are typical for CFT systems or aim at achieving typical effects of a CFT (later referred to as "mixed systems"). This can include payment or distribution of income being the triggering event for taxation or allowing for a notional interest deduction based on equity (in order to achieve debt-equity equality, see the Allowance for Corporate Equity (ACE) systems). In order to separate those mixed systems that have a low degree of conformity with CFTs as developed in academic papers from with a high degree of conformity, we analysed the effects of these elements (see section 3.3 for a detailed discussion) against the reasons which academics brought forward in criticising the classical CIT systems.

These reasons are the:

- tax wedge between debt and equity financing,
- improvement in compliance and alleviation of administrative burden resulting from the complexity of the classical corporate income tax,
- fostering of both domestic and international investment, and
- limitation of the potential for erosion of tax revenue caused by transfer pricing.

Against this background, some systems are explained in greater detail in order to get a clearer picture as to the existence and distinction of pure cash-flow tax systems from systems with essential elements of a cash-flow system and other mixed systems.

This report is structured mainly in two parts as follows:

Part 1 (chapters 3-4): Stock-taking: discussion, identification, classification and qualification of CFTs

Identification, classification and qualification of CFTs whether proposed, implemented or already abandoned. For the countries where taxes were proposed, the main hurdles to adoption (or the reasons for the abandonment) of the proposal are described. The choices/arguments that led to a specific design of the tax are explained.

For those countries that have adopted a CFT, this report identifies how it was designed:

(a) how the base is calculated,

(b) what is the rate,

(c) what is the scope of the tax (organisational forms of companies, size, etc.),

(d) what are possible exemption,

(e) what are the revenues,

(f) what are specific administrative provisions,

(g) which qualitative and quantitative (administrative or economic) benefits or problems it brought, and

(h) how the potential problems identified by the Commission were addressed.

In particular, the impact of CFTs on the indebtedness of firms is an integral part of the analysis

Part 2 (chapter 5): Typology and optimal design.

The final report offers a typology of existing CFTs along their characteristics. It will also conclude on their optimal design, based on countries' experiences, the academic literature, and practical aspects, both in a domestic and international context.

2 Executive summary

CFTs occur in several forms which are commonly divided into **three main classes**:

- Cash-flow tax on "real" business activity: the **R-based CFT**. Its tax base is set on sales, minus wage costs and purchases of material, good and services, and fixed assets.
- A cash-flow tax on real and financial transactions: the **R+F-based CFT** tax combines taxation on real transactions and on financial transactions. Its tax base is the same as for R-base CFT, plus it adds received borrowing and interest minus repayment in borrowing and interest paid. Contrary to R-based, the R+F-based CFT can be applied to financial sector.
- A cash-flow tax on distribution of dividends ("stock"): the **S-based CFT**. Its tax base comprises distributions of a corporation to its shareholders. Cash inflows resulting from the issuance of new shares decrease the tax base, while a repurchase of shares increases its tax base. Cash inflows or outflows from or to the corporations from third-party transactions are not taxable.

From our country research, we have defined a pure cash flow tax system as a system comprising the following essential elements: a tax which can be classified as a R, R+F or S-based system with immediate expensing[1], equal treatment of debt and equity, based on cash in-cash out without accrual accounting surrogating the corporate tax and striving for administrative simplicity. In addition we have examined those countries which implemented a tax which shows essential elements of a cash flow tax system surrogating the corporate tax.

Therefore, we did not cover ACE systems which form part of the normal corporate tax system or tax systems mainly covering individuals. We have included one FAT system applied to SME as an example (see Hungarian KIVA) which showed essential elements of a CFT.

Sector specific taxes which aim at taxing the economic rent of exploitation of natural resources (extraction industry) and corporate taxpayer specific systems which strive for administrative simplicity and which reflect also other CFT elements (taxation of SMEs) are dealt with separately.

This report (based on the questionnaire in Annex 1 which was sent to the relevant countries, additional interviews with officials from tax administrations and publicly available reports and legislation) identifies **three jurisdictions where a (close to) full-fledged CFT was implemented, namely Mexico, Estonia and Macedonia**.

With the exception of Mexico, there is no clear evidence that the CFT-systems were derived from academic models as discussed in the literature.

- Mexico's CFT system operated in parallel with a CIT system and generally applied an R-based, while it applied an R+F-based CFT to financial institutions. This system

[1] With regards to an S-based system immediate expensing is not relevant

was abandoned in 2014 mainly due to the administrative burden that an additional tax put on the Mexican businesses.

- Macedonia and Estonia both applied elements of an S-base CFT, only taxing distributed profits and leaving retained profits untaxed.[2] Macedonia abandoned this system in 2014, as the regime was a temporary measure introduced to counteract the financial downturn of the Macedonian economy at the time of its introduction. The Estonian S-base CFT is still in place. The Estonian tax system is considered by some to be the most competitive tax system in the OECD.[3] In general the Estonian CFT system is considered to be efficient and has been well received by Estonian businesses.
- Australia, New Zealand and the United States had in-depth discussions with regard to reforming the CIT system and introducing a CFT. However these discussions did not evolve into legislative proposals due to various criticisms. Feasibility of the tax, international recognition and lack of political support were some of reasons identified for the non-implementation of these proposed systems.

The other identified CFTs relate to three broad categories: small and medium enterprises, sector specific taxes and gross receipt taxes.

There is a predominant presence of CFT elements in the **extraction industry**. CFT elements were present in the extraction industries of Australia, Canada, Norway, Poland and the UK. The leading motivation for applying a CFT in this sector was for governments to be able to tax the economic profits (supernormal profits or super-rents) of the industry.

Brazil and Hungary applied elements of a CFT system to their **SMEs**. The main motivation was to reduce the complexity of the tax compliance requirements and to allow for a less complex way of complying with the administrative requirements for SMEs that have fewer resources to keep up with such high burdens.

CFT elements were identified in gross receipts tax in Brazil and in individual US States (see Annex 5). Under a gross receipts regime, tax is charged on gross receipts, but a credit is granted for certain expenses incurred by the business. The method of calculation is hence based mainly on cash inflows subject to certain exemptions and accounts for cash outflows in the form of a credit.

Given the real-world experiences with cash-flow taxation, and the theoretical understanding thereof, it is possible to claim that there is no one, single best practice for an R-/R+F-based CFT system. Rather, we have seen jurisdictions using cash-flows to determine the tax base in a number of quite different tax systems. Macedonia and Estonia apply an almost fully-fledged S-type system with the single difference that these countries do not allow a deduction for the issuance of new shares or capital contributions by shareholders.

There are systems to measure the profit of companies that have (some of) the following characteristics of a CFT: can be classified as an R-, R+F- or S-based system

[2] It is interesting highlighting that both Estonia and Macedonia do or did not recognise its corporate tax system as an S-based CFT.
[3] Tax Foundation's International Tax Competitiveness Index

with immediate expensing; achieve an equal treatment of debt and equity; are based on cash in-cash out without accrual accounting surrogating the corporate tax; and strive for administrative simplicity. The overall purpose of a CFT (as defined in the context of this report) is as an alternative for applying the CIT and as a way to improve the CIT system. Given that starting point, we have assessed the alternatives.

Of the three types of CFTs theoretically most often discussed (being the R-based CFT, the R+F-based CFT and the S-based CFT), **the R-based CFT is particularly attractive for small businesses** (with primarily domestic transactions and with a limited turnover and/or number of employees) whose activity is based on "real business" activity, and not on financial transactions (and hence the distinction of financial transactions is less important and presumably less difficult compared to if it has to be made vis-a-vis larger businesses). R-base CFT would ensure administrative simplicity since only information on cash inflow and outflow should be provided to tax administrations. In practice such systems are applied to corporations rarely. Our research only detected the Brazilian systems (Simples Nacional, Lucro Presumido and Pis-Pasep and Cofins) and the Hungarian system (KIVA) as experiences showing this administrative advantage for SMEs.

With respect to the international dimension of CFTs, **a destination based CFT is attractive from a theoretical perspective**. It could alleviate problems with the current CIT regimes in a cross-border context. However, despite its attractiveness, we have not seen examples in practice where a destination based CFT is applied. At the present stage of both practical and theoretical knowledge of exactly how it could be designed, and the effects it would have on the allocation of the tax base between jurisdictions, we have stopped short of suggesting it as a best-practice. We acknowledge that once a destination based CFT is better understood, both in theory and in practice, it might become a preferred alternative. However, for now**, an origin-based CFT is the only option that has been tested in practice**.

The administrative simplicity inherent in the theoretical understanding of the CFT was not always clearly visible in practice. However, that seems to be contingent not upon the CFT system itself but how it has been implemented. When a CFT system has been implemented to replace a CIT (and, in some instances with regard to CFTs for SMEs, social security contributions and other taxes) there is evidence of CFTs alleviating the administrative burden both for administrations and the taxpayers. Macedonian and Estonian regimes are an example of this. But when a CFT is applied alongside a CIT, it creates additional administrative burdens and is then not perceived as a simplification. This could be seen in the Mexican IETU system. We conclude that, in itself, the **CFT has proved to lead to more administrative simplification over CIT.** However, it is the tax mix and total administrative burden that in the end determines how it has been perceived.

The CFT system acts as an investment incentive. We found evidence of this in the extraction tax CFT regimes. More generally, whether a CFT regime attracts foreign investment is difficult to assess. There are indications that the tax regime is only one aspect of importance, and enacting a CFT regime is not a miracle measure to attract foreign capital.

With regard to the revenue collected under a CFT, evidence is mixed and conclusions are to a certain degree uncertain. There are some indications that it is more **difficult**

to avoid a CFT than a CIT (Mexico). It has also been reported that revenues initially decrease, though that could be due to the fact that transitional rules and past investment reduced the profit calculated in the very first years (Macedonia, Estonia). Lastly, it has also been reported that a **CFT could raise revenue effectively (Estonia).**

Critique of the CFTs and complexities of the system concern the sector-specific taxes and CFT regimes that are present alongside a CIT. The fact that a CFT is operated alongside a CIT system creates particular difficulties.

The fear of the unknown seems to be among the important reasons for not implementing a CFT. The uncertainties surrounding the CFT, especially as regards the international recognition and the fact that it departs substantially from the current system, are the most important reasons not to go further and propose the introduction of a CFT. Interestingly, **we found evidence that a CFT could be recognised in international tax law (Mexico)**. The resistance to adopt a CFT for international tax law reasons could hence not be confirmed. At least for Mexico, Estonia and Macedonia this reason could not be confirmed in practice.

Transition issues may pose considerable problems in practice as regards R-based and R+F-based CFT systems. Under a CFT the issue of how to treat "old" investment that used to benefit from standard depreciation allowances is a difficult one. An initial revenue decrease and some avoidance patterns seen in practice are typically due to problems inherent in the transition phase.

With regard to concrete examples in practice, an R- and an R+F-based CFT system had been operating in Mexico. We note that these CFTs operated alongside a CIT and the system was not perceived to be simple to administer. Despite its unpopularity in Mexico, it is an important **example and proof that a CFT system can be introduced and recognised internationally.** However, we also note that the transitional issues were considerable.

With regard to S-based CFT, there are less transitional issues and generally this system seems to be simpler to be introduced. In the single country where the S-based CFT completely replaced the CIT, and where it is still in force, in Estonia, no specific transitional issues were identified. The **S-based system, though, seems the most simple**. **Avoidance issues arise, primarily through shifting profit distribution to fringe benefits, loans to related parties etc. These seem to be manageable by introducing anti-avoidance rules.**

Lastly, the choice of a tax cannot be determined outside the context of the specific jurisdiction. This report contains numerous examples as to how the total tax situation impacts greatly the success of a CFT system. The benefits of the CFT system will clearly be less visible, if the CIT system is not abolished and both systems work in parallel.

Résumé exécutif

L'impôt sur le cash-flow (« CFT » ci-après) peut prendre plusieurs formes, communément divisées **en trois catégories :**

- Un impôt sur le cash-flow sur les activités entrepreneuriales « réelles », le **CFT *R-based*** : sa base taxable se définit comme les ventes moins les achats de matériel, biens et services, les coûts salariaux et les actifs immobilisés.
- Un impôt sur le cash-flow sur les transactions réelles et financières, le **CFT *R+F-based*** : il combine l'imposition des transactions réelles et des transactions financières. Sa base taxable est similaire à celle du CFT *R-based*, mais intègre en plus les emprunts et les intérêts reçus, moins les remboursements d'emprunts et d'intérêts. Contrairement au CFT *R-based*, le CFT *R+F based* peut être appliqué au secteur financier.
- Un impôt sur le cash-flow sur la distribution des dividendes, le **CFT *S-based*** : sa base taxable comprend les distributions faites par une entreprise à ses actionnaires. Les flux de trésorerie entrants résultant de l'émission de nouvelles actions diminuent la base taxable, tandis que les rachats d'actions l'augmentent. Les flux de trésorerie entrants et sortants des entreprises liés à des transactions réalisées avec des tiers ne sont pas imposables.

Dans le cadre de notre recherche par pays, nous avons défini un modèle d'impôt sur le cash-flow « pur », comportant les éléments essentiels suivants : un impôt pouvant être qualifié comme relevant d'un système *R-*, *R+F-* ou *S-based* avec une comptabilisation immédiate en charge[4], un traitement identique de la dette et des capitaux propres, fondé sur les entrées/sorties de fonds sans comptabilité d'exercice, se substituant à l'impôt sur les sociétés et visant la simplicité administrative. En outre, nous avons examiné les pays ayant mis en place un impôt présentant des caractéristiques essentielles d'un système d'impôt sur le cash-flow se substituant à l'impôt sur les sociétés.

Par conséquent, nous n'avons couvert ni les systèmes ACE qui font partie intégrante du système normal d'impôt sur les sociétés, ni les systèmes d'imposition couvrant principalement les personnes physiques. A titre d'exemple, nous avons inclus un système FAT appliqué aux PME (se référer au KIVA hongrois) qui présente des éléments essentiels d'un CFT.

Nous avons traité séparément les taxes spécifiques à un secteur qui visent à imposer la rente économique tirée de l'exploitation des ressources naturelles (industrie de l'extraction), ainsi que les systèmes spécifiques applicables aux entreprises contribuables, qui recherchent la simplicité administrative et qui reflètent également d'autres éléments du CFT (imposition des PME).

Ce rapport (fondé sur le questionnaire disponible en annexe 1 envoyé aux pays pertinents, sur des entretiens additionnels avec des agents des administrations fiscales et sur des rapports et textes de lois publics) identifie **trois juridictions dans lesquelles un CFT (presque) complet a été mis en place, à savoir le Mexique, l'Estonie et la Macédoine.**

A l'exception du Mexique, il n'existe pas clairement de preuves que les systèmes de CFT ont été tirés des modèles académiques, comme mentionné dans la littérature.

[4] Dans le cas d'un système *S-based*, la comptabilisation immédiate en charge n'est pas pertinente

- Le système de CFT du Mexique a fonctionné en parallèle avec un système d'impôt sur les sociétés et a généralement utilisé un modèle *R-based*, tandis qu'un modèle *R+F based* était appliqué aux institutions financières. Ce système a été abandonné en 2014, principalement à cause de la charge administrative qu'un impôt additionnel faisait peser sur les entreprises mexicaines.
- La Macédoine et l'Estonie ont toutes deux appliqué certains éléments d'un CFT *S-based* en imposant uniquement les bénéfices distribués et n'imposant pas les bénéfices non distribués.[5] La Macédoine a abandonné ce système en 2014, il s'agissait d'une mesure temporaire introduite pour contrebalancer le ralentissement de l'économie macédonienne au moment de son introduction. Le CFT *S-based* estonien est toujours en vigueur. Le système fiscal estonien a été considéré par certains comme le système fiscal le plus compétitif de l'OCDE[6]. En général, le système de CFT estonien est perçu comme efficace et a été bien accueilli par les entreprises estoniennes.
- L'Australie, la Nouvelle-Zélande et les Etats-Unis ont eu des discussions avancées sur une possible réforme de l'impôt sur les sociétés et l'introduction d'un CFT. Cependant, du fait de critiques nombreuses, ces discussions n'ont pas évolué en propositions législatives. La praticabilité de l'impôt, sa reconnaissance au niveau international et le manque de soutien politique furent quelques-unes des raisons identifiées pour expliquer que ces systèmes proposés n'aient pas été mis en place.

Les autres CFT identifiés relèvent de trois grandes catégories : les petites et moyennes entreprises, les taxes spécifiques à un secteur et taxes sur les ventes brutes.

Il existe une présence prédominante d'éléments du CFT dans **l'industrie de l'extraction**. Ces éléments du CFT ont été mis en place dans les industries de l'extraction en Australie, au Canada, en Norvège, en Pologne et au Royaume-Uni. La raison majeure à la mise en place d'un CFT dans ce secteur était de permettre aux gouvernements d'imposer les profits économiques de l'industrie (bénéfices supranormaux ou surprofits).

Le Brésil et la Hongrie ont appliqué des éléments d'un système de CFT à leurs **PME**. La raison principale était de réduire le niveau de complexité des obligations en matière de conformité fiscale et de permettre la mise en place d'un moyen plus simple pour les PME de respecter les obligations administratives, celles-ci ayant moins de ressources pour supporter des charges si lourdes.

Des éléments du CFT ont également été identifiés au niveau de la taxe sur les ventes brutes au Brésil, et dans certains Etats des Etats-Unis (voir l'annexe 5). Sous un régime de taxe sur les ventes brutes, l'impôt est calculé sur les ventes brutes, puis un crédit est octroyé pour certaines dépenses encourues par l'entreprise. La méthode de calcul est donc principalement fondée sur les entrées de fonds, sujettes à certaines exonérations, et tient compte des sorties de fonds sous la forme d'un crédit.

[5] Il est intéressant de noter que l'Estonie et de la Macédoine ne reconnaissent pas leurs systèmes d'impôt sur les sociétés comme un système de CFT.
[6] Tax Foundation's International Tax Competitiveness Index

D'après les expériences de mise en place d'impôt sur le cash-flow, dans la plus large acception du terme, et la compréhension théorique de celles-ci, il peut être établi qu'il n'existe pas une seule bonne pratique applicable aux systèmes de CFT *R- / R+F-based*. Nous avons en revanche constaté qu'il existe des modèles utilisant le cash-flow pour déterminer la base taxable dans un certain nombre de systèmes fiscaux différents. La Macédoine et l'Estonie appliquent un système *S-based* presque complet, à la seule différence que ces pays ne permettent pas de déduction pour l'émission de nouvelles actions ou pour les apports en capitaux par les actionnaires.

Il existe actuellement des systèmes visant à mesurer le bénéfice des sociétés qui présentent (certaines des) les caractéristiques d'un CFT, c'est à dire une taxe pouvant être classifiée comme un système *R-, R+F- ou S-based* avec une comptabilisation immédiate en charge[7], un traitement identique de la dette et des capitaux propres, fondé sur les entrées/sorties de fonds sans comptabilité d'exercice, se substituant à l'impôt sur les sociétés et recherchant la simplicité administrative. En général, le but d'un CFT (tel que défini dans le cadre de ce rapport) est de se présenter comme une alternative à l'application de l'impôt sur les sociétés et comme une manière d'améliorer le système de l'impôt sur les sociétés. En partant de ce principe, nous avons évalué les différentes alternatives.

Des trois types de CFT les plus étudiés théoriquement (c'est-à-dire le CFT *R-based*, le CFT *R+F-based* et le CFT *S-based*), **le CFT *R-based* est particulièrement attractif pour les petites entreprises** (réalisant principalement des transactions nationales et avec un chiffre d'affaires et/ou un nombre d'employés limité) dont l'activité est basée sur des transactions « réelles » et non pas sur des transactions financières (et pour lesquelles l'identification des transactions financières est donc moins importante et vraisemblablement moins complexe comparée à celle qui devrait être faite en présence de plus grandes entreprises). Le CFT *R-based* assurerait une simplicité administrative puisque seules les informations relatives aux mouvements de fonds entrants et sortants devraient être fournies aux administrations fiscales. En pratique, de tels systèmes sont rarement appliqués aux entreprises. Notre recherche a seulement identifié le système brésilien (Simples Nacional, Lucro Presumido et Pis-Pasep et Confins) et le système hongrois (KIVA) comme expériences démontrant les avantages administratifs précités pour les PME.

Concernant la dimension internationale du CFT, **un CFT basé sur le principe de destination est attractif du point de vue théorique**. Cela pourrait pallier certains problèmes engendrés par les régimes d'impôts sur les sociétés en place dans un contexte transfrontalier. Néanmoins, malgré ces avantages, nous n'avons pas vu d'exemple pratique où le système CFT basé sur le principe de destination est appliqué. En l'état actuel des connaissances théoriques et pratiques sur la manière dont il pourrait être conçu et sur les effets qu'il pourrait avoir sur l'allocation de la base taxable entre juridictions, nous avons cessé de proposer cette solution comme étant la meilleure pratique. Nous reconnaissons que si le CFT fondé sur le principe de destination était mieux compris, tant en théorie qu'en pratique, celui-ci pourrait devenir une alternative préférable. Néanmoins, pour le moment, **un CFT fondé sur le principe d'origine est la seule option qui ait été testée en pratique.**

7 Dans le cas d'un système *S-based*, la comptabilisation immédiate en charge n'est pas pertinente

La simplicité administrative inhérente à la compréhension théorique du CFT n'était pas toujours visible en pratique: néanmoins, elle semble subordonnée non pas au système CFT en soi mais bien à la manière dont celui-ci a été mis en place. Lorsqu'un système CFT a été mis en œuvre pour remplacer l'impôt sur les sociétés (et dans certains cas concernant le CFT pour les PME, les contributions de sécurité sociale et d'autres taxes), il est prouvé que le système CFT simplifie les formalités tant pour les administrations que pour les contribuables. Les régimes macédonien et estonien en sont de bons exemples; mais lorsque le CFT est appliqué en parallèle de l'impôt sur les sociétés, cela créé une charge administrative supplémentaire et n'est donc pas perçu comme une simplification. Le système mexicain IETU a permis de le constater. Nous concluons que **le CFT a prouvé qu'il apportait une simplification administrative comparée à l'impôt sur les sociétés.** Néanmoins c'est en définitive l'ensemble de taxes et les charges administratives total qui déterminent comment celui-ci a été perçu.

Le système CFT agit comme une incitation à l'investissement. Nous en avons trouvé des preuves dans les régimes CFT des industries d'extraction. Plus généralement, il est difficile de mesurer si le système CFT attire des investissements étrangers. Il existe des indications donnant à penser que le régime fiscal n'est qu'un des aspects importants, et qu'instaurer un système CFT n'est pas une solution miracle pour attirer des capitaux étrangers.

Concernant le revenu collecté par un CFT, les preuves sont mitigées et les conclusions sont à certains niveaux incertaines. Certaines indications tendent à montrer **qu'il est plus difficile d'éviter un CFT que l'impôt sur les sociétés (Mexique)**. Il a également été rapporté que le revenu diminue dans un premier temps, cela peut être dû au fait que les règles transitoires et les investissements passés diminuent le profit calculé les premières années (Macédoine, Estonie). Enfin, il a également été rapporté que **le CFT pourrait efficacement accroître le montant des revenus (Estonie).**

La critique des CFT et la complexité du système concernent les taxes spécifiques à un secteur et les régimes de CFT qui sont mis en place en même temps que l'impôt sur les sociétés. Le fait qu'un CFT soit appliqué en même temps que l'impôt sur les sociétés pose des difficultés particulières.

La peur de l'inconnu semble également être une raison importante pour ne pas mettre en œuvre un CFT. Les incertitudes entourant le CFT, particulièrement au regard de sa reconnaissance internationale et le fait qu'il parte en grande partie du système existant, sont les raisons les plus importantes conduisant à ne pas aller plus loin et à ne pas proposer l'introduction d'un CFT. De manière intéressante, **nous avons trouvé des preuves qu'un CFT pouvait être reconnu en droit international (Mexique)**. La réticence à adopter un CFT pour des raisons de droit fiscal international ne peut donc pas être confirmée. Au moins au Mexique en Estonie et en Macédoine, cette raison ne peut pas être confirmée en pratique.

Les mesures transitoires peuvent poser des problèmes considérables en pratique pour les systèmes CFT *R-based* et *R+F-based*. Sous un CFT, il est difficile de savoir comment traiter des « anciens » investissements qui bénéficiaient auparavant de provisions pour dépréciation standard. Une diminution du revenu initial et certain schémas d'évasion constatés en pratique sont souvent dus à des problèmes inhérents à la phase de transition.

Concernant des exemples pratiques, un système de CFT *R*- et *R+F-based* fut mis en place au Mexique. Nous avons noté que ces systèmes de CFT étaient opérés parallèlement à un système d'impôt sur les sociétés, et qu'ils n'étaient pas perçus comme simple à mettre en œuvre. Hormis son impopularité au Mexique, c'est **un exemple important et une preuve qu'un système de CFT peut être introduit et reconnu sur le plan international**. Nous avons également constaté qu'il existait d'importants problèmes dus à la transition.

Concernant les CFT *S-based*, il existe moins de problèmes de transition et, en règle générale, ce système semble être plus simple à introduire. Dans le seul pays où le CFT *S-based* a complètement remplacé l'impôt sur les sociétés et où celui-ci est toujours en vigueur, en Estonie, aucun problème de transition n'a été identifié. **Le système *S-based* semble être le plus simple. Des problèmes d'évasion se produisent essentiellement lorsque la distribution de bénéfices est transformée en avantages sociaux, en prêts à des parties liées etc. Cela semble pouvoir être géré en introduisant des règles anti-évasion.**

Enfin, le choix d'un impôt ne peut être déterminé en dehors du contexte d'une juridiction spécifique. Ce rapport contient de nombreux exemples qui montrent comment la situation fiscale générale influence considérablement le succès d'un système de CFT. Les avantages de ce système seront nettement moins apparents si l'impôt sur les sociétés n'a pas été aboli et si les deux systèmes fonctionnent en parallèle.

3 The various manifestations of CFTs

3.1 From CIT to CFT – a background survey

3.1.1 Background and outline of this report

The global financial crisis has led to questions as to the appropriateness of the techniques currently used to tax businesses. One of the alternatives proposed by academics is shifting the subject of taxation from profits determined on the basis of accounting principles to net cash-flows. Such regimes are mainly referred to as CFT systems. For the purpose of this report, a CFT is defined as a "tax on the net positive cash-flow of a company which uses as a tax base the difference between the cash inflows and the cash outflows, rather than the profit made measured through income minus expenses".

A tax on the net cash position can, from an economic perspective, be classified as a consumption or expenditure tax. The discussion of such taxes is mature, yet the first proposals for such taxes stem from the 1970-ies. Since then, various academics have contributed with more elaborate proposals for CFTs. CFTs take several forms but are usually classified in three main categories (see section 3.1.4):

- Cash-flow tax on "real" business activity: the R-based CFT. The tax base of an R-based CFT is set on sales, less purchases of material, goods and services, wages and fixed assets.
- A cash-flow tax on real and financial transactions: the R+F-based CFT tax combines taxation on real transactions and on financial transactions. Its tax base is the same as for R-base CFT, adding received borrowing and interest less repayment in borrowing and interest paid. Unlike an R-based CFT, the R+F-based CFT can be applied to the financial sector.
- A cash-flow tax on distribution of dividends ("stock") minus the net receipts on issued shares: the S-based CFT. The tax base includes distributions of a corporation to its shareholders. Cash inflows resulting from the issuance of new shares decrease the tax base, while a repurchase of shares increases it. Cash inflows or outflows from or to the corporations from third-party transactions are not taxable.

The CFTs are intended to:

(i) overcome the tax wedge between debt and equity financing;
(ii) improve compliance and alleviate administrative burden resulting from the complexity of the classical corporate income tax;
(iii) foster both domestic and international investment; and finally
(iv) limit the erosion of tax revenue caused by transfer pricing.

Some of the proposals have specifically addressed the international context in which a CFT may be embedded. Two choices have been identified in the literature: a CFT could be either source-/residence-based or destination-based, meaning that the revenue from a CFT could either be located based on the source/residence aspect or the destination aspect.

A source-/residence-based CFT is considered to have two major drawbacks. First, it distorts the location decisions of production on the basis of a comparison of the post-tax net present value. Second, it creates incentives to shift profit between countries where the statutory tax rate is lower. This incentive is considered to be even exacerbated through a source-/residence-based CFTs as compared to under a CIT. In contrast, a destination based CFT is considered to address these problems.[8]

By tendering this report, the Commission essentially intended to gather information on practical experiences with the implementation of CFTs. The report explains the reasons for implementing CFTs or for refraining from implementing CFTs, problems arising in the transitional phase and measures taken to solve these problems. Further, motivations for abolishing existing CFTs are covered in this report. The purpose of this study is not to discuss the proposals suggested in the literature, but to look into the experiences and prospects of CFTs. With the academic contributions as starting point, we have identified the key features of CFTs and key design options as regards CFTs (see sections 3.1.4 and 3.1.7).

In a first step, this report elaborates the defects and problems of the most common accrual-based corporate income tax system (CIT) and hence the motivations to propose other systems (see section 3.1.2) Second, it summarizes the academic proposals to introduce new systems; in particular the CFT-systems (see 3.1.3, 3.1.4 and Annex 2). Third, it discusses the three basic, tax bases of CFT (see 3.1.5.1 - 3.1.5.3). As well as the international dimension in more detail (see 3.1.5.4 and 3.1.7.3) and issues with the implementation of CFTs (see 3.1.8). On this basis, the report separates those tax systems in place which show essential features of a CFT from those which are only slight deviations from classical systems (see section 3.3). With this exercise the report concentrates on countries with pure CFT systems or countries with essential elements of a CFT and scope out countries where only a single but not essential feature of a CFT has been introduced (see section 3.3). Following this, this report outlines the results received from the replies of the various countries within the survey conducted amongst EU- and OECD Member States as well as among other countries which have experiences with CFTs (see chapter 4). That selection forms the basis for task 2 of this report under chapter 5 where the report first highlights the typology of CFT systems and then elaborates on the optimal design of a CFT on the background of the deficiencies of the classical corporate income taxes.

3.1.2 Motivations for reforming CIT[9]

While the CIT is the most widely used corporate taxation system, this system holds some flaws.

For purposes of this report, a classical corporate income tax is understood as a tax on profits which are determined based on some type of standard accounting rules (being modified by corporate income tax rules not changing the character of the tax as a tax on business profits). In contrast, a CFT is understood as a tax on net cash-inflows of a

[8] Commission expert group on taxation of the digital economy report, (2014); de la Feria R. and Devereux M.P., (2014); Auerbach A.A., Devereux M.P. and Simpson H., (2008).
[9] This paragraph reflects the analysis of the individual papers as described in Annex 2.

business (R-base and R+F-base systems) or on the net cash-outflow of an entity to its shareholders (thus reflecting the net inflow of the business of a corporation). In a pure CFT system these flows are not subject to adjustments for the purposes of taxation. While CFTs have specific features in common with VAT systems (both systems are perceived as taxing consumption), a VAT is a transaction-based, consumption tax system eventually taxing the expenditure for consumption of goods and services whereas a CFT aims at taxing the cash-flow position of a business.

First, from an economic perspective, the tax base of a CIT is the full return to equity (i.e. capital return less debt interest) which makes it highly distortive in relation to investment and financing instruments by companies. By reducing the return on capital, it induces investors to reduce the scale of their investment and by allowing debt deduction it favours debt financing over equity financing. This distortion, often also referred to as debt-equity bias, may induce firms to issue excessively high levels of debt and hence introduce greater risk of financial instability[10].

Furthermore, companies may take advantage of tax legislation and allocate their capital to a certain location in order to receive an advantageous taxation. This capital allocation may not be driven by economic efficiency and hence may be sub-optimal. In addition, companies may take advantage of weaknesses in tax legislation to shift profits between countries and to achieve an advantageous taxation. Aggressive tax optimization (e.g. abusive transfer pricing) can erode government revenue. Increasing documentation provision requirements by government can partly limit these issues but also introduce new distortions.

Upon deciding on the location of an investment, companies examine, amongst other things, the after tax rate of return of an investment project. This return depends on the CIT rate applicable.

Finally, the accounting rule based measurement of taxable profits makes the system rather complex. This complexity may not only burden smaller companies and tax administrations but also distort the allocation of investment and consumption over time.[11]

3.1.3 Existing options for reforming CIT

The above flaws are not new. They are discussed, for example, in the Meade Committee report in 1978 and they have been discussed in various contexts, notably by academics, since then.

CIT reform proposals can be classified according to two dimensions[12]:

1. The tax base.

   There are three kinds of income that can be subject to tax:

[10] The debt-equity bias of current CITs is at European level an aspect being considered in other tax reform projects like the Common Consolidated Corporate Income Tax Base; Moscovici P. (2015).
[11] Auerbach A.A., Devereux M.P. and Simpson H., (2008); Zee H.H., (2006); Bénassy-Quéré A., Trannoy A. and Wolff G.B., (2014).
[12] Auerbach A.A., Devereux M.P. and Simpson H., (2008).

- full return to equity,
- the full return to capital (i.e. not allowing the deduction of debt) and
- the capital rent.

Capital rent denotes the difference between above normal returns and normal returns. Normal return denotes the capital return necessary to cover investment cost and risk.

2. The location of the tax base.

   Corporate income can be taxed:

   - where the production takes place, in which case the CIT is said to be source based;
   - at the location of the company headquarters (place of effective management) and shareholders (residence based); and finally
   - where the consumption takes place, in which case the tax regime is said to be destination based.

The latter dimension is specific to international taxation issues. Capital income is easy to shift so source/residence based systems are prone to tax optimisation and can be expected to distort the behaviour of both companies and governments. In addition, company headquarters can be moved from one country to another with relative ease. Destination based systems are considered less prone to these matters as tax is paid where the consumption takes place. Unlike capital and profit, consumption is much more difficult to reallocate across differing countries. Such a feature may alleviate some of the issues raised by the traditional corporate income tax at the international level.[13]

[13] Devereux M.P. and Sorensen P.B., (2006); de la Feria R. and Devereux M.P., (2014).

Table 1: CIT and its existing reform models within this two dimensions framework[14]

Location of tax base	Type of income subject to business tax		
	Full return to equity	Full return to capital	Rent
Source country	1. Conventional corporate income tax with exemption of foreign source income	4. Dual income tax 5. Comprehensive Business Income Tax	6. Corporation tax with an Allowance for Corporate Equity 7. Source-based cash flow corporation tax
Residence country (corporate shareholders)	2. Residence-based corporate income		
Residence country (personal shareholders)	3. Residence-based shareholder tax		
Destination country (final consumption)			8. Full destination-based CFT 9.VAT-type destination based CFT

As illustrated in the above table there have been several proposals to improve CIT and tackle some of its shortcomings:

- The dual income tax combines a proportional tax rate on all net capital income with a progressive tax on labour and pension income. By taxing the full return to capital it introduces neutrality regarding debt and equity financing in comparison to CIT.
- Likewise, Comprehensive Business Income Tax (CBIT) eliminates the difference between equity and debt by disallowing deductibility of interest from taxable income.
- Allowance for Corporate Equity (ACE) taxes the investment's economic rent by deducting the normal return to capital from the tax base. It does so by allowing the deduction of a notional interest on equity. In doing so it reduces investment distortion brought by CIT. Furthermore, by including a separate allowance for the cost of equity, it also neutralizes the distortion between debt and equity financing.
- Finally, CFT systems only tax the economic rent[15]. By comparison with other proposals, CFTs stand out as they can be destination based.[16]

3.1.4 Evolution of economic environment has revived the interest for CFT

The Meade Committee advocated in 1978 that CFTs were more desirable than CIT on the grounds that they were non distortionary. Indeed they tax the economic rents[17],

[14] Auerbach A.A., Devereux M.P. and Simpson H., (2008).
[15] See section 3.1.4.
[16] Devereux M.P. and Sorensen P.B., (2006); Zee H.H., (2006); Auerbach A.A., Devereux M.P. and Simpson H., (2008).

leaving the normal return earned by a marginal investment free of tax. This is achieved by allowing all expenses to be deducted from taxable profits as they are incurred, essentially taxing positive (inward) and negative (outward) cash flows at the same rate. In consequence, they do not affect the decision and the scale of investment and do not discriminate in favour of a source of finance. However, since the 1978's Meade Committee, the economic environment has changed.

Development of financial services and economic activity

In industrialized countries, the shrinkage of the manufacturing sector came along with the increase in importance of the services and financial sectors:

- The finance industry has grown and represents a potentially large revenue base for governments.
- Depreciation of buildings and plants, which used to be an important issue under CIT, is now less important (except in certain sectors where investment costs are still high, such as mining and exploitation of oil and gas resources).
- Innovation in financial instruments leads to less clear distinction between debt and equity.

Globalization: flows of capital and profit

Discrete investment choices have intensified with globalization and multinationals face the issues of where to locate their production facilities and their profits between different jurisdictions.

Tax competition between countries and the downward pressure on tax rate has intensified: in order to attract internationally mobile capital in their country, a jurisdiction has to offer a business environment comparable to what is available elsewhere.

Revived attention for destination-based CFT

According to the academic literature, a destination-based CFT is one of the best options in the current economic environment. Since the Meade Committee the focus has partially shifted from the neutrality with respect to the source of finance to location choice neutrality and more generally international taxation issues (See section 3.1.7.3).

[17] Economic rent is any payment to a factor of production in excess of the cost needed to bring that factor into production..

3.1.5 Basic forms of a pure CFT as discussed in academic literature

3.1.5.1 R-based CFT

An R-based CFT by definition is characterized to tax cash-inflows of a business less cash-outflows. Since, from an economic standpoint, only rents from the activity shall be taxed, but not rents resulting from the financing of the business, the rules determining the tax base need to eliminate flows relating to the financing from the entirety of the cash flows generated by the business.

The tax base is the net cash-inflow from a business (i.e. the difference between the sales of goods and services and purchases of goods and services from other businesses and employees).[18] Following the approach of the Meade-Report, the following flows qualify as taxable income and as tax-deductible expense:

- The cash-inflows consist of income from:
  - the sale of products;
  - the sale of services; and
  - the sale of fixed assets and inventory.
- The cash-outflows consist of expenditure relating to:
  - the purchase of materials;
  - the payment of wages and salaries; and
  - the purchases of other services and goods used in the business, including the purchase of fixed assets and inventory.

As cash flows of financial items and related to the financing of the business are irrelevant for an R-base CFT, the following items are excluded from the calculation of the tax base:

- Cash inflows resulting from:
  - increase in creditors of loans in money and money equivalents;
  - decrease in debtors of loans in money and money equivalents;
  - increase in overdraft of bank accounts etc.;
  - decrease in cash balance held;
  - increase in other borrowing of money/financial assets;
  - decrease in other lending of money/financial assets; and
  - interest received.
- Outflows resulting from:
  - decrease in creditors;
  - increase in debtors;
  - decrease of overdraft;

[18] The Institute for Fiscal Studies, (1978), p. 230 et seq.

- increase in cash balance;
- decrease of other borrowings;
- increase in other lending; and
- interest paid.

Based on the rationale of a CFT, as outlined in section 3.1.2 of this report, the following features are essential in an assessment of whether a tax which contains (some) of the above features is in essence a CFT, and not a CIT with investment incentives.

1. Timing.

   Taxation of net revenue takes place only upon actual receipt of payments / or effectuation of payment. GAAP-rules on relevance of a transaction for profit determination are irrelevant, as well as any other system of determining the amount of deductible expenditure depending on the use over time of a capital asset, or the deduction claimed for inventory depending on inventory held.

2. Accruals

   Accruals (like contingency reserves) are per se irrelevant for determination of the tax base. They represent current risks to incur expenses in the future and reflect principle of prudence which is inherent to many accounting systems.

3. Interest payments

   Third, the treatment of interest paid. It should be excluded from the tax base in order for it to meet the CFT criteria.

The above detailed outline of the features of criteria can be abbreviated into the following, shortened description which we use in the remainder of this report as a bench-mark description of a pure R-based CFT system and its features.

R-based CFT

The tax base is the net cash-inflow from a business i.e. the difference between the sales of goods and services and purchases of goods and services from other businesses and employees. Taxable cash-flows result from “real activities” only.

Pure financial flows from financial transactions such as interest from granting loans as well as payments made in the context of a financial transaction (e.g. a repayment of debt) are disregarded. No deduction is allowed.

Taxation of net revenue takes place only upon actual receipt of payments / or effectuation of payment. Capital expenditure is immediate expensed, i.e. purchases of assets (buildings, equipment, inventories) are deducted from the tax base, as well as all purchases of inventory. Inflows from the sale of assets and inventory increase the tax base. Accruals (like contingency reserves) are per se irrelevant.

3.1.5.2 R+F-based CFT

The key difference between an R-based CFT and an R+F-based CFT is that financial flows are included in the tax base of an R+F-based CFT. The tax system could be construed as a dual system, with separate calculations and tax rates for real and financial flows.

The relevant features of an R-based CFT have to be present, with the exception of the exclusion of financial flows. Thus, an R-based tax base is the net cash-inflow from a business i.e. the difference between the sales of goods and services and purchases of goods and services from other businesses and employees. Taxation of net revenue takes place only upon actual receipt of payments / or effectuation of payment. Capital expenditure is immediately expensed, i.e. purchases of assets (buildings, equipment, inventories) are deducted from the tax base as are all purchases of inventory. Inflows from the sale of assets and inventory increase the tax base. Accruals (like contingency reserves) are per se irrelevant.

In addition to these features, an R+F-based CFT taxes the net position of financial flows. Financial flows from financial transactions reduce/increase the tax base.

The following features are present:

- Interest paid on debts decrease the tax base,
- Interest received for borrowed amounts increase the tax base,
- Amounts borrowed increase the tax base,
- Repayment of past borrowings decrease the tax base,
- Amounts received from repayments of loans increase the tax base, and
- Amounts lent decrease the tax base.

R+F-based CFT

The tax base is the net cash-inflow from a business i.e. the difference between the sales of goods and services and purchases of goods and services from other businesses and employees. Taxable cash-flows result from "real" and "financial" activities.

Taxation of net revenue takes place only upon actual receipt of payments / or execution of payment. Capital expenditure is immediately expensed, i.e. purchases of assets (buildings, equipment, inventories) are deducted from the tax base as are all purchases of inventory. Inflows from the sale of assets and inventory increase the tax base. Accruals (like contingency reserves) are per se irrelevant.

3.1.5.3 S-based CFT

The S-based CFT is economically equivalent to the R+F-based CFT. The key features in terms of economic effects are met equally by an S-based CFT. Yet, the design is very different. It is furthermore, at least at first sight, less complex. The S-based CFT has as its tax base the net cash flow vis-à-vis shareholders. Tax is levied on the net cash-flow relating to inflows and outflows from/to a company from its shareholders. It measures the "success" of a (corporate) business by taking into account the shareholder contributions and profit distribution provided to the shareholders.

Over the lifetime of the corporation the tax base by definition equals the "profits" generated through the corporation's business. However, the S-based CFT cannot result in a tax burden equalling the R-base taxation as it is not possible under an S-base CFT to distinguish between real and financial cash-flows. It is the gross, net cash-flow position that is taxed.

The following features distinguish the S-based CFT:

- The tax base is the net distribution of a corporation to its shareholder:
- Open distributions increase the tax base,
- Repurchase of shares increase the tax base,
- Increases in own shares reduce the tax base.
- There is no profit calculation needed at level of the corporation.

Exactly as under the R-based CFT and the R+F-based CFT, the S-based CFT, taxation takes place only upon actual distribution of profits (open or "hidden" in benefits provided to shareholders not linked to work done for the shareholding). As a consequence, acquisitions of capital assets, inventory and inflows from sale of assets and inventory are irrelevant. These are not affected by the tax, except for the fact that the S-based CFT creates a preference to invest in the company. As long as the profits stay in the company, no tax is levied. Accruals (like contingency reserves) are per se irrelevant.

S-based CFT

An S-based CFT taxes the cash-flows from a corporate entity to its shareholders. Contributions into the corporate entity's equity are deductible from the tax base. Over the lifetime of the entity, the net profit of the business is taxed, however, only upon the distribution of the proceeds to the shareholder. If a shareholder receives other benefits from the entity, e.g. fringe benefits, the value of these benefits is taxable. Other than under an R-base or an R+F-base CFT, retained earnings remain untaxed.

3.1.5.4 International dimension of CFTs

There are two important international dimensions with regard to a CFT: first, the consequences in the international context of the different characteristics of CFTs compared to the CIT; and second, the prospects of the CFT to create a more sustainable solution to address the problem of profit shifting, currently being experienced under the traditional CIT systems.

In academic literature, a distinction can be drawn between proposals advocating source- and residence-based CFTs, and proposals advocating destination-based CFTs. The aspect of allocation of income has not been the focus of the early literature on CFT, following the classical approach of source- vs. residence-based allocation of income. Yet, newer articles propose a so-called destination based CFT. Under such a CFT, the profit made by an enterprise is taxable in the country where the customer buying the goods or services is located. In other words, the country of the market shall have the right to tax the profit generated by an enterprise.

In contrast, under the classical principles of profit allocation to countries (which can be found in nearly all classical accounting-based corporate income tax systems), income is taxed in the country where the production of the goods or services (including its distribution) takes place[19], i.e. where the profit is deemed to be earned[20]. This follows from the fact that, as a principle, business income is taxable in the hands of the owner of the business (individual or legal entity) in the country of its residence[21]. If the owner produces the goods or services in a country other than his residence country, the income is allocated to the country where the production takes place, if there is a permanent establishment[22]. However, the country of residence remains in a position to tax such profits, but (typically) has the obligation to avoid double taxation (either by exempting such income or if such income is included in the tax base, to credit foreign taxes levied by the source state).

Permanent establishments may be, but are not necessarily, located in the country of residence of the customer. Hence, under the source/residence concept the customer's country is not necessarily entitled to tax the profit from selling goods in a cross-border situation and, if it is entitled to do so, it may only tax the full amount of profit if the

[19] See de la Feria R. and Devereux M.P., (2014), p. 6
[20] de la Feria R. and Devereux M.P., (2014), p. 6
[21] Notably, the overwhelming majority of corporate tax systems the statutory seat of an entity as well as the place of management and control gives rise to an unlimited tax liability of the entity. See in this respect also Art. 4 para 1 and 3 and Art. 1 OECD-Model Convention and Art. 7, 10, 11, 12, 13 OECD-MC for an allocation of taxing rights between the countries, see also de la Feria R. and Devereux M.P., (2014), p. 6
[22] See Art. 5 of the OECD-MC as well as Art. 10 para. 4, 11 para. 4, 12 para. 3 and 13 para. 2 OECD-MC.

entire production takes place in its territory. Thus, the right to tax profits is allocated to the country in which the production of the goods or services (source concept) and/or where the residence of the owner of the business is located.

A destination-based tax assigns the entitlement to tax income to the country where the customer is located[23]. This approach aims to avoid distortions which academic literature considers to be inherent to classical tax systems with a source/residence concept. To establish such a feature, two approaches are discussed in literature[24].

- On the one hand, profits from the export of goods and services (sales to foreign customers) would not be included in the tax base of the residence state of the owner of the business and profits from imports (sales to resident customers) would be subject to taxation[25].
- On the other hand, profits from the export of goods and services would be taxed in the hands of the domestic supplier, but such profits should then be taxed at the tax of rate of the destination state and the tax levied on the income from the exported goods or services needs to be remitted to destination state.

In cross-border transactions, profits derived from imports would be taxed in the state of the foreign supplier under the tax rate of the destination state and the tax levied on that income would be remitted to the destination state. It is also pointed out in the literature that in order to avoid distortions, it would be sufficient that the source / residence concept is maintained for purposes of income allocation, while the tax rate - which the state of the supplier applies - would be the one set by the country where the consumer is located[26].

Hence, a destination-based CFT can be deemed to exist where:

- Income related to goods or services being supplied to a foreign customer is exempted while income of a foreign supplier of goods or services to a domestic customer is subject to tax or,
- Income related to goods or services being supplied to a foreign customer is taxable in the supplier's state but is taxed under the tax rate set by the destination state and the tax levied on this income is remitted to the destination state or,
- Income related to goods or services being supplied to a foreign customer is taxable in the supplier's state but is taxed under the tax rate set by the destination state.

A source-/residence based CFT can be deemed where:

- The state of the supplier taxes the income of a domestic supplier of goods or services, regardless of where the customer is located. The tax rate in the state of the customer does not play a role for determining the tax rate applicable to the income of the supplier.

[23] See Bradford D.F. (2003), p.6.
[24] See de la Feria R. and Devereux M.P., (2014), p. 10.
[25] See Bradford D.F., (2003), p. 6; de la Feria R. and Devereux M.P., (2014), p. 3.
[26] de la Feria R. and Devereux M.P., (2014), p. 10.

- Relief for double taxation is granted only if the income is deemed to be foreign sourced (e.g. where a foreign permanent establishment is deemed to exist), either by way of crediting foreign tax or by way of exempting such income.
- Income of a foreign supplier is deemed to be domestic source income (e.g. due to the existence of a domestic permanent establishment) and is taxed in the source state under the source state's statutory tax rate.

3.1.6 Advantages: Motivations for introducing a CFT

The following advantages of CFT can be gathered from the economic literature.

3.1.6.1 CFT fosters investment

CFT has a zero marginal effective tax rate (METR). The METR calculates the relative difference between the marginal cost of capital before and after tax.

The METR affects the equilibrium level of the investment in the economy. The higher the marginal cost of capital, the lower is the equilibrium level of investment. A zero METR value means that there is no distortion brought by taxation on the equilibrium level of investment.[27]

In the absence of taxation, the marginal cost of capital would be equal to the opportunity cost (the return from alternative choices) for investors – being the normal return on investment. Therefore, a zero METR means that the deductions allowed under a tax system are sufficiently large that the normal return is exempt from tax, while the above normal returns are subject to tax at the statutory rate (since they are not offset by any deduction).

Given that under a CFT the tax base corresponds to the rent i.e. above normal returns, its METR is always zero.

3.1.6.2 CFT establishes neutrality between debt and equity

As mentioned in the introduction, the CIT tax base is the full return to equity. The deduction of interest costs reduces the user cost of capital under CIT. As a consequence, and at the company level, investment financed by debt has a lower user cost than the investment financed by equity. Under a CIT this difference provides an incentive to finance investment with debt. It should be noted that this difference may be mitigated by the fact that, in the hands of the investor, dividends and capital gains on shares may be taxed more lightly than interest.

On the contrary, from an economic perspective under CFTs, only investment rent is taxed. The rent of an investment project corresponds to the difference between super normal and normal return, normal return being the return required to cover costs and risk. As above-normal returns are independent of the way the investment has been financed, this tax base remains the same whether it is financed through debt or equity. Thus, there is neutrality between debt and equity financing. [28]

[27] Zee H.H., (2006); King M., (1987).
[28] Zee H.H., (2006); King M., (1987); Auerbach A.A., Devereux M.P. and Simpson H., (2008).

Since CFT should ensure the neutrality between debt and equity, one may expect that with the introduction of a CFT companies should reduce their leverage, strengthening their financial structures.

3.1.6.3 CFT provides neutrality between present and future investment

Immediate relief for expenditure, whether capital or operating in nature, means neutrality with respect to the choice between present and future investment. The immediate relief itself is an incentive to investments, compared to the situation under a classical CIT which does not allow for such immediate relief. The neutrality exists because the tax does not affect the return to marginal investments.

3.1.6.4 Immunity to inflation

The base of a CFT is independent of inflation, contrary to the CIT base, where inflation erodes the values of depreciable assets, inventories, capital gains and principal of debt. Investments expenses and taxation are realized in the same time period.[29]

3.1.6.5 Compliance and administrative simplicity

CFT requires no adjustment for inflation, nor indexation for provision depreciation, contrary to CIT.[30] In principle, these features should make CFT easier to administer by the tax authorities and easier to comply with for the taxpayers.

3.1.6.6 Limited tax optimization and transfer pricing

Under a destination-based CFT, tax is collected where the consumption takes place. As moving final consumers for tax reason is more difficult than shifting profits, tax optimisation becomes more difficult reducing the scope of aggressive tax optimisation.[31]

3.1.7 Specific issues with pure CFT systems

3.1.7.1 Transitional issues

The issue of how to move from a CIT to a CFT and the various transitional issues that would arise have been addressed in academic literature but not extensively[32].

The main issue identified is that, in the transition period, companies have a stock of depreciation allowance that they expect to be able to carry forward and deduct. Once a CFT is put into place, mechanisms should be implemented to provide relief for depreciation allowance on past investment.

One option could be that all the available deductible allowances are deducted immediately at the time of the implementation of a CFT[33]. Another option would be a denial of all depreciation of assets being part of the business at the time of the

[29] McLure Ch.E. Jr and Zodrow G.R., (2007).
[30] Zee H.H., (2006); King M., (1987); McLure Ch.E. Jr and Zodrow G.R., (2007); Devereux M.P. and Sorensen P.B., (2006).
[31] Auerbach A.A. and Devereux M.P., (2012), p. 8, p. 30 et seq.; Auerbach A.A., Devereux M.P. and Simpson H., (2008); OECD, (2007), p. 214 et seqq.
[32] King M., (1987), Bradford D.F., (1998).
[33] See 4.1 of the Wilson-Report, (2002), referred to as “free entry”.

implementation of the CFT[34]. Still another option is that the depreciation for past investment could continue under the old rules and hence apply a certain part of the former CIT system in parallel to the new introduced CFT[35]. The deductibility could also be spread over a specific period, in order to preserve the tax revenue of the State.[36].

Also with respect to profits which are recognized in the tax base of an entity before the cash-flow has occurred, transitional rules need to ensure that upon the introduction of a CFT profits are not taxed twice.

Where the introduction of S-base taxation is considered, rules need to be implemented to deal with retained earnings having been taxed in the fiscal years in which the profit arose in order to avoid that this profit is taxed again at the time of the distribution.

3.1.7.2 Anti-Avoidance

In practice, during discussions of practical scenarios of implementation of CFT it turned out that these types of tax systems have inherent weaknesses requiring the creation of specific anti-avoidance rules.

The most obvious deviation from classical tax systems, the immediate expensing of investment expenditure, appears to be a mechanism which allows taxpayers to strongly influence the tax basis of a specific fiscal year, as the full amount of the acquisition price is available for immediate deduction, while under the classical CIT systems the diminishing effect of the acquisition of an asset being used for more than one fiscal year is, under the depreciation rules, spread over the (deemed) lifetime of the asset. Moreover, if there is room for shifting the payment between two tax years a taxpayer can decide in which fiscal year a specific expenditure is effective. Furthermore, a taxpayer can agree with his supplier on the most tax efficient point of time or mode of the payment. However, in practice, this seems not to have led to specific anti-avoidance rules, as the immediate expensing has also the effect of fostering investment by providing a cash tax advantage immediately upon the implementation of an investment decision. Anti-avoidance rules could mitigate this (desired) effect. Further, as in subsequent fiscal years no depreciation of the acquired assets is possible, the advantage of an immediate expensing disappears over the time (only the timing effect of a deferred of taxation remains, compared to a tax system with depreciation rules).

Where an R-based CFT is considered, a taxpayer might be tempted to avoid taxation by structuring expenses, which have a financial nature, as expenses with a real character, while cash-inflows with a real character could be structured in a way that a financial character is deemed.

For an S-based CFT, it is crucial to tackle transfers of earnings to the shareholder or another person related to the shareholder without using a profit distribution to transfer the earnings. All distributions of profit, whatever the form they take, must be covered in order to capture the correct S-base. Hence, anti-avoidance rules need to declare to following transfers as taxable events:

[34] See 4.1 of the Wilson-Report, (2002), referred to as “cold turkey”.
[35] See 4.1 of the Wilson-Report, (2002).
[36] See 4.1 of the Wilson-Report, (2002).

- Hidden profit distributions
- Payments which deviate from the arm's length principle with respect to the difference between Fair Market Value (FMV) and the selling price of assets transferred between a shareholder and the company[37]
- Fringe benefits
- Donations
- Other expenses which are not business-related

3.1.7.3 Issues with the different types of CFTs (international dimension)

The CFT differs in its characteristics from the CIT and questions arise as how a CFT would function in an international taxation setting tailored around CIT's. For example, all investments are immediate expensed under a CFT. This raises the question as to whether that could cause issues under controlled foreign corporation (CFC) systems[38] which various countries have in place and which determine low taxation from the perspective and by applying their own (classical accounting based) CIT to the activities of a foreign subsidiary. If this subsidiary is taxed locally under a CFT, immediate expensing can result in a low taxation from the perspective of the country of the parent company in the year an investment is made. Further, it needs to be ensured that is treated as a creditable tax in countries applying the credit method for foreign sourced business income (see below 3.1.8.1).

Similar issues arise with regard to other features of the CFT, namely the timing of taxation and the lack of distinction between debt and equity financing. Under current rules, thin capitalization rules often apply to protect the domestic CIT base from erosion through excessive, often internal, financing of the business through debt, as opposed to equity. If no distinction is made under a CFT, it is not clear how these rules shall apply where a CFT jurisdiction interacts with a CIT jurisdiction. Similarly, it is unclear how a situation of double taxation would be defined as the timing of taxation differs between a CFT and a CIT.

In addition, particular issues arise within the EU, as regards the relationship with present harmonization within the EU (Merger Directive[39], Parent Subsidiary Directive[40] and Interest and Royalties Directive[41]). The scope of the Directives is limited to corporate income taxes, which are listed individually in the Directives[42]. The question arises whether a move from a classical CIT to a CFT would render the EU tax Directives inapplicable. In this respect it should be noted that each of the Directives is flexible in this respect as they explicitly cover also taxes which replace the listed corporate income taxes. Hence, in situations where a CIT is replaced by a CFT, the applicability of these Directives should not be affected as long as the specific CFT aims

[37] Same issues exist where a company takes out a loan from his shareholder with an excessive interest rate.
[38] CFC-Systems seek to impute the income of a foreign low taxed subsidiary to its domestic parent in order to combat profit shifting to a more favourable tax regime. Typically, CFC regimes apply to passive income only.
[39] Directive 2009/133/EC of 19 October 2009, OJ L 310 of 25.11.2009, p. 34.
[40] Directive 2011/96/EU of 30 November 2011, OJ L 345 of 29.12.2011, p. 8.
[41] Directive 2003/49/EC of 3 June 2003, OJ L 157 of 26.06.2003, p. 49.
[42] See Annex 1 part B of the Merger Directive (fn. 44); Annex 1, part B of the Parent Subsidiary Directive (fn. 45) and Art. 3 (a) (iii) of the Interest and Royalty Directive.

at taxing corporate profits. This might be viewed differently where CFT's accompany existing CIT's (e.g. where they have the function to provide a minimum taxation or where they are levied in addition to the classical CIT).

Specific issues arise with respect to an S-based CFT. Since the profits of an entity are taxed upon the distribution, the tax is close to a withholding tax on dividends. Such withholding taxes are prohibited under Art. 5 of the Parent-Subsidiary Directive. With respect to the Estonian approach to tax corporate profits by way of an S-base CFT, a discussion arose prior to the accession of Estonia to the EU in 2004 whether the CFT is to be classified as a withholding tax[43]. In consideration of this discussion, the Act on the Accession to the EU allowed Estonia to levy its CFT until 31 December 2007[44]. However, the European Court of Justice held in its Burda-decision[45] that the levy of corporate income tax upon distribution under the former imputation tax system was in line with Art. 5 of the Merger Directive. Consequently, the Estonian taxation upon distribution was no longer seen as a withholding tax in the sense of the Parent-Subsidiary Directive, and Estonia was no longer required to abolish or alter its system of taxing corporate profits.

We have not found any contributions from (legal) scholars addressing these specific issues. How exactly a CFT would function in an international tax law setting seems not to have been addressed thoroughly[46].

A destination-based CFT has been proposed as a way to address the difficulties seen with the CIT in an international setting and the BEPS problems. A CFT could, it has been claimed, be either source/residence-based or destination-based[47]. According to Bradford, a destination based system settles the issue of transfer pricing, but would entail difficulties to realise as it would require that cross border flows of goods and services are monitored. Under a source-/residence based system, according to Bradford, the problems of profit shifting (or "tourism problem" as he calls it) would remain.

A destination-based CFT has been proposed by many scholars[48]. It has been claimed that theoretically such a tax would not distort the pricing or location decisions of multinationals (i.e. profit shifting)[49]. The difficulties discussed by Bradford with regard to the implementation of a destination-based CFT have been also discussed by Devereux & de la Feria (2014). It is evident from these commentaries that the

[43] See Uustalu E., European Taxation (2003), pp. 162, 165.
[44] See Annex 5, chapter 7 of the Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded, OJ L 236 of 23.9.2003, at. p. 816: "By way of derogation from Article 5(1) of Directive 90/435/EEC, Estonia may, for as long as it charges income tax on distributed profits without taxing undistributed profits, and at the latest until 31 December 2008, continue to apply that tax to profits distributed by Estonian subsidiaries to their parent companies established in other Member States."
[45] CJEU, judgment of 26 June 2008, C-284/06, Burda GmbH.
[46] See for a discussion Auerbach A., Devereux M.P. and Simpson H. (2010), chapter 6.
[47] See, for example, Bradford D.F., (2003).
[48] Avi-Yonah R., (2000), pp. 1670 et seq.; Bond S. and Devereux M.P., (2002); Devereux M.P. and Sorensen P. B., (2006); European Economic Advisory Group, (2007), pp. 121-32; Auerbach A.A., Devereux M.P. and Simpson H., (2010), pp. 837-893; Auerbach A.A, (2010); Auerbach A.A. and Devereux M.P., (2012); Devereux M.P., (2012), pp. 709-730.
[49] de la Feria R., Devereux M.P., (2014), p. 10; OECD, (2013).

destination-based feature refers to the destination of goods and services sold, rather than of the destination of the cash-flows. Thus, the taxation would, in principle, follow where consumption takes place.

Destination-based CFT could be implemented on an R or R+F basis[50]:

- R-base would give relief for exports, and tax imports on real activity. It would provide neutrality between debt and equity. However with such a CFT it would not be possible to tax the financial sector.[51]
- R+F-base would include both real and financial activities (comprising also mere financial cash-flows). It would include only domestic transactions in the taxable income. Border adjustments would apply to transactions with non-residents (borrowing from foreign bank would not generate taxable income and repayment to a foreign bank would not be relieved from tax).[52]

An S-based CFT should not be a suitable basis for a destination-based tax as the tax is levied upon distribution of the profits only. A destination-based approach would require documentation allowing to track back the countries to which the profits are to be allocated to and specific sourcing rules allowing for the determination of which parts of the profits of an entity (and to which country they relate) are deemed to be used for a specific distribution. In practice, a complex set of rules would be needed to ensure the destination-based character of an S-based CFT[53].

A destination based CFT was advocated as a fundamental tax reform in the EC report[54] on the taxation of the digital economy.

"Given the pace of technological development and the need to avoid creating barriers to trade more fundamental changes to the corporation tax system such as a destination based cash flow system could also be looked at, combining, if appropriate, various different building blocks to create an acceptable and workable system on the basis of the principles of neutrality and simplicity. [55]"

As has been noted by academics[56], this would entail a shift in where the corporate tax would be collected. Moreover, the jurisdiction which would have the right to tax would not necessarily remain the country where the profit is generated. When the income generating establishment is the entity to which tax charged is attributed to, the country (at least in theory) where the actual income is generated receives the tax

[50] See sections 3.1.5.1 and 3.1.5.2 for a detailed description of an R-based and an R+F-based CFT.
[51] See further section 3.1.5.1.
[52] See further section 3.1.5.2; Devereux M.P. and Sorensen P.B., (2006); Auerbach A.A., Devereux M.P. and Simpson H., (2008).
[53] We believe that rules providing for a country-by-country reporting, as currently discussed in the context of Action Point 13 of the BEPS-Project (OECD 2014) cannot provide the information necessary for the implementation of a destination-based S-based CFT, as under such a tax system profits of a corporation are taxed only upon distribution and not in the year the corporation makes the profits. Hence, these rules need to provide information of the origin (i.e. its destination) of the "profits" made probably years before the distribution. This goes beyond what is necessary for country-by-country reporting. In this context it may be mentioned that the former German imputation tax system created similar legislative needs with respect to tracking a company's profits initial corporate tax burden ("körperschaftsteuerliche Vorbelastung"). The rules providing for this information (by establishing specific accounts and sourcing rules for distributions) were highly complex.
[54] Commission expert group on taxation of the digital economy report, (2014).
[55] European Commission, (2014), p. 8.
[56] See e.g. de la Feria R. and Devereux M.P., (2014), p. 11; Hellerstein W., (2003), pp. 1-39.

created by that activity. If the productive activity is dissociated from the place where the tax is charged, the country that receives the revenue is no longer the country where the profit is generated, but another country, where the consumption of the productive activity takes place. Thus, implementing a destination-based CFT would entail a paradigmatic shift in the fundamental features of corporate taxation as compared to the current CIT systems.

Furthermore, if the destination-principle were applied to CFT, the issue arises as to where a supply of goods or services actually is made (or at least where it is destined). This issue is a key aspect of international taxation in VAT/GST[57]. The same issues would arise in a destination-based CFT. However, in contrast to VAT/GST systems (where tax charged to a business is in principle deductible and refundable, and thus situations of double imposition of tax do not always result in actual double taxation), under a CFT system situations of double impositions would have to be dealt with under double tax treaties. Under the EU VAT system, the equivalent to a "double tax treaty" exists in the form of harmonized rules for determining the place of taxation in the VAT Directive[58]. No such system exists for international (non-EU) transactions (only soft-law guidelines have been issued[59]).

Lastly, the above considerations concern the implementation of an R-based CFT as well as an R+F-based CFT. With regard to an R+F-based CFT, one additional issue arises, namely that there would be a need to distinguish real from financial transactions.

3.1.8 Issues with implementation of **CFTs**

There are several issues concerning the implementation of a CFT that need to be addressed.

3.1.8.1 Tax creditability

Countries that operate source-/residence-based taxes and do not exempt foreign-sourced income could refuse to regard CFT as a creditable tax. Foreign cash flows would then be subject to double-taxation which may deter foreign investment and thereby the adoption of CFT. Countries wishing to implement a CFT will therefore need to renegotiate existing double tax treaties with other countries applying the credit method.

We have received indications of that recent court decisions tend to indicate that CFT can be recognized as creditable by the US. This may pave the way to the adoption of CFT, as one of the key reasons provided for not adopting a CFT is the fact that it is uncertain how a CFT would function in an international tax law setting, and whether a CFT is creditable under current income tax legislation.[60]

[57] OECD, (2013).
[58] Directive 2006/112/EC of 28 November 2006, OJ L 347, 11.12.2006, p. 1.
[59] OECD, (2013), "OECD International VAT/GST Guidelines, Draft consolidated version".
[60] McLure Ch.E. Jr and Zodrow G.R., (1998); McLure Ch.E. Jr, Mintz, J. and Zodrow G.R. (2014).

3.1.8.2 Treatment of past investment

When a CFT is introduced companies have a stock of depreciation allowance that they expect to be able to carry forward and deduct. Once a CFT is put into place, transitional mechanisms might be needed to treat depreciation allowance on past investment. [61]

3.1.8.3 Anticipation effect

In the period between announcement and passed legislation companies' anticipation effect may lead to the collapsing of investment because taxpayers could defer investment until the CFT has entered into force, in order to have the new rules providing for immediate expensing applicable on planned investment. This could trigger an economic slump in the period prior to the system change. The timing of such a decision therefore requires careful consideration.[62]

3.1.8.4 Silent partner

Under a CFT government can be viewed as an investor. By allowing immediate expensing of the investment cost, a tax credit is provided and the government is taking a stake in the business and its future income, by funding parts of the investment cost. In a pure cash-flow system, the tax value of the investment should be refunded to the company if exceeding the tax value of cash inflows. Hence, unlike CIT, under CFT government revenue may be negative. Under a CIT, the shareholders take the risk that investments lasting several years will not yield profit. Under a CFT, the Government shares that risk by funding the tax share of the investment.

Government would need to recover its investment. In the absence of profits, the government, just like any investor, will lose its investment. Government tax revenues thus become fully dependent upon the success of the company. This increases the risk borne by the government under a CFT as compared to a CIT[63].

In addition, since investments are immediately deductible, a CFT is more dependent upon the economic cycle than a CIT. The CFT could be said to be pro-cyclical. The CFT burdens firms more than a CIT in recession, when the firms' investments are lower- and therefore cash outflows' credits for firms are lower. This is an undesirable feature for taxation in time of crisis. Moreover, this mechanism introduces more volatility in government revenue, since it is negatively correlated with the Gross Domestic Product[64].

3.1.8.5 Tax base and government revenue with a CFT

The introduction of a CFT as a replacement of a CIT carries several potential effects on corporate tax revenues.

The timing pattern of government revenues will change with the introduction of a CFT compared to a CIT. Because of the upfront deduction, compared to over the life-time of the investment under the CIT, there should be an effect on government revenues.

[61] King M., (1987).
[62] Ibid.; Wilson P, (2002)
[63] King M., (1987); Zee H.H., (2006).
[64] Panteghini P., (2007).

In addition, if looked at in isolation, under a CFT because of the fact that only rents are taxed, at the beginning, there will be a reduction of revenues. Over time, this may change if the CFT regime fosters investments (see below).

On the one hand, in theory the tax base is narrower under a CFT compared to a CIT. In comparison to CIT, only above normal returns are taxed under a CFT. Therefore, to collect the same amount of revenue, either the tax rate should be increased or another source of revenue needs to be activated.

On the other hand, with the transition to a CFT from a CIT, if the tax expenditures for corporations present in the current CIT were eliminated, the tax base would not necessarily be narrower. In this context since many CIT systems contain tax expenditures for corporations, the effect of moving to a CFT is ambiguous.

The above effect as regards the theoretical narrower tax base and the initial presumed reduction in revenue could be mitigated with the fact that a CFT should foster investment which will raise economic activity leading in turn to higher tax revenues. The relative strength of the different effects will determine the final impact on government revenues. If the new investments generate rents larger than those generated by the previous stock of capital, then revenues may ultimately increase.

3.2 Classical Corporate Tax Systems and other taxes with features of CFTs

3.2.1 Corporate Income Tax Systems addressing the debt/equity bias

3.2.1.1 ACE-Systems

A number of countries (e.g. Belgium, Italy, and Brazil) have a classical CIT system that provides for a notional interest deduction (also known as Allowance for Corporate Equity - ACE). Under these regimes, the amount of an entity's equity forms the basis of a deemed interest deduction (in some countries an increase of equity is taken as basis for the deemed interest deduction). The rationale behind such a notional interest deduction is to eliminate the wedge between equity and debt-financing by allowing for a deduction for equity financing.

Whilst the effect of such an ACE is similar to one of the main features of cash-flow taxes, it deviates from a cash-flow tax in that it does neither feature the cash-in, cash-out approach nor does it allow immediate expensing of acquisitions. Furthermore, an ACE only provides for a deduction calculated under a pre-defined interest rate, which may deviate from the interest rate an entity must pay at market conditions. Consequently, ACE systems are considered classical accounting based corporate income tax systems with the specific feature of granting a deduction for deemed cost of equity.

Whilst, by definition, an ACE can aim at eliminating the debt-equity bias and provides for neutrality with respect to marginal investment decisions and inflation, other shortcomings of the traditional corporate income tax (like the vulnerability to profit shifting, the complexity of profit determination) are not addressed by an ACE.

3.2.1.2 CBIT-Systems

CBIT was proposed by the U.S. Department of the Treasury in 1992 but it has not been implemented in practice[65].

CBIT-Systems aim at eliminating the debt-equity bias of classical CIT systems by disallowing interest expenses deductions on a company's debt[66]. By ignoring such expenditures, equity is treated in an identical manner as debt. In both cases related expenses (which are only fictitious in case of equity funding) do not decrease the tax base of an entity. Under a CBIT, both the (deemed) cost of investment and the actual cost of debt funding is not deductible and hence is included in the tax base. Nevertheless, the basis of the tax remains the classical accounting based corporate income tax system.

3.2.2 CFT's applying to SME's only

The specific features of cash-flow tax systems have attracted the attention of tax policy makers since such systems might be a suitable option to tax small and medium-sized entities. In particular, interesting features are: the fact that – compared to traditional CIT's - a cash-flow tax might operate with a relative simple legislative set-up; the fact that such a system can - not only replace the CIT - but also other taxes or social insurance contributions (see in this respect the Hungarian KIVA (4.4.1) and the Brazilian "Simples National" (4.3.2)).

Further, the fact that investment in business assets allows for immediate expensing is perceived to be a useful attribute to foster investment for this specific group of businesses.

Some CFTs applying specifically to SMEs may be restricted to individual taxpayers only (being out of the scope of our report). In some countries we have found CFTs applying also to corporate taxpayers (see in this respect Hungary, Brazil). In another country there were discussions about a CFT for SMEs but policy makers finally decided to abstain from implementing such a tax (New Zealand, see 4.6.2 and 4.6.3)

3.2.3 Corporate Income Tax Systems allowing for immediate expensing (Extraction industry)

Certain countries have implemented specific CFT features in their corporate income tax system applying to certain sectors (typically the extraction industry) by allowing for immediate expensing of investment expenditures. Under the classical corporate income tax systems, such expenditures for acquisition of recordable assets are deductible over a (pre-determined) lifetime period of the acquired assets. Under a system with deferred recognition of investment expensing, the acquisition of an asset affects the taxation of all tax assessment periods following the year of acquisition until the end of the lifetime period, increasing the complexity of the system. Under CFT systems, there is an immediate expensing of investment cost.

[65] For a detailed discussion, see de Mooij R. and Devereux M.P., (2008).
[66] See Auerbach A.A, Devereux M. P. and Simpson H., (2008), p. 878.

In order to reduce complexity and to foster investment, a number of countries which run a classical accounting based corporate income tax allow for an immediate expensing of such investment expenditure. Some of these countries limit this privilege to specific sectors of their economy, which is mainly the extraction sector (e.g. Norway), while other countries apply this principle to SMEs (e.g. Hungary, Brazil, see 3.2.2. However, extraction taxes can also be genuine CFT's (like Australia). The system for taxing the oil and gas industry in the UK shows several similarities with a pure cash-flow tax. The system allows for immediate expensing of all acquisitions (which is a clear CFT feature), but the income is calculated as in the traditional CIT.

3.2.4 Other Taxes with cash-flow features

3.2.4.1 Cumulative turnover taxes and Gross Receipts Taxes

A basic, and presumably also the original, form of cash-flow tax is the cumulative turnover tax. The tax base constitutes the turnover of a company during a specific period (or, originally in the Roman Empire, on a particular place, namely the market square). The formula is simple: the total amount of revenue during a period is multiplied with the tax rate and the result is paid in taxes.

Cumulative turnover taxes, enacted as consumption taxes, were frequently used in Europe before the introduction of the Value Added Tax (VAT) in the 1960s. These taxes were charged on gross turnover and presumed to be passed on in the prices of goods and services. They were abolished with the introduction of the First VAT Directive, as they could not exist in a Community with a free market, as exports would either be either subsidized or taxed (and it was impossible to know which was the case for each export and it was hence impossible to find the correct level of refund). The VAT is the unique turnover tax allowed presently in the EU, as set out in Article 401 of the EU VAT Directive.

As the tax is based on cash inflows, it could be placed in the category of cash-flow taxes. However, it deviates from the characteristics described above. Gross turnover tax systems are not neutral to how the business is conducted, i.e. the organisation form (which the CFT is). A cumulative turnover tax could be avoided simply by integrating businesses in the supply chain (vertical integration). The CFT could not be avoided in that manner. The cumulative turnover tax thus distorts investment, production and organizational behaviour in a manner the CFT does not do. Consequently, and despite the fact that it is based strictly on cash-inflow, cumulative turnover taxes do not qualify as a cash-flow tax for the purposes of this study. But they undoubtly have cash-flow features in that they use cash inflow as the tax base.

Gross receipts taxes are used as taxes on business activities in some countries, notably in some States in the US (see Annex 5.1) and in Brazil (on financial operations – see Annex 5.2). These are referred to as cash-flow taxes. However, they share the characteristics of cumulative turnover taxes that they are charged on sales proceeds or on the value of the financial operations only (i.e. charged on cash inflows without regard to cash-outflows). In our analysis, gross receipt taxes do not qualify for the status of CFT systems but they may be considered as having elements of a CFT.

3.2.4.2 Consumption-type and production-type VATs, including Italian IRAP

In the EU, the EU VAT Directive harmonises a consumption-type VAT system. The system is intended to tax consumption expenditure, but it is levied at all stages of the production and distribution process.[67] Article 401 of the EU VAT Directive forbids the introduction of other turnover taxes other than the VAT. The Court of Justice of the EU has in one case been confronted with the legality of a production-type VAT, namely the Italian IRAP (a regional tax on productive activities).[68]

The Court of Justice found that, whereas VAT is levied on individual transactions and its amount is proportional to the price of goods or services supplied, IRAP is, in contrast, a tax charged on the net value of the production of an enterprise in a given period and it is not levied on transactions. The Court also noted that the IRAP is not intended to be passed on to the final consumer in a way that is characteristic of VAT. In other words, IRAP is thus a production-type VAT and not a consumption-type VAT.

A production-type VAT would thus be allowed at the EU level. This would not hold for a consumption-type VAT with similar characteristics as the EU VAT. Furthermore, a consumption-type VAT could not be considered as a replacement for a CIT, provided that the intention is the same, namely to tax values created at the level of a corporation. A consumption-type VAT taxes consumption which is a different tax base than the value created by a business. So, provided that the intention is not to change completely the tax base in the tax mix, a consumption-based VAT is not a replacement for the CIT. In addition, in a consumption-based VAT, it is the supplies that are subject to VAT, not the turnover which is used merely to measure the value of the supplies. This differs significantly from the objective of a CFT where the cash-flows themselves constitute the basis for the calculation of the tax. The objects of the cash-flow taxes compared to the consumption-based VAT are thus different. That is also reflected in how the taxes are levied. Production type VAT systems are accounts based rather than based on the turnover of each individual supply. For all these reasons, we have concluded that consumption-type VATs do not fall within the scope of the purposes of this report.

As a consequence, we have excluded systems that are calculated primarily using the accruals method meaning that the tax is not calculated on the cash-flows. As an example, we have excluded the Italian Regional and production tax IRAP from the scope of this study. In fact, the IRAP taxable basis is basically equal to the so called “net value of production”, which is calculated by subtracting the cost of production from the value of production as resulting from the Profit and Loss of the Italian Financial Statements. It can therefore be stated that IRAP does not depend on the cash flows of the company but rather on costs and revenues accounted in the Financial Statements according to the “accrual basis” accounting principle (as provided by the Italian Civil Code) (see section 4.7.7).

[67] See Article 1 of the EU VAT Directive.
[68] CJEU, judgment of 3 October 2006, C-475/03, Banca popolare di Cremona.

3.2.4.3 Financial Activities Tax

In its most general definition, the financial activities tax (FAT) is a tax on the sum of profits and remuneration of financial institutions. The tax has been defined as a direct tax on cash-flow based value added.[69] It is a framework definition of three different kinds of taxes.[70]

1. FAT 1 has as its tax base wages plus profits. It is used to compensate for the fact that financial institutions are taxed on their inputs with a Value Added Tax (VAT) rather than on their outputs (they are exempt). A FAT designed as a tax on wages and profits taxes the value added created by the financial institution that escapes taxation with VAT.

   The tax base could, exactly like a VAT, also be defined based on the inputs and outputs of a business (real output and remuneration for financial services – real input and expenditure for financial services)[71]. However, due to the problems of measuring financial expenditure the tax base in a FAT could also be measured only on real input and output but also at a lower rate imposed, to compensate for the fact that financial transactions are left out of the calculation.[72]

   FAT 1 could be designed in such a way that it is similar to an R-based cash-flow tax. However, in contrast to the cash-flow tax discussed by academics, it is not collected through the measuring of cash-flows, but on the components of value added created. Consequently, only a FAT 1 that measures the value added through tracing cash-flows should be considered a CFT and not one that measures value added through the addition system. As a consequence, a FAT on wages does not fall within the scope of a report on cash-flow taxes.

   As a consequence, the FAT on wages in Denmark, and the Single Business Tax in Michigan are not classified as cash-flow taxes for the purposes of this report. Israel has been reported to have a broad-based FAT 1[73]. Our research however, could not confirm the cash-flow character of the Israeli FAT.

2. FAT 2 is designed to tax the economic rents in the financial sector. Or any returns to capital and labour in the financial sector above the minimum their providers require[74].

3. FAT 3 is designed to discourage risk taking by taxing high returns higher than low returns. Essentially, it is a tax on 'very' high wages and profits.

FAT 2 and 3 are closer to direct taxes than indirect taxes and could not be translated into cash-flow terms. They clearly fall outside the scope of a report on cash-flow tax.

[69] Naess-Schmidt H. S., (2013).
[70] International Monetary Fund, (2010).
[71] Compare Tait, (1988).
[72] See Annex 6 of International Monetary Fund, (2010).
[73] International Monetary Fund, (2010).
[74] International Monetary Fund, (2010).

3.3 Scope of the study for mixed systems sharing specific features with CFTs

For our country research, we have defined a pure CFT to comprise the following essential elements: a tax which can be classified as a R, R+F or S-based system with immediate expensing[75], from an economic viewpoint an equivalent treatment of debt and equity, based on cash in-cash out without accrual accounting surrogating the corporate tax and striving for administrative simplicity. In addition we have studied those countries which implemented a tax which presented essential elements of a CFT substituting the corporate tax. Mixed tax systems with a relative low degree of conformity with a pure CFT are not analysed in this report while accounting based tax systems which have been altered in a way that they share most of the characteristics of a pure CFT are further considered in this report.

Based on the above analysis and in the light of the ToR, the following limitations as concerns the scope of the research can be made.

ACE-Systems and CBIT's

As outlined under sections 3.2.1.1 and 3.2.1.2, accounting based, classical corporate income tax systems, which (only) allow for a notional interest deduction (ACE's) aim at eliminating the debt/equity-bias. However, they do not share the other key features of CFTs, the cash in-cash out approach and the immediate expensing feature. Hence, we do not consider tax systems with an ACE-element as a mixed system qualifying for further consideration in the course of this report as, by its character, an ACE-Systems remains a classical accounting-based CIT-system and cannot reach a similar level of simplicity as a genuine CFT. It follows that not all types of CFT's show this feature. Hence, it should not be characterized as a paradigmatic feature of CFT's. Nevertheless, classical CIT systems combining the ACE-feature with additional CFT-elements may be taken into account in this report. However, we did not see such a hybrid tax system in practice. The Brazilian system of granting a notional interest deduction is in this context to be mentioned, as it grants a deduction for equity only upon a distribution of the entities profits (and as long as the shareholders of for a treatment of the distribution as interest expense). It is therefore even more distant to a CFT than a pure ACE-System. Also this type of tax is therefore not studied further.

Likewise, CBIT-systems show a relatively low degree of convergence with genuine CFTs as, like ACE-systems, they do not share key CFTs specific features other than tackling the debt-equity bias. Hence, we consider such type of taxes as outside the scope of this report and will refer to it only where appropriate.

Sector specific taxes

Several varieties of hybrids can be found in the field of sector specific taxes. The system for taxing the oil and gas industry in the UK shows several similarities with a pure cash-flow tax. The system allows for immediate expensing of all acquisitions (clear cash-flow tax feature), but the income is calculated based on CIT.

[75] With regards to an S-based system immediate expensing is not relevant

It could therefore be argued that only one feature of a cash-flow tax is present. However, the system has complementary features, such as an additional tax on top of the CIT (which presumably taxes, from an economic point of view, the cash inflow rather than net income). As a whole, this system has enough cash-flow tax features to be considered as an interesting hybrid to discuss - and it is indeed referred to as a cash-flow tax by practitioners etc. We will therefore continue to consider this system in more detail in the further course of this report.

The Australian systems of MRRT and PRRT share more features of a typical CFT. They contain positive cash-in-consideration (taxation of the super-rent) which is typical for a CFT. As well, investment expenditure is deductible immediately. Hence, this type of exploration tax is similar to a pure CFT and is hence further explained below.

The tax base of the NR/NCP tax regime of the province of British Columbia in Canada results from a contrasting juxtaposition of certain revenue and expenditure amounts. Temporal frame of reference is the fiscal year. Under the NR/NCP tax regime the respective amounts experience certain adjustments, e.g. certain expenditure amounts are not deemed deductible in the current fiscal but are subject to a carry forward resulting in lowering the tax base in future years. However, the fundamental principle of this regime is that it does ignore the accounting and income tax principle of matching expenditures against revenue earned as a result of those expenditures. Since the general outset of this tax regime is close to a pure CFT and it shall be considered further in this report.

3.4 Conclusion

For our country research we have defined a pure CFT to comprise the following essential elements:

- a tax which can be classified as a R, R-F or S-based system with immediate expensing,
- equal treatment of debt and equity,
- based on cash in-cash out without accrual accounting surrogating the corporate tax and
- aiming for administrative simplicity.

In addition we have studied those countries which implemented a tax which shows essential elements of a CFT surrogating the corporate tax.

Therefore, we did not cover:

- ACE systems which form part of the traditional corporate income tax system or
- tax systems mainly covering individuals.

We have included one FAT 1 system applied to SMEs since it showed the presence of various essential elements of a pure CFT (see Hungarian KIVA in section 4.4.1).

Sector specific taxes aiming at taxing the economic rent of extraction industries and corporate taxpayer specific systems targeting SMEs which strive for administrative simplicity and which show also other CFT elements are dealt with separately in this report.

4 Experiences with CFT systems or elements therefrom

4.1 Main Findings

Based on the questionnaire in Annex 1 which was sent to the relevant countries, additional interviews with officials from tax administrations and publicly available reports and legislation, this report identifies three jurisdictions where a (close to) full-fledged CFT is or has been implemented, namely Mexico, Estonia and Macedonia.

With the exception of Mexico, none of the countries examined showed evidence that the CFT-system was based on the CFT models discussed in the academic literature.

- In Mexico the CFT system applied operated in parallel with a CIT system and generally applied an R-based system, while it applied an R+F-based CFT with respect to financial institutions. This system was abandoned in 2014 mainly due to the administrative burden that the tax put on the Mexican businesses.
- Macedonia and Estonia both applied an S-base CFT. In Macedonia the regime was introduced as a temporary measure to counteract the financial downturn of the Macedonian economy in 2009. The system was abandoned in 2014. In Estonia the S-base CFT is still in place. The Estonian tax system was determined to be the most competitive tax system in the OECD by the Tax Foundation's International Tax Competitiveness Index. In general the Estonian CFT system was favoured by Estonian businesses as it gave them a degree of discretion as to when to pay the taxes.
- Three countries, namely Australia, New Zealand and the United States had in depth discussions on a reform which would abolish the CIT system and introduce a CFT. However these systems did not get to the legislative proposals stage due to various criticisms. Feasibility of the tax, international recognition and lack of political support were among the main reasons identified for the non-implementation of these proposed systems.

The other identified CFTs relate to three broad categories: small and medium enterprises, sector specific taxes and gross receipt taxes.

CFT elements in the extraction industry were identified in various jurisdictions, namely in Australia, Canada, Norway, Poland and the UK. The principal motivation for applying a CFT in this specific sector was for governments to be able to tax the economic profits (supernormal profits or super-rents) of the industry.

The analyses of the Brazilian and Hungarian tax jurisdictions revealed tax systems applying to SMEs with essential elements of a CFT. The leading motivation for applying these tax systems was to minimise the complexities of tax compliance requirements and to allow for a less complex way of complying with the administrative requirements. This aim was based on the reasoning that a SME has less resources to keep up with high administrative burdens.

In Brazil and in individual US States, a gross receipts tax is applied (see Annex 5). These systems make use of elements of a CFT system. A gross receipts tax is calculated by taking the gross receipts as a starting point and then granting a credit

for certain expenses incurred by the business. The method of calculation is hence based mainly on cash inflows subject to certain exemptions and accounts for cash outflows in the form of a credit.

Table 2: Classification of the CFT regimes in the examined countries

Category	Countries
R-base/R+F-base CFT	Mexico
S-base CFT	Estonia, Macedonia
Essential elements of a CFT system applied to SME	Brazil (Simples Nacional, Lucro Presumido), Hungary
Essential elements of a CFT system applied to the Extraction industry	Australia (MRRT, PRRT), Canada (BCMT), Norway, Poland, United Kingdom (PRT, RFCT and SC)
Gross receipts tax with essential elements of CFT	Brazil (IOF, Pis-pasep and Cofins), US States[76]
In-depth discussions on implementing a CFT system or elements therefrom	Australia, New Zealand, United States
Considered briefly but did not implemented a CFT/ CFT was considered prior to 2000	Bolivia, Colombia, Denmark, France, Ireland, Italy, Netherlands, Sweden, Switzerland
No discussion or implementation of a CFT	Argentina, Austria, Belgium, Bulgaria, Chile, Croatia, Cyprus, Czech Republic, Finland, Germany, Greece, Iceland, Israel, Japan, Latvia, Lithuania, Luxembourg, Malta, Portugal, Romania, Russia, Slovak Republic, Slovenia, South Korea, Spain, Turkey

In the remainder of this chapter we outline the results gathered from the answered questionnaire (displayed in the Annex 1) in more detail. All the responses have been presented in the order of relevancy considering the scope and the aims of this report.

4.2 Countries with CFT system

4.2.1 Mexico (IETU)

4.2.1.1 Synopsis

In 2008, Mexico started applying a general R-base CFT and an R+F-base CFT for the financial sector. These CFT regimes worked in parallel to the Mexican income tax system: the taxpayer had to compute both taxes, pay the income tax due and - if the CFT due was higher - pay the additional tax over and above the income taxes.

The main motivations to introduce this tax were to simplify compliance and administration, create new jobs, reduce poverty through new investments and increase tax collection. Since it was a parallel system, the Mexican CFT regime did not decrease the cost of compliance or the cost of administration; to the contrary, it

[76] Brazilian IOF and US States taxes are displayed in the Annex since they displayed merely non-essential elements of a CFT.

increased such costs. On the other hand, considering this was an additional tax it increased substantially government's tax revenues.

Mexico successfully managed to ensure that the tax was creditable in 34 countries. In particular, although the US seemed to usually show doubts about the creditability of CFT regimes, it agreed with Mexico to accept this tax as creditable. In addition, several countries specifically mentioned the regime as a creditable tax in their bilateral double tax treaties with Mexico.

Private sector companies criticised this tax as it disallowed as deductible expenses, amongst others, royalties, interests paid to related parties and wages. They also filed complaints in this regard to the Mexican Supreme Court arguing that the tax was unconstitutional as it was implemented based on non-fiscal reasons. In this respect the Supreme Court ruled that the tax was constitutional. Notwithstanding this decision, the tax was abandoned in 2014 as a result of a promise made during the political campaign.

4.2.1.2 ACE or CBIT as alternatives to IETU

ACE and CBIT were not considered since when IETU was introduced there was no issue with respect to the neutrality between equity and debt. According to the Mexican Legislation, equity cannot be considered as debt. So, for IETU tax purposes, interests[77] and equity were not deductible. Specifically, IETU eliminated the deductibility of interests derived from loans or financial transactions. On the other hand, interest revenue was not subject to tax (except for the financial system regime). Based on the latter, IETU substituted the Asset tax, which was a minimum complimentary tax. According to the Government's exposition of motives, they needed to stop tax evasion as the burden has relapsed only in part of the population, which is unfair an unsustainable. With the introduction of the IETU, it was pretended to strengthen the tax system by nullifying the "legal distortions" currently existing in the Mexican Income Tax Law and to propel new investments.

4.2.1.3 Motivations for implementation of the IETU

The proposal of the IETU stated that tax would (i) simplify compliance and administration; (ii) foster investment and; (iii) broaden the tax base. In addition, this proposal indicated that Mexico had the obligation to seek "a more fair distribution of income and wealth"; thus, Mexico could impose taxes to achieve this redistribution of income and wealth.

The proposal states that as a result of the gaps of the tax system, the tax burden has relapsed only in part of the population, which is unfair an unsustainable. With the introduction of the IETU, it was pretended to strengthen the tax system by nullifying the "legal distortions" currently existing in the Mexican Income Tax Law.

According to the Mexican Government, the significant reasons were (ranking that can be inferred from the proposal):

1. To simplify compliance and administration.

[77] Except for financial institutions

2. IETU would create new jobs and reduce poverty through new investments fostered by IETU.
3. Increase tax collection

Other reasons supported by the Mexico's President in his proposal were that the IETU would (i) eliminate special tax regimes, (ii) discourage tax planning, and (iii) reduce reliance on oil income.

4.2.1.4 Design of the IETU

4.2.1.4.1 General

The CFT regime applied in Mexico in parallel with the income tax regime. The tax was calculated independently from the income tax. Then the tax payer paid the higher between the flat tax and the income tax. The Business Flat Tax /Impuesto Empresarial a Tasa Única (IETU) was implemented on 1 January 2008. IETU was based on the theoretical model of the Flat tax as proposed by Robert Hall & Alvin Rabushka.

4.2.1.4.2 Scope

IETU was a source based tax. Regardless of where the income was generated, individuals and legal entities residing in Mexico, as well as foreign residents with a Permanent Establishment (PE) in Mexico were obliged to pay IETU on revenues obtained from:

(i) transfer of goods;

(ii) rendering of independent services and;

(iii) granting of temporary use or enjoyment of goods.

4.2.1.4.3 Tax calculation

R-base

IETU was an R-base CFT. However, certain payments were non-deductible and credits could be obtained in exchange. For the financial sector an R+F-base CFT was instead used.

IETU's tax base was the taxable revenues minus allowed deductions. The taxable revenue was the price collected from the transfer of goods, rendering of independent services and granting of temporal use or enjoyment of goods. Interest and royalties between related parties were not allowed as deduction. Wages and fringe benefits paid to employees were not deductible either; however, there was a tax credit calculated upon a certain percentage of wages.

To avoid that the IETU payment was deferred with activities performed on credit (i.e., to avoid the reduction of the tax base), the IETU Law subjected to tax the interest collected by the acquirer of the goods, independent services or temporary use or enjoyment of goods (i.e., the interest component was considered as part of the sales price collected).

R+F-base

The tax basis of the financial sector regime was R+F-base CFT. The IETU Law provided that the "financial intermediation margin" related to services in which the financial

sector pays and collects interests, shall be deemed as an independent service subject to IETU.

The financial intermediation margin was determined by subtracting accrued interest payable from accrued interest receivable. So the inflows and outflows considered were the net accrued interest (receivable or payable by the taxpayer).

If the calculation of the financial intermediation margin turned out to be positive, such margin would be considered as income subject to IETU Tax. On the other hand, if such margin turned out to be negative, the financial institutions could deduct it from other income subject to IETU.

Unlike the IETU general regime, the financial sector regime calculated the financial intermediation margin on an accrual basis, and not on a cash-flow basis. The IETU on financial intermediation (i.e., on interest paid or gained by financial sector) was separately calculated from other activities (for example, rent).

The financial inflows and outflows taken into consideration were the interest expense and interest income on an accrual basis.

The financial intermediation margin applicable to the services whereby such sector paid or collected interests plus the income receive from the transfer of goods, rendering of independent services and granting of temporal use or enjoyment of goods, activities different from the financial activities taxable for IETU purposes and were effectively paid.

For IETU purposes, the following entities were considered to belong to the financial sector: banks, financial leasing companies, special-purpose financial institutions, multipurpose financial institutions (SOFOMs), warehouses, insurance companies, brokerage firms.

4.2.1.4.4 Rate

The tax rate during 2008 was 16.5%. The rate increased to 17% in 2009 and to 17.5% from 2010 to 2013.

4.2.1.4.5 Exemptions

The Mexican Tax System distinguished between an exemption and a “non-object activity”. An exemption was a legal concept where some activities or situations (that were generally subject to tax) were removed from the general rule due to equity, convenience, and/or economic or political reasons. A “non-object activity”, was an activity that was not regulated in the law.

Exemption applied for:

- Independent Constitutional Entities
- Public Administration Entities
- States
- Municipalities
- Federations and Confederations authorized by the Savings and Popular Loans Law (since they do not perform lucrative transactions).
- Consumer Cooperative Associations

- Savings and Loans Cooperative Associations
- Charities
- Legal entities whose shareholders were pension and retirement funds resident abroad
- Individuals who obtained income from accidental activities (isolated activities with a non-lucrative intention).
- Transfer of negotiable instruments
- Entities exempt from income tax (political parties, labour unions, among others).

On the other hand, there were certain activities that were not object of the IETU (the revenue would not be subject to tax and the expenses would not be deductible):

- Financing or loan transactions that gave rise to the payment of an interest component that was not considered as part of the sales price.
- Financial derivative transactions when the sale or disposal of the underlying was not subject to the IETU Law.
- Sale of shares
- Dividends
- Granting of temporary use or enjoyment of goods between related parties that gave place to royalty payments.
- Individuals who obtained revenue from accidental activities (isolated activities with a non-lucrative intention).

Interest was not taxable except for financial institutions (R+F-base).

4.2.1.4.6 Treatment of financial expenditure in R-based CFT

See section 4.2.1.4.3.

4.2.1.4.7 Net refund position

IETU Law did not allow the crediting of IETU against income tax, but provided a credit for net operating losses (NOL's), which was equivalent to the result of applying the IETU rate (17.5 percent) to the excess of deductions over income in a tax year. This credit could be carried over for ten succeeding tax years and could be credited against the Mexican income tax (MIT) for the tax year that gave rise to the credit, if it was only used once (however, since 2010, Congress limited the possibility to credit the NOL credit against the MIT for the tax year).

IETU payments in advance could be credited against IETU annual tax return, if it was the case, a tax offset or IETU refund could be requested.

4.2.1.4.8 Carry forward of Losses

IETU Law provided a transitory system for past losses; however it was limited to losses corresponding to fiscal years 2005, 2006 and 2007, derived from immediate or accelerated deduction of investments.

4.2.1.4.9 Administrative provisions

Administrative provisions regarding the IETU include: transfer pricing, issuance of invoices, advanced payments, annual tax return, and formal requirements.

4.2.1.4.10 Qualitative and quantitative benefits and problems

IETU did not reduce costs of compliance and administration. It was indeed an additional tax with different tax provisions with respect to the standard income tax.

For IETU tax purposes, interest and equity costs were not deductible. Specifically, IETU eliminated the deductibility of interests derived from loans or financial transactions (except financial system). On the other hand, interest revenue was not subject to tax.

The IETU was neutral with respect to the choice between present and future investment, as long as the goods/services were used to perform the activities taxed by IETU and were effectively paid. In addition, IETU was immune to inflation since it was calculated on cash-flow.

The rationale given in the official speech of the government for the implementation of the IETU (in 2007) was to promote the capital investment since such investment would be deductible at 100% if it was effectively paid. However, the law did not fully recognize the previous investments made by companies prior to 2008 (except for the investments made in the last quarter of 2007 and a 50% credit was granted in certain cases). A similar situation occurred with the inventory. Furthermore, the taxpayer still had to calculate income tax and for purposes of this tax investments shall be deducted on a straight line basis.

Other reasons supported by the President of Mexico in his proposal were that the IETU would

(i) generate jobs,

(ii) reduce poverty,

(iii) eliminate special tax regimes,

(iv) discourage tax planning,

(v) reduce reliance on oil income, and

(vi) increase tax collection.

In addition, IETU would eliminate preferential tax regimes and discourage tax avoidance.

4.2.1.4.11 Transitional rules

Transitional rules included:

- Revenue (cash) obtained from the performance of activities subject to IETU prior to 1 January 2008 would not be subject to the payment of the tax.
- Accrued expenses prior to 1 January 2008 would not be deductible, even if the payment was made after that date.
- Deduction of new investments acquired between 1 September and 31 December 2007 (taxpayers had to calculate the outstanding balance pending deduction updated by inflation and multiplied it by the factor 0.175. The result was credited on a straight line basis 5% during 10 years starting 2008. For fiscal year 2008 the factor was 0.165 and for 2009 fiscal year the tax factor was 0.17).
- Tax credit for investments made between 1998 and 2007.
- Tax credit for stock acquired between 1998 and 31 December 2007.

4.2.1.4.12 International recognition

Taxpayers calculated their IETU liability by applying the different credits (NOLs & payroll) and were also entitled to credit an amount equal to the Mexican income tax (MIT) paid. This last credit had the effect of making the IETU complementary to MIT, because taxpayers would only pay IETU to the extent that the IETU liability exceeded the MITI liability, after applying the NOL and payroll credit.

Although the bases of both taxes were income, they had different deduction and inclusion systems. This created distortions when the same activity was taxable for both MIT and IETU purposes, because although the IETU would be affected only to the extent the MIT fails to result in a liability, the different recognition and deduction system created disparities.

The IETU Law completely disregarded items that were created for MIT purposes before the existence of the IETU. Specifically, the IETU Law did not take into account adjusted basis for depreciable and non-depreciable assets, cost of inventory or NOLSs generated under the existence of the MIT (although taxpayers could reduce their MIT liability, the reductions did not affect their IETU liability). The IETU was intended to be a complementary tax to end the loss of revenue through the preferential tax regimes of the MIT; however, IETU was designed as a flat tax and not as an income tax, being a major difference between a flat tax and an income tax, the timing and method to calculate the basis. Several provisions to mitigate these problems were adopted in Presidential Decrees (published in the Official Gazette on 5 November 2007 and 30 March 2012).

In this way, according to the Government's statement, it helps to credit IETU in foreign countries as this tax is not considered by some countries as an income tax or similar to income tax for tax treaty purposes. In this sense, IETU could not be credited in those countries as it didn't share the same characteristics as the income tax. Additionally, the statement determined that it would also help to ease to comply with tax regulations.

The Ministry of Finance issued a press release on December 10, 2007 (No.115/2007) to announce that around 34 countries accepted the IETU paid as creditable, between them, Austria, Barbados, Belgium, Brazil, Canada, Korea, Chile, China, Denmark, Ecuador, Spain, Finland, New Zealand, Netherlands, Poland, Portugal, United Kingdom, Czech Republic, Romania, Russia, Singapore, South Africa, Sweden and Switzerland.

With respect to the United States of America, the same press release informed that the US Government, through the IRS announced that the US taxpayer could credit, against the US income tax, the IETU paid in Mexico.

Some countries expressly included the IETU in their Double Taxation Treaties entered with Mexico, such as Barbados, Iceland, India, Germany, Netherlands, Panama, South Africa, Switzerland, Ukraine, and United Arab Emirates."

4.2.1.4.13 Avoidance schemes

One of the objectives of the IETU mentioned in the official speech of the government was discouraging tax avoidance. However, this was not materialized in the IETU Law; there were no specific rules in the IETU Law regarding tax evasion and tax avoidance.

IETU was repealed after 6 years of its creation, so IETU tax planning was not relevant. Some IETU tax planning was implemented to be able to deduct assets and/or investments that were acquired before IETU came into force.

Given that IETU only allowed the deduction of assets that were effectively paid, during 2008 -year that IETU was introduced in Mexico- assets that could be depreciated for income tax purposes (and were acquired before 2008) were not deductible for IETU purposes.

Therefore, the following scheme was commonly used:

Company “A” transferred its assets (acquired previously to 2008) to Company “B”. Company “B” granted the use and enjoyment of such assets to Company “A”, thus Company “A” could have a deductible expense for IETU purposes: the payment of the rental fees.

Neither the IETU Law nor the proposal of the law established any anti-avoidance measure.

4.2.1.5 Effects

4.2.1.5.1 Economic effects

When the IETU Law was proposed, it was criticized and discussed as unconstitutional by the private investors, especially because of the non-tax reasons that motivated its creation and the disallowance of certain deductions. The private sector filed around 34,000 legal proceedings against the IETU Law.

The IETU Law established a three years period to the Ministry of Finance (hereinafter SHCP) to draft a report on the convenience of keeping or repealing several chapters of the Mexican Income Tax Law (i.e. The SCHP would have decided if the tax treatment provided by said chapters would have remained regulated only by the IETU Law).

Three years after (June, 2011), the SCHP published the report concluding that the IETU: (i) was an important part of the Mexican Tax System, (ii) did achieve its mains goals and (iii) had the feature of a minimum tax under the Income Tax Law.

According to the SCHP's report, the IETU increased the income tax collection due to the fact that it made less profitable Income Tax planning's and put a minimum to special tax schemes. For 2007, the original estimate of the collection was MXN 111 million. For 2008, the first year of the IETU in Mexico, the overall revenue collected increased up to MXN 100 million.

Additionally, an econometric model was used in order to isolate the effect of the IETU on the Income Tax collection. The IETU explains 6% of the Income Tax collection from 2008 to 2010, which means that for every MXN collected directly from the IETU, 78 additional cents were obtained in the Income Tax.

The report also concluded that the income tax cannot work without a minimum tax (IETU), and the IETU cannot work separately from the income tax, so making a structural adjustment in the Mexican Tax System where the income tax is eliminated and only the IETU remains would represent a risk for the public finances.

4.2.1.5.2 Revenue implications

IETU was an additional tax that implied additional costs of compliance and administration since the tax basis of IETU was different from income tax basis. However, IETU generated more tax revenues in addition to the income tax.

Table 3: IETU tax revenues compared to income tax revenues

Collected*	Income Tax	IETU
2007	515,209.4	N/A**
2008	549,614.2	49,319.4
2009	527,810.4	44,451.0
2010	617,530.7	45,459.7
2011	712,073.2	48,036.6
2012	751,844.2	41,234.9
2013	895,540.6	47,205.0

**Quantities in MXN.*
***IETU Tax was introduced in 2008.*
Source: Mexican Ministry of Finance (2014)

Table 4 compares the estimated IETU with the actual IETU earned by the Mexican Government. In the first five years the tax generated lower revenue than what was expected.

Table 4: IETU estimated tax revenues compared to actual tax revenues[78]

IETU	Estimated IETU*	Collected IETU*
2008	69,687.5	49,319.4
2009	55,408.4	44,451.0
2010	53,195.1	45,459.7
2011	60,605.3	48,036.6
2012	50,737.5	41,234.9
2013	44,638.4	47,205.0

**Quantities in MXN.*
Source: Mexican Ministry of Finance (2014)

Table 5 shows the revenues that were generated in 2007, the year prior to the introduction of the IETU.

[78] The Federal Revenue Law of each year (i.e. 2008), usually published at the end of the year before it is in force (i.e. between November and December 2007), officially established the estimated tax collection of the FY in which the mentioned Law would be in force. A fiscal year is considered from January to December. By November 15 of each year, before the mentioned Law is in force, a draft of it must be issued by the Mexican President and then discussed in the Mexican Congress for its approval (before the end of December). At this stage, the tax estimations are done but are not officially set until the Federal Revenue Law is in force.

Table 5: Mexican tax revenues prior to the introduction of IETU

2007	IMPAC*	Income Tax*
	15,435.0	511,259.0

2008	IETU*	Income Tax*
	49,319.4	549,614.2

IMPAC = Impuesto al Activo (Asset Tax)
**Quantities in MXN.*
Source: Mexican Ministry of Finance (2014)

4.2.1.6 Criticized aspect

The IETU Law was heavily criticized by the private sector due to the disallowance of certain deductions (such as royalties, interests paid to related parties, wages, among others), leading to the private sector to file a big amount of legal proceedings against the IETU Law.

The unconstitutionality of the IETU was argued in these legal proceedings, but the Supreme Court ruled that it was constitutional and it will stay in the Mexican Tax System (this ruling was taken by the Supreme Court for political reasons).

In an administrative and compliance perspective, the implementation of the IETU represented a double accounting effort for taxpayers (one for IETU purposes and other for income tax purposes).

4.2.1.7 Reasons for abandoning the IETU

IETU was abandoned on *December 31, 2013.*The proposal to repeal the IETU Law (2014 Tax Reform) established that the complexity to pay taxes is prejudicial to taxpayers, since companies and individuals destine financial and human resources to comply with this assignment. It was repealed as a result of a campaign promise of current President Enrique Peña Nieto.[79]

According to the motivations of the Mexican Congress, IETU was repealed, among the main causes, because the taxable events which triggers the tax did not considered the particular situation of the taxpayers, which caused significant losses to the micro, small and medium companies in the country, specifically in its cash flows. Irregular practices were also identified such as claiming of inappropriate deductions and tax credits as well as omissions in the registry of income. In addition, IETU never reached the annual collection goal programmed (i.e. 77% of the goal was reached).

4.2.2 Estonia (Corporate Tax)

4.2.2.1 Synopsis

Estonia abolished the conventional corporate income tax system in 2000, replacing it by an S-base CFT, taxing corporate profits upon distribution to the shareholders. This

[79] It was also established in the IETU transitory rules that a specific analysis to eliminate the Income Tax should be done in 2011 (this was more a political speech at that time rather than a real thing to happen).

change was motivated by the need for a simpler tax system that would reduce costs of compliance and administration. The new regime was also thought to discourage the use of tax havens.

Neutrality between debt and equity is not a feature of this regime since dividends are taxed while interest payments are not. In this regard, the CFT regime is criticised for making Estonia a conglomerate bank of corporate profits, enabling MNE to take out profits in the form of loans to related companies. In addition, Estonia found problems with the creditability of the tax levied on profits of permanent establishments.

Upon the introduction of this regime the tax revenues initially decreased but reached the previous level of revenues shortly afterwards. In 2014, the Tax Foundation's International Tax Competitiveness Index established that the Estonian tax system is the most competitive within the OECD 34 member countries. A relatively low corporate tax rate, no double taxation on dividend income and a nearly flat income tax rate are amongst the most prominent features of the Estonian regime.

4.2.2.2 ACE or CBIT considered as alternatives to the Estonian Corporate Tax regime

Specific information on whether ACE or CBIT were considered as alternatives was not obtainable.

4.2.2.3 Motivations for implementation the Estonian Corporate Tax regime

An excerpt from the explanatory note to the draft law which established the new system for profit taxation since 1 January 2000:

"A private-law legal person is established in private interests and the goal of such a legal person is to earn profits to its founders or shareholders. A legal person is an abstraction; its activities are an expression of interests and will of the natural persons who are behind its establishment. The result of business activities, which is used within that business, is theoretically not justified to be considered as income subject to income tax. Income is present when the result of business activities is diverted from the business, i.e. when private interests of shareholders are being satisfied."

An excerpt from the speech of Mr Siim Kallas, at the time the finance minister, when presenting the draft legislation to the parliament:

"As long as owners do not consider use of firm's profits through taking them out as dividends or in any other way, it is expedient to let the enterprise invest its moneys and not collect income tax. This means faster development not only for a specific firm, but also for the economy in general. Finance world uses quite widely an expression "profit is an estimate". In fact, profit size may be manipulated quite a lot by using multiple accounting methods. Object of taxation, however, should ideally be understood as clear and as uniquely as possible.

One of the main goals of the income tax reform is to bring foreign moneys into Estonia, which will make the wheels of economic development turn faster. International capital market competition is tight, as we know it. In addition to measurable monetary gain, with which we raise interest of foreign businesses deeming investment into Estonia, we will attract a great deal of attention to ourselves with the novelty of this planned tax policy. The law will lure the more stable investments of the two good kinds. We are not interested in portfolio investments, which can leave the country very quickly in changing environments, as much as we are interested in

particularly stable direct investments. Benefits arising from an improved environment can truly be used only by investors who are willing to develop their enterprises in a long term by investing in their main activities."

4.2.2.4 Design of the Estonian Corporate Tax regime

4.2.2.4.1 General

In 2000, Estonia abolished the classical CIT regime and introduced an S-based CFT. Under this regime resident companies (as well as permanent establishments of non-resident companies in Estonia) pay income tax only from distributed profits (dividends) and disbursements equalized with profit distributions. This means that the tax liability is shifted from the moment of earning profits to the moment of distributing profits.

4.2.2.4.2 Scope

The Estonian CIT applies to all companies being resident in Estonia and to permanent establishments of foreign companies. Non-profit organizations are not subject to Estonian CIT as they do not distribute profits to their shareholders.

4.2.2.4.3 Tax calculation

The tax base is the amount distributed to the shareholders. Distributions include not only dividends but also disbursements equalized with profit distributions, such as transfer price adjustments, expenses not related to business activities and representation costs (see below). In addition, the following items increase the tax base: fringe benefits[80]; transactions with related entities not at arm's length; donations (exceeding a certain amount); gifts and entertainment expenses; dividends; liquidation proceeds and capital reductions; profit adjustments; and non-business expenses. Entities in a loss position, i.e. having no profits available for distribution and hence, without potential to generate a taxable event, are still subject to income tax on other taxable expenses and payments.

The tax base is the net amount of profit distribution or expense subject to income tax. Income tax is calculated from the net amount by multiplying the tax base with 20% and dividing it with 80%. For example, in case of distribution of dividends at the net amount of 100 EUR, the income tax liability would be EUR 25 (100*20/80)[81].

The above mentioned expenses increase the tax base meaning that income tax is charged on them similarly to profit distributions. Fringe benefits which increase the tax base are described in detail below:

Dividends

[80] This includes fringe benefits for individuals working under employment contract or providing services under other types of service arrangements, members of board or controlling body and also individuals engaged in sale of goods to particular company for longer than 6 months. Owners are not included unless falling under any of these categories.

[81] The law defines the tax base as net amount and therefore the tax calculation is provided from net basis.

Companies, including general or limited partnerships, pay income tax on profit distributed[82] as dividends or other profit distributions upon payment thereof in monetary or non-monetary form.

Income tax is not charged on dividends in following cases:

1) the resident company paying the dividend has derived the dividend which is the basis for the payment from a resident company of the EEA state or the Swiss Confederation subject to income tax (except for companies located within a low tax rate territory) and at least 10 per cent of such company's shares or votes belonged to the company at the time of deriving the dividend;
2) the dividend is paid out of profit attributed to a resident company's permanent establishment located in the EEA state or Swiss Confederation;
3) the company paying the dividend has derived the dividend which is the basis for payment from a company of a foreign state not specified in clause (1) (except for a company located within a low tax rate territory) and at the time of deriving the dividend, the company owned at least 10 per cent of the shares or votes of such company, and income tax has been withheld from the dividend or income tax has been charged on the share of profit which is the basis thereof;
4) the dividend is paid out of the profit attributed to foreign permanent establishment of a resident company and income tax has been charged on such profit.

Fringe benefits

Determining the value of the fringe benefit is defined by the ruling of the Ministry of Finance. Certain fringe benefits have a fixed value. An example is the use of a company car for private purposes where the maximum monthly fringe benefit value of EUR 256 per car is considered when a travel diary is not kept. In other cases usually the market value is used.

In addition to income tax, fringe benefits are also subject to social tax[83].

Transactions with related entities not at arm's length

If the price of a transaction concluded between a legal person and a person associated with the legal person differs from the market value of the transaction, income tax is imposed on the amount which the taxpayer would have received as income or the amount which the taxpayer would not have incurred as expenses if the transfer price had conformed to the market value of the transaction.

Donations (not exceeding a certain amount)

Income tax is not charged on gifts and donations made to persons included in the list of non-profit associations, foundations and religious associations benefiting from income tax incentives or to a similar association established in another Contracting State[84] in an amount not exceeding one of the following limit values:

[82] There is no difference whether dividends are paid to local or foreign companies.
[83] All fringe benefits (including use of company car for private purposes) are taxed at the level of company under CIT and not in the hands of employee under PIT.
[84] A state with which Estonia has a double tax treaty

1) 3 per cent of the amount of the payments subject to individually registered social tax (e.g. salary and wages) made by the taxpayer during the same calendar year;
2) 10 per cent of the profits for the last financial year which ended as of 1 January of a calendar year, calculated pursuant to the legislation regulating accounting.

Gifts, donations (exceeding a certain amount) and entertainment expenses
Legal persons, except for persons included in the list of non-profit associations, foundations and religious associations benefiting from income tax incentives pay income tax on gifts or donations received, considering the exemptions provided above.

Liquidation proceeds and capital reductions
Companies pay income tax on the portion of payments made from the equity upon reduction of the share capital or contributions, upon redemption or return of shares or contributions or in other cases, and on the portion of the paid liquidation distributions which exceed the monetary and non-monetary contributions paid into the equity of the company.

A company which is deleted from the register without liquidation pays income tax on the share of the equity which exceeds the monetary and non-monetary contributions paid into the equity.

Profit adjustments
Hidden profit distributions detected by a 'substance over form'-rule are taxed similarly to dividends.

Non-business expenses
Companies pay income tax on expenses not related to business activities when such expenses are not already taxed as fringe benefits, gifts and donations, entertainment costs or profit distributions[85].

Expenses and payments not related to business include for example:

- enrolment and membership fees paid to non-profit associations, unless participation in such associations is directly related to the business of the taxpayer;
- payments concerning which the taxpayer does not have a source document in compliance with the requirements prescribed in legislation regulating accounting;
- expenses incurred or payments made in order to purchase services not related to the business of the taxpayer;
- expenses incurred or payments made in order to fulfil obligations not related to the business of the taxpayer.
- acquisition of property not related to business;
- acquisition of securities issued by a legal person located in a low tax rate territory unless such securities meet the requirements specified in subsection 257 (1) of the Investment Funds Act;

[85] Expenses that are not deductible in a traditional system are taxable in Estonia. The provided list defines non-business expenses which are always taxed. However, provided the particular expense qualifies also for e.g. as a fringe benefit or donation etc. the basis for taxation will not be non-business expense but fringe benefit or donation etc. respectively. The applicable CIT is the same and there is no double taxation.

- acquisition of a holding in a legal person located in a low tax rate territory;
- payment of a fine for delay or a contractual penalty, or extra-judicial compensation for damage, to a legal person located in a low tax rate territory;
- grant of a loan or making of an advance payment to a legal person located in a low tax rate territory or acquisition of a right of claim against a legal person located in a low tax rate territory in any other manner.

4.2.2.4.4 Tax Rate

The tax rate was 21% for 2014 and has been reduced to 20% as from 2015.

4.2.2.4.5 Exemptions

Entertainment expenses in connection with the provision of catering, accommodation, transportation or entertainment to guests and co-operation partners are taxable for legal persons. Income tax is not charged on such payments in the amount of up to 32 euros per calendar month[86]. In addition, if such legal person is making payments subject to individually registered social tax, the legal person may make, in a calendar month, payments exempt from income tax in connection with the provision of catering, accommodation, transportation or entertainment to guests and co-operation partners in the amount of up to 2 per cent of the total amount of the payments subject to individually registered social tax made by the legal person during the same calendar month. The tax free limits are cumulating in the calendar year.

4.2.2.4.6 Treatment of financial expenditure in R-based CFT

Not applicable to Estonian regime since this is an S-base CFT.

4.2.2.4.7 Net refund position

Not applicable to Estonian regime since this is an S-base CFT.

4.2.2.4.8 Carry forward of losses

Not applicable to Estonian regime since this is an S-base CFT.

4.2.2.4.9 Administrative provisions

Monthly tax returns (TSDs) are submitted and tax is paid to the tax authority by the 10th of each month following a payment.

4.2.2.4.10 Qualitative and quantitative benefits and problems

See section 4.2.2.2.

4.2.2.4.11 Transitional rules

No specific transitional issue or rules were identified.

4.2.2.4.12 International recognition

[86] This exemption is per company (taxpayer) and does not depend on the number of guests or employees or size of company.

Estonia had problems with the creditability of the tax levied for Permanent Establishments (PE). PE profits are only taxed in Estonia when the money is taken out of the PE; this means that when the jurisdiction of the parent company taxes profits they do not consider the future liability of taxes in the Estonian PE. Hence, the parent jurisdiction taxes profits when they arise and then Estonia taxes again these profits when the PE money is withdrawn. This problem can be mitigated by immediately withdrawing the profits from the PE and re-contribute them immediately afterwards to the PE.

Estonia abolished the withholding tax on dividends and hence did not find any difficulties in dealing with the requirements of the parent-subsidiary directive[87].

Problems with interaction of the Estonian tax with foreign CFC-systems (due to the fact that profits are not necessarily taxed in the year they arise) are not known.

4.2.2.4.13 Avoidance schemes

Avoidance of the Estonian S-based CFT requires remitting profits to the shareholder or a related person without using the form of a formal distribution. In order to avoid such circumvention the Estonian CIT provides for an increase of the tax base in case of hidden profit distributions, agreements with related persons not at arm's length, etc. (see section 4.2.2.2.2)

4.2.2.5 Effects

4.2.2.5.1 Economic effects

Following the introduction of the S-base CFT in Estonia;

- investment growth[88] between 2000 and 2004 has been 39 percentage points faster than neighbouring Latvia and Lithuania,
- the share of debt financing has dropped by 10 percentage points;
- accumulation of highly liquid assets has significantly increased and as a result, the share of forfeited debt obligations under the crisis was three times smaller in Estonia compared to Latvia and Lithuania (6% vs ca. 20%).[89]

In addition, according to a study ordered by the EC[90], Estonian businesses have in general a low debt-equity ratio. Local business owners confirm that the regime promotes retention of earnings.

Revenue implications

The revenue from taxing corporations dropped for a few years following the introduction but then reached the former level, as shown in Figure 1 and Table 6 below.

Figure 1: Tax Revenue in Estonia between 1995 and 2009

[87] Directive 2011/96/EU of 30 November 2011, OJ L 345 of 29.12.2011.
[88] Investment into fixed assets, measured as change in net value of fixed assets.
[89] Praxis, (2010).
[90] European Commission, (2015).

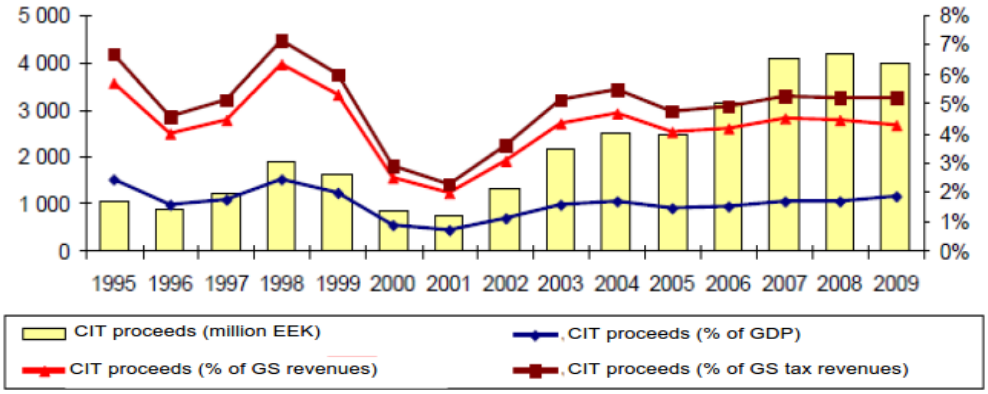


Chart: Corporate Income Tax contribution in Estonia 1995-2009
Source: *Estonian Statistics Authority (2015)*

Source: Estonian Statistics Authority (2015)

Table 6: Corporate Income Tax Revenue in Estonia between 2003 and 2014

Year	EUR
2000	54,611,740
2001	47,822,270
2002	86,155,780
2003	137,822,019
2004	161,189,183
2005	159,551,212
2006	199,622,090
2007	260,996,383
2008	266,257,334
2009	256,309,910
2010	195,755,613
2011	201,052,361
2012	252,420,328
2013	326,600,214
2014	344,722,892

Source: Estonian Statistics Authority (2015)

4.2.2.6 Criticized aspects

The criticism of the Estonian system came from other countries and not locally. Estonia, by not taxing profits that are withheld in the company, was considered to have become a conglomerate bank for company profits. Multinationals are considered by other countries as using Estonian companies to finance other companies. Similarly, other countries consider Estonia as allowing intra-group restructurings enabling transferring of profit abroad. As a result they argue that profits leave Estonia without taxes being paid as they leave Estonia as loans with low or no interest. Additionally, the system was criticized for not promoting job creation. Payroll taxes are high (100 EUR net for employee means approx. 170 EUR cost for the employer) and therefore it is better to direct investments to fixed assets and financial assets rather than in the workforce.

4.2.2.7 Reasons for maintaining the Estonian Corporate Tax regime

The Estonian government did not identify any critical issues, which would press for immediate change of the system. On the contrary, the Tax Foundation's International Tax Competitiveness Index found that Estonia has the most competitive tax system in the OECD. Estonia has a relatively low corporate tax rate at 20 percent, no double taxation on dividend income, a nearly flat 20 percent income tax rate, and a property tax that taxes only land (not buildings and structures).

4.2.3 Macedonia (Corporate Tax)

4.2.3.1 Synopsis

Macedonia abolished the classical CIT system in 2009 and introduced an S-base CFT regime whereby tax is levied at the moment of distribution of company's profits. The Macedonian government introduced this regime as a temporary anti-crisis measure aiming to promote reinvestment and sustain economic growth and liquidity in the local economy. This combined with the low tax rate of 10%; the tax regime became probably the most attractive in the region.

The tax revenue earned from this regime was lower than the revenue that Macedonia was earning when it had a classical CIT system in place due to the evolving financial crisis. Still, the volume of foreign direct investment in the country continued to grow during the period though with a slower pace.

The imposition of tax on non-deductible expenses was criticised as it resulted in a tax burden on companies with a negative cash-flow situation. In addition, due to avoidance schemes with the aim to extract profits from the local investments without paying taxation, Macedonia had to extend the list of non-deductible expenses of its regime. The regime was abolished in 2014 when national statistics showed signs of economic recovery. Apart from that the state had to improve tax revenue collection, as well as to close loopholes used to avoid taxation and for bringing the system in line with majority of EU Member States. Although it was widely known that this was a temporary measure, its abandonment came all of a sudden with no notice to taxpayers. This did impact adversely on the budget forecasting and financial management decisions.

4.2.3.2 ACE or CBIT as alternatives to the Macedonian Corporate Tax regime

ACE and CBIT were not considered in Macedonia as an alternative to the CFT system that they implemented in 2009.

4.2.3.3 Motivations for implementation the Macedonian Corporate Tax regime

As a relatively young and small economy which went through a deep transition from a direct command into an open market economy, after declaring independence from Socialist Federal Republic of Yugoslavia in 1991, Macedonia regularly reforms its tax policy to cope with the effects of the fast changing external economy conditions and to facilitate its attraction for new investments in the real business. One of the tax measures of the country was keeping the corporate income tax rate moderate by decreasing it from 30 % in the years before 1996 to 10% flat in 2008.

With a view to raise its competiveness for new foreign investments in comparison to the neighbouring countries which have also lowered their corporate income tax rates to 10%, as well to achieve fiscal sustainability during the global financial crisis of 2008, in 2009, Macedonian rapidly reformed the corporate income tax regime by introducing tax deferral for corporate profits for as long as they are not distributed to shareholders.

The regime in Macedonia was developed around an existing issue as a solution and although there are many similarities with the Estonian system, there is no official information that the Macedonian government followed their model.

4.2.3.4 Design of the Macedonian Corporate Tax regime

4.2.3.4.1 General

In 2009 Macedonia switched from the conventional corporate income taxation to a taxation of company profits upon distribution to non-resident companies or individual shareholders. In this line, the annual corporate tax base was reconstructed to include only expenses treated as non-deductible under CIT law (basically seen as some potential form of hidden distribution).

The tax is a source based tax applying to companies established in the country and branches of foreign entities in Macedonia.

4.2.3.4.2 Scope

Covered by the relevant rules were dividend payments of resident companies to non-resident companies or individual shareholders.

4.2.3.4.3 Tax calculation

Companies in Macedonia are preparing their statutory financial statements under IFRS. The regular profits realized in line with IFRS are not taxed on annual basis to the extent they are retained in the business. However, companies were still required to file an annual tax return where they declare certain “non-deductible” items that are subject to taxation. These include:

- non-deductible interest expense subject to thin capitalization restrictions
- transfer pricing adjustments
- written-off receivables
- fringe benefits
- allowances paid above statutory thresholds,
- entertainment expenses
- other non-business related expenses.

The income was determined in accordance with the accounting regulations and accounting standards. Macedonia applies the IFRS. Only operating expenses were eligible for immediate deduction from the income. No immediate deduction was available for capital expenditures as following IFRS they are normally amortized over their useful life.

4.2.3.4.4 Rate

The tax rate is a flat 10%.

4.2.3.4.5 Exemptions

Macedonian entities distributing profits to local company shareholders were effectively exempt from tax. Corporate tax is levied only when a Macedonian legal entity distributes profits to individuals or non-resident companies.

The relevant corporate income tax regime applied to all forms of companies, partnership and branches / permanent establishment of foreign entities established in the country with an exception to:

i) Small-sized companies with an annual turnover of up to MKD 6 mill (approx. EUR 97,500) which are eligible to pay tax under a special regime. Namely, small-sized companies which have earned not more than approx. EUR 97,500 in the last three years and do not perform banking, financial, insurance or game on chance activity are entitled to pay tax of 1% calculated on the revenue earned in the relevant year.

Moreover, in case the yearly company's revenue does not exceed half of the set threshold i.e. MKD 3,000,000 (approx. EUR 48,750), the company is exempt from paying CIT at all. If a qualified company has chosen to pay CIT under the special regime then, it was obliged to keep the same tax practice within the next 2 subsequent years provided its yearly revenue in those years do not exceed the set threshold; and

ii) Companies operating in the so called Technological Industrial Development Zones (Free Zones) which were exempted from corporate income taxation for 10 years.

The special corporate income tax regime that is applicable to the small-sized companies was introduced as a special anti-crisis measure. This regime is still applicable.

On the other hand, the tax holiday provided to the companies operating in the Free Zones was introduced to attract new foreign direct investment in the country and thus decrease the unemployment rates.

4.2.3.4.6 Treatment of financial expenditure in R-based CFT

The CFT law applied to real and financial sector in same manner.

In relation to deductible and non-deductible expenses please refer to aforementioned outline on tax calculation (see section 4.2.3.4.3).

4.2.3.4.7 Net refund position

With the filing of the annual tax return after the end of the year, the taxpayers were entitled to claim for refund the difference between the overpaid tax through advance tax payments and the real annual tax determined in the annual tax return. The tax authorities were obliged to refund the amount claimed to the taxpayer within 30 days following the request of the taxpayer.

4.2.3.4.8 Carry forward of losses

No tax loss regime was in place. As long as the book losses reduce distributable earnings, they can be carried forward virtually forever until fully absorbed by profits and dividend is paid out. Under the Trade Company law, there is a particular schedule for use of realized profits. Namely, profits must first be used for netting off the losses

accumulated from the preceding years by reaching of a relevant shareholder's board decision and after that, what is left can be used for dividend payment.

If any bad debts or loans (for which tax has been imposed as the expense was treated as a non-deductible item, see above section 4.2.3.4.3) are subsequently collected by the taxpayer, it can claim a tax credit in the year of collection. If there is no sufficient tax base (not enough non-deductible items) in the respective year, the taxpayer could have carried the credit to the subsequent tax periods.

4.2.3.4.9 Administrative provisions

Taxpayers were obliged to prepare an annual tax return for the calendar year. The annual tax basis comprised of tax non-deductible expenses which the taxpayer incurred during the year such as transfer pricing adjustments, thin capitalization adjustments, impairment of bad debts, fringe benefits etc.

During the year, the taxpayers were obliged to make advance monthly payments of corporate income tax by the 15th day of each month. The tax base for the monthly payments equalled 1/12 of the non-deductible expenses incurred in the preceding year adjusted by the percentage of the cumulative growth of retail prices in the country in the preceding year. Filing of monthly tax returns was not required. Within 30 days following the tax return submission date the taxpayers were obliged to pay the difference of higher the tax determine in the annual tax return and the advance tax payments made in the year.

Profitable taxpayers who decide to distribute their profits to shareholders or managers were obliged to file profit tax return on the day the profit distribution occurs and pay 10% tax on the profits distributed[91]. No corporate income tax was paid if the distributed earnings had been already taxed under the traditional corporate tax regime which applied before 2009. In this respect, the taxpayers were obliged to specify in the profit tax return from which year the profits are distributed.

4.2.3.4.10 Qualitative and quantitative benefits and problems

The system is easier to administer in general. No fixed asset depreciation schedules were required additionally for tax purposes. However, the transition from annual taxation to distribution taxation required efforts to differentiate the distributable profits earned and already taxed during the old regime.

The tax does not treat debt and equity financing in a similar way. Classification of debt and equity and recognition of assets and liabilities follows IFRS. However, paying dividends to foreign shareholders triggers corporate income taxation while repatriating cash through interest does not (subject to thin capitalization rules[92]).

The system is designed to promote reinvestment of profits in operations so it is fair to say that is was meant to promote present consumption. To the extent that the taxation of profits is deferred until a future point in time when distribution is made, the tax corresponding to profits earned in a given year might be immune to inflation.

[91] On the net distribution i.e. on the profit determined in accordance with IFRS reduced for the 10% tax paid on non-deductible expenses.
[92] Untaxed interest would only be the interest portion which is not subject to thin cap rules.

Promoting investment was one of the main reasons for considering implementation and it was considered as attractive by foreign investors. The tax system helps taxpayers maintain better liquidity as tax is due only when cash and earnings are available for distribution. Since taxation of the profits earned by a local entity is deferred until repatriated abroad or distributed to the ultimate individual shareholders, this theoretically allows a form of effective local group relief between a profitable subsidiary and its loss making local parent company.

The tax does not affect the choice of organisational form and location.

4.2.3.4.11 Distinction between business and personal expenses

The tax law and its related administrative guidelines do not contain a definition regarding marketing and promotional expenses. Furthermore, the relevant law and guidelines do not contain a definition of what is deemed to be a representation (entertainment) expense for corporate income tax purposes. Namely, the relevant definitions have been deleted from the CIT administrative guidelines with the changes of the relevant CIT guidelines in 2009. Hence, the taxpayers are left based on their judgment to determine whether related expenses are deemed to be marketing and promotional costs or representation costs where the latter is deemed to be tax non-deductible expenses triggering personal income taxation if incurred for non-employed persons.

4.2.3.4.12 Transitional rules

Specific information respectively experience on transitional rules was not obtainable. Generally, with regard to the transition please see above in relation to administrative provisions (see 4.2.3.4.10).

4.2.3.4.13 International recognition

Specific information respectively experience on international recognition was not obtainable.

4.2.3.4.14 Avoidance schemes

The authorities tried[93] to prevent avoidance schemes regarding extracting profits from the local investments without taxation by expanding the list of non-deductible expenses. In particular, the reformed tax law stipulated:

- Any hidden profit distribution will be taxed together with the non-deductible expenses through the annual corporate income tax. Under the law, hidden profit distributions are defined to be sales and loans to and from physical persons shareholders, partners and close persons in as much as they are under-priced or overpriced respectively.
- Default[94] interest charged between related parties became tax non-deductible expense

[93] The same law which brought taxation only on distributed profits, also expanded the list of non-deductible expenses for corporate income tax purposes.
[94] Default interest refers to interest charged for late payment of liabilities.

- Allowances for transportation paid to employees became tax non-deductible expenses
- Inventory shortages became deductible up to the standard rate recognized for the particular sector, unless they are caused by force major
- a new guideline was issued in respect to related party transactions imposing explicit obligation for the taxpayer to document the arm's length character of the related party charges/income
- Safe harbour rules for intercompany financing arrangements were implemented in the law by virtue of which if the taxpayer is not able to prove that the related party interest cost/income is at arm's length
- Step up value of company's assets in corporate restructurings was clarified that it is deemed to be profit distribution triggering corporate income tax.

4.2.3.5 Effects

4.2.3.5.1 Economic effects

The tax regime did not lead to the desired effects on the economy since other factors impacted the decision making process of both local businesses and foreign investors (see section 4.2.3.6)

4.2.3.5.2 Revenue implications

The Macedonian government collected less tax revenue under the CFT regime. Based on the publicly available data, CIT revenue in 2008 i.e. before the implementation of CIT on profit distribution, were approximately MKD 8,580 million (approximately EUR 139 million). Revenues under the CFT system were as follows:

Table 7: Macedonian tax revenues

Year	MKD (millions)	EUR (millions)
2009	4,435	72
2010	3,700	60
2011	3,900	63
2012	3,660	59
2013	4,420	72

4.2.3.6 Criticized aspects

Due to the low flat tax rate of 10%, the tax regime did not turn to be a decisive factor as to whether local entities would use debt or equity funding. Many MNEs were discouraged to keep cash holdings or implement financing structures in the country due to non-tax reasons (e.g. banks; stability in the region).

Nevertheless, foreign investors and domestic businesses acclaimed the regime as it was beneficial from liquidity standpoint during times of financial crisis.

However, in its aim to prevent cash distribution through non-collecting trade receivables, the tax system proved to be counter-productive for those businesses that had problems with bad debt collection. When non-cash sales (giving rise to trade receivables in line with accruals accounting) had to be written off, taxpayers had to pay cash tax on the non-deductible book impairment loss which exacerbated their liquidity problems. Thus, contrary to what a traditional CFT system would strive to

achieve, the Macedonian regime was effectively taxing gross credit sales that do not lead to operating cash inflows.

The system of imposing tax on non-deductible expenses was also detrimental for over indebted businesses which fell under thin capitalization restrictions. Thus, for example, a decapitalized company that was funded with shareholder debt had to pay effectively tax on the part of the accrued interest expense subject to thin capitalization regulation, even if it was carrying out loss-making activities.

The introduction and abolishment of the regime created room for potential abusive attempts as to whether dividends are paid out of the profits realized before the CFT regime which have already been taxed or respectively from 2009 onwards.

A criticized aspect of the regime is that despite being commonly known that it is a temporary measure, its abolishment in 2014 came all of a sudden with no notice to taxpayers which impacted adversely budget forecasting and financial management decisions.

4.2.3.7 Reasons for abandoning the Macedonian Corporate Tax regime

In parallel with the introduction of the distribution tax regime, the legislators have also introduced 10 years corporate income tax exemption to companies operating in so called Technological Industrial Development Zones. The last 5 years' experience showed that holding both tax attractive measures at the same time has hampered the fiscal revenues of the country. In this respect, based on the fact the economy was going out of recession, Macedonia abandoned the tax regime in 2014 and kept the tax holidays in the free zones.

Other potential reasons included loopholes used to avoid taxation and for bringing the system in line with majority of EU Member States which may politically enhance chances for a future entry into the EU.

4.3 Countries with essential elements of a CFT system applied to SME

4.3.1 Brazil (Lucro Presumido)

4.3.1.1 Synopsis

In 1995, "Lucro presumido" was introduced as an optional simplified way of calculating the corporate income tax and the social contribution on net profits for SME. Under the "lucro presumido" the amount of taxes to be paid is calculated on the basis of the gross receipts and no deductions are allowed. The amount of income/profits is determined by means of a presumption and the list of items that make up the tax base is provided in the law.

This simplified assessment diminished the compliance costs for SMEs and has been considered easier to administer by the tax authorities. "Lucro presumido" is popular among small and medium enterprises in Brazil; however it represents a minority of the revenue when compared to the total tax revenue of the Brazilian government.

Given that only small and medium enterprises may opt for the "lucro presumido", some taxpayers split their business into various small legal persons in order to be able to avail themselves of the regime. The splitting of the business is allowed by the tax authorities if the small enterprises have economic substance.

The "lucro presumido" is still in force and is considered as accomplishing its principal aim of simplifying the assessment of corporate income tax and social contribution on net profits by small and medium enterprises.

4.3.1.2 ACE or CBIT as alternatives

ACE and CBIT were not considered as alternatives to the "lucro presumido".

4.3.1.3 Motivations for implementing Lucro presumido

The possibility of calculating the corporate income tax and the social contribution on net profits on the basis of presumptive profits was created to diminish the compliance costs of small and medium enterprises. In addition, the tax authorities consider this calculation method as easier to administer.

4.3.1.4 Design of Lucro presumido

4.3.1.4.1 General

"Lucro presumido" is not a tax, but an alternative simplified way of calculating the corporate income tax and the social contribution on net profits ("contribuição social sobre o lucro líquido"). [95] The assessment of taxes according to the "lucro presumido" is not obligatory. Instead, it is an option that can be made by enterprises with annual receipts not exceeding 78,000,000 BRL (approx. 23,000,000 EUR). Under the "lucro presumido" the amount of taxes to be paid is calculated on the basis of the gross receipts. Accordingly, no deductions, such as wages, license fees and interests, are allowed.

The payment of taxes according to the "lucro presumido" occurs quarterly and the option for the "lucro presumido" is exercised by paying the taxes owed in the first quarterly according to this regime. Once the option is exercised, it is applicable to the whole tax year. When opting for the "lucro presumido", the legal person may decide whether it wants to assess their gross receipts on cash basis or on accrual basis.

Corporate income tax ("Imposto de renda da pessoa jurídica apurado com base no lucro presumido") and social contribution on net profits are assessed on the basis of presumptive profits ("contribuição social sobre o lucro líquido (CSLL) apurada com base no lucro presumido"). The present system came into force in 1995. The possibility of calculating the corporate income tax on the basis of "presumptive profits", however, was foreseen in the 1960s specifically in the Brazilian General Tax Code.

4.3.1.4.2 Scope

The possibility of calculating the corporate income tax and the social contribution on net profits on the basis of presumptive profits was created to diminish the compliance costs of small and medium enterprises. Coherent to this scope, big enterprises (i.e.,

[95] The simplified assessment method "lucro presumido" can also be used by small and medium enterprises to calculate the amount of the social contributions Pis-Pasep and Cofins. In this study, we consider these contributions only with regard to their non-cumulative assessment method, which is not applicable in the case of option for the "lucro presumido". For the sake of understanding the "lucro presumido", however, no further explanations on Pis-Cofins and Pasep are required.

those with annual total receipts surpassing 78,000,000 BRL (approx. 23,000,000 EUR)) are outside the scope of this tax system. Also enterprises receiving income from abroad and acting in strongly regulated sectors – such as financial and insurance – shall not opt for the assessment of the corporate income tax on the basis of presumptive profits (see section 4.3.1.4.5)

4.3.1.4.3 Tax Calculation

In Brazil, income is defined in the Brazilian General Tax Code as "the product of the capital, the work or the combination of both". In the case of assessment of the corporate income tax on the basis of presumptive profits, however, as the name says, the amount of income / profits is determined by means of a presumption. There is no definition of what presumptive profits are, but the law and the revenue rulings describe which items have to be included in the tax base.

The tax base is composed of the following items:

1. **A percentage of the so-called gross receipts** ("receita bruta") earned in the quarters ending on 31 March, 30 June, 30 September and 31 December. The percentage depends on the taxpayer's activities branch and for the purposes of the corporate income tax varies from 1.6 % to 32%, as presented in the following table:

Table 8: Percentage of the gross receipts

Activities	Percentages (%)
Activities in general	8.0
Resale of fuel	1.6
Transport services (excepting load)	16.0
Services of load transport	8.0
Services in general (excepting hospital services)	32.0
Hospital services	8.0
Business intermediation	32.0
Management, rent or cession of goods and rights of every kind (including real estate)	32.0

For the purposes of the social contribution on net profits the applicable rates are 12% or 32%, also depending on the economic activity carried out by the taxpayer.

The gross receipts encompass the results from the sales of goods on own account, the price of services rendered and the results from operations on someone else's account (i.e. commissions). The value added tax "ICMS" is included in the concept of gross receipts. From the gross receipts the following items are excluded: cancelled sales; discounts granted without the imposition of conditions; and non-cumulative taxes separately collected from the purchaser, so that the seller merely acts a depositary.

2. The **sum of the following components**:
   - capital gains, revenues and net gains from financial investments (with fixed or variable returns);
   - active monetary variations;
   - all other positive results obtained by the legal person, including the interests on own capital ("juros sobre o capital próprio", i.e., the Brazilian allowance for corporate equity), financial discounts received, active interests not deriving from investments, and others, such as:
     - revenues from lending operations between controlling and controlled companies, associated companies or affiliated companies;

- gains from hedge operations that take place in the stock, securities, commodities and futures exchange market or in the over-the-counter market;
- receipts from the location of immovable property, when the location is not to the business object of the company;
- interests regarding taxes and contributions to be compensated or refunded, calculated on the basis of the monthly value of the *Selic*[96] target rate.

- the value of the realized inflationary profit;
- penalties and other advantages deriving from the termination of a contract;
- retrieved values corresponding to costs and expenses, inclusive with losses regarding credit losses. Exceptions: (a) if the taxpayer can prove that said values have not been deducted in previous tax years in which his profits were accessed according to the "lucro real", i.e., on the basis of the general non-simplified assessment method; or (b) if these values refer to periods in which the tax assessment was made on the basis of presumptive profits ("lucro presumido") or in which the value of the profits have been arbitrated by the tax authorities ("lucro arbitrado");
- the difference between the amount of cash or the value of goods and rights received from an exempted legal person in the context of an assets' refund and the amount of cash or the value of the goods and rights that have been previously given in order to build the assets.

Given that the presumptive profits are calculated mainly on the basis of the gross receipts, no deductions are allowed. Where the amount paid is in excess, this can be used to reduce future tax liabilities but it is not refunded.

The "lucro presumido" is a way of calculating the corporate income tax and the social contribution on net profits. Both the corporate income tax and the social contribution on net profits are federal and are levied on a worldwide basis with regard to legal persons that are resident in Brazil. Therefore, the genuine link for taxation is the corporate residence in Brazil.

4.3.1.4.4 Rate

The corporate income tax rate is 15% for profits amounting up to 60,000 BRL (approx. 18,000 EUR) in a quarterly and 25% for profits surpassing this threshold. The rate of the social contribution on net profits ("contribuição social sobre o lucro liquido" (CSLL)) is 9%.

[96] The *Selic* target rate is an interests' rate daily determined by the Brazilian Central Bank and corresponding to the average of the interbank interest rates which are charged for the trade of government securities with a maturity of one day.

4.3.1.4.5 Treatment of financial expenditure in R-based CFT

Financial institutions are not allowed to opt for the "lucro presumido" (see section 4.3.1.4.6).

4.3.1.4.6 Exemptions

The assessment of corporate income tax and social contribution on net profits on the basis of presumptive profits is forbidden for the following legal persons, who have to assess their profits according to the general non-simplified assessment method called "lucro real" i.e. on the basis of balance sheets:

- Legal persons whose total annual receipts in the previous tax year were superior to 78,000,000 BRL (approx. 23,000,000 EUR).

  For the purposes of calculating whether the limit was surpassed, total receipts are considered to be the sum of following items:

  - the monthly gross receipts (for the definition of gross receipts, see answer to question 4);
  - other receipts and capital gains;
  - net gains obtained in transactions in the markets of variable returns ("mercados de renda variável");
  - the nominal revenues from financial investments with fix returns;
  - receipts from exports to related persons or to preferential tax regimes exceeding the values already included in the balance sheets (due to transfer pricing adjustments).
- Legal persons whose activities are those of commercial banks, investment banks, development banks, funding agencies, securities and currency brokers, securities' distributors, leasing enterprises, credit cooperative societies, private insurance enterprises, and open private pension funds.
- Legal persons with profits, revenues or capital gains deriving from abroad. This category does not encompass legal persons earning receipts from the export of merchandises and from direct services provisions abroad.
- Legal persons that, due to authorization contained in tax laws, receive fiscal benefits in the form of corporate income tax exemption or reduction.
- Legal persons that in the current tax year have already paid corporate income tax on a monthly basis according to another assessment method.
- Legal persons carrying out the activities of cumulative and continuous provision of following services: credit advisory, market advisory, management of credit, selection and risks, management of debts and receivables, factoring.
- Legal persons carrying out the activities of securitization of credits regarding immovable assets, financial products and agribusiness.
- Legal persons carrying out the activities of buying credit rights, even if with the aim of securitizing them.

The assessment of corporate income tax on the basis of presumptive profits is optional for legal persons that are not forbidden to make use of this system and whose total annual receipts do not surpass 78,000,000 BRL (approx. 23,000,000 EUR).

4.3.1.4.7 Net-refund position

The amount that was paid in excess can be used to reduce future tax liabilities.

4.3.1.4.8 Carry forward of losses

Given that the tax bases under the "lucro presumido" are the receipts and deductions are not allowed, no losses are ascertained under this regime. Nevertheless, if a taxpayer that has opted for "lucro presumido" decides to return to the general non-simplified assessment method (so-called "lucro real"), he is allowed to compensate the losses that have been ascertained in the balance sheets. According to the general rule for loss compensation, losses may be charged against up to 30% of the taxable profits and there is no temporal limitation to the right of carry forward.

4.3.1.4.9 Administrative provisions

Specific information on the administrative provisions was not obtainable.

4.3.1.4.10 Qualitative and quantitative benefits and problems

The "lucro presumido" has diminished the taxpayers' compliance costs and from the tax authorities point of view it is easy to administer.

From the perspective of the legal person being financed through debt or equity and opting for the "lucro presumido", both debt and equity payments are not deductible. From the perspective of the person receiving dividends or interests, however, there is a bias towards equity. This is because dividends received are exempt from corporate and personal income tax, whilst interests are subject to tax (up to 22.5% income tax in the case of individuals and up to 25% corporate income tax + 9% social contribution on net profits in the case of legal persons).

Given that no deductions are allowed, one could say that this tax system is neutral as to whether costs are incurred in the present or in the future. The choice of organisational form is not affected. The choice of the company size, however, may be affected. In addition, "Lucro presumido" acts as an incentive for individuals to create small and medium enterprises and in this sense fosters investment.

4.3.1.4.11 Transitional rules

The taxpayer fulfilling the requirements to opt for the "lucro presumido" is allowed to opt in or out of this method of assessing the tax base every year. In this sense, no transition rules were / are necessary. There are solely some exceptional rules regulating the possibility of changing from the general assessment method to the "lucro presumido" within a tax year.

4.3.1.4.12 International recognition

Specific issues were not identified with respect to international recognition.

4.3.1.4.13 Avoidance schemes

Given that only small and medium enterprises may opt for the “lucro presumido”, some taxpayers split their business into various small legal persons in order to be able to avail themselves of the regime. The splitting of the business is allowed by the tax authorities if there is no simulation, i.e., if the small enterprises have economic substance. If, however, a big enterprise is only divided into small ones contractually, the division is considered as abusive and the taxpayer will be assessed as a single taxpayer according to the general non-simplified assessment method (“lucro real”). In these cases, high penalties are imposed by the tax authorities. Only legal persons and individuals treated as legal persons for tax purposes may avail themselves of the “lucro presumido”.

4.3.1.5 Effects

4.3.1.5.1 Economic Effects

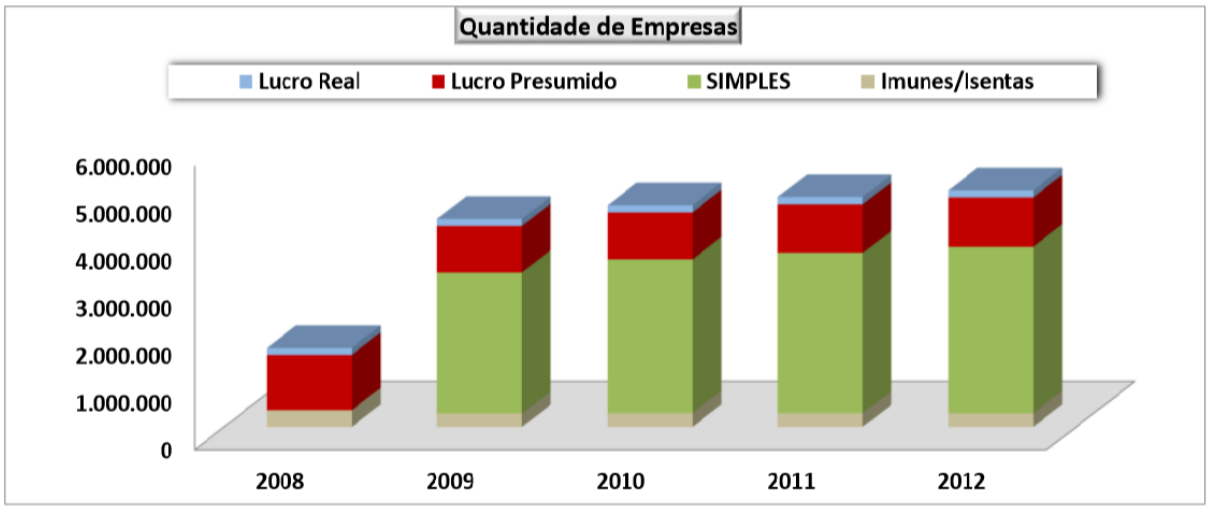
The regime was successful in reducing the costs of compliance making it possible for small and medium enterprises to be able to sustain their businesses without excessive burdens.

4.3.1.5.2 Revenue implications

The special assessment regime “lucro presumido” is a stimulus to small and medium entrepreneurs due to its simplicity. In fact, probably a considerable part of small and medium entrepreneurs would be part of the so-called informal sector of the economy if this special regime were not available.

According to a study of the Brazilian Federal Tax Authorities (“Receita Federal do Brasil”) published in 2014, the greatest part of the Brazilian enterprises opt for the “simples nacional” and for the “lucro presumido”. This can be seen in the following figure:

Figure 2: Brazilian enterprises that opt for the "simples nacional" and for the "lucro presumido"

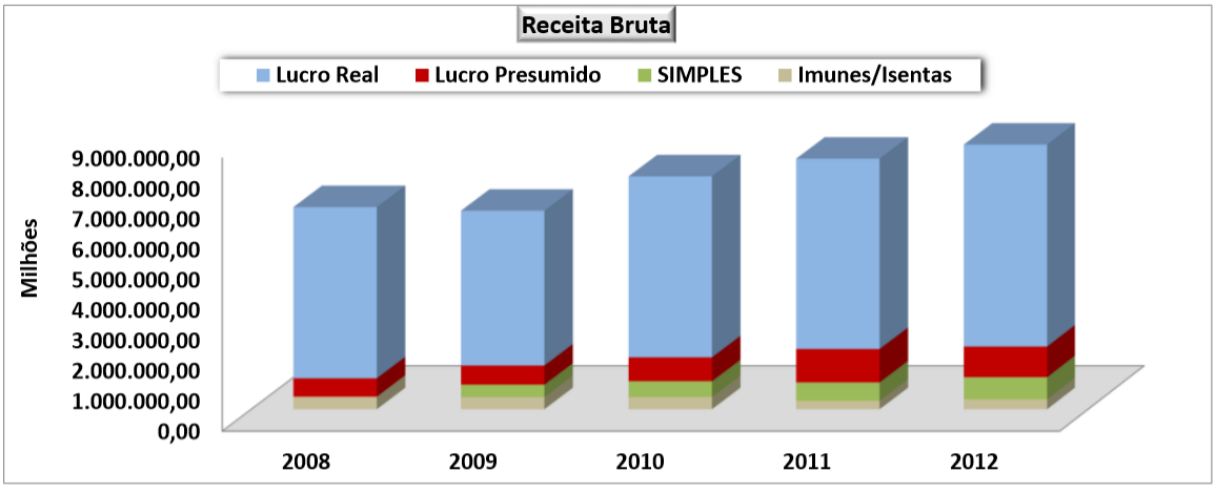


	2008		2009		2010		2011		2012	
Lucro Real	149.256	8,92%	147.189	3,34%	150.829	3,22%	153.417	3,15%	151.005	3,02%
Lucro Presumido	1.170.471	69,92%	982.523	22,33%	991.912	21,16%	1.027.451	21,13%	1.039.429	20,77%
SIMPLES	0	0,00%	2.984.515	67,32%	3.253.497	69,39%	3.390.536	69,72%	3.526.564	70,46%
Imunes/Isentas	354.371	21,17%	286.122	6,50%	292.430	6,24%	291.951	6,00%	287.904	5,75%
Total	1.674.098	100,00%	4.400.349	100,00%	4.688.668	100,00%	4.863.355	100,00%	5.004.902	100,00%

Source: Brazilian Ministry of Finance (2014), p. 3

Despite the great number of the enterprises opting for the special assessment regimes "simples nacional" and "lucro presumido", the gross receipts of these micro, small and medium enterprises represent only a small share of the total, as it is shown in the figure 3 (where "receita bruta" means gross receipts"):

Figure 3: Gross receipts of micro, small and medium enterprises



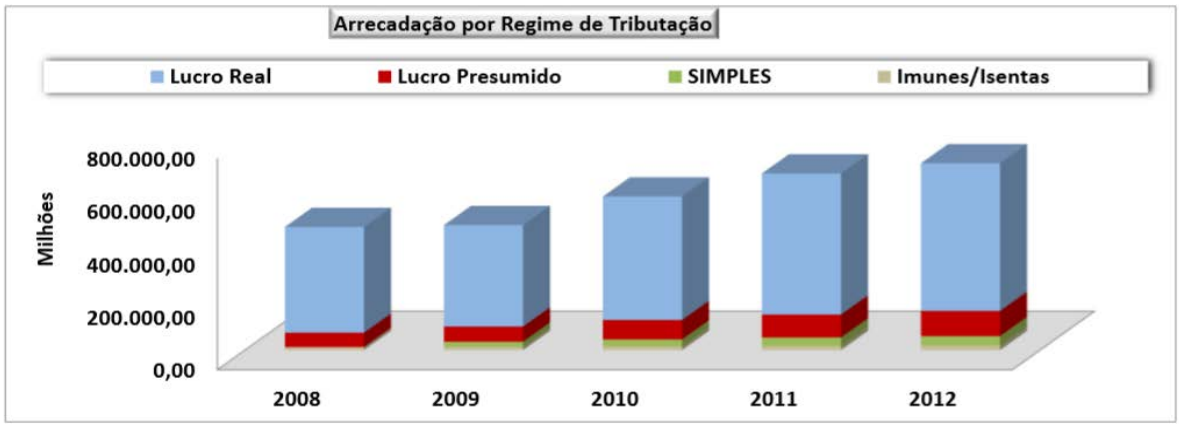
R$ milhões

	2008		2009		2010		2011		2012	
Lucro Real	5.641.409	84,70%	5.102.636	78,01%	5.964.350	77,73%	6.272.769	75,97%	6.655.298	76,32%
Lucro Presumido	606.208	9,10%	629.478	9,62%	786.617	10,25%	1.100.604	13,33%	1.008.930	11,57%
SIMPLES	0	0,00%	409.515	6,26%	521.629	6,80%	603.650	7,31%	729.426	8,37%
Imunes/Isentas	412.825	6,20%	399.752	6,11%	400.821	5,22%	279.974	3,39%	326.071	3,74%
Total	6.660.442	100,00%	6.541.382	100,00%	7.673.417	100,00%	8.256.998	100,00%	8.719.725	100,00%

Source: Brazilian Ministry of Finance (2014), p. 3

Figure 4 shows the fiscal revenues of the different types of assessment regimes, i.e. the "simples nacional", the "lucro presumido" and the general non-simplified regime named "lucro real":

Figure 4: Brazilian tax revenues



R$ milhões

	2008		2009		2010		2011		2012	
Lucro Real	400.317	85,87%	384.082	81,15%	467.645	80,40%	534.553	79,89%	559.123	79,02%
Lucro Presumido	54.302	11,65%	57.458	12,14%	73.836	12,69%	86.962	13,00%	95.624	13,51%
SIMPLES	0	0,00%	19.828	4,19%	26.410	4,54%	31.718	4,74%	35.120	4,96%
Imunes/Isentas	11.559	2,48%	11.937	2,52%	13.738	2,36%	15.877	2,37%	17.683	2,50%
Total	466.178	100,00%	473.304	100,00%	581.629	100,00%	669.110	100,00%	707.550	100,00%

Source: Brazilian Ministry of Finance (2014), p. 3

4.3.1.6 Criticised aspects

Refer to section 4.3.1.4.13.

4.3.1.7 Reasons for maintaining Lucro presumido

The "lucro presumido" is considered as accomplishing its principal aim of simplifying the assessment of corporate income tax and social contribution on net profits by small and medium enterprises.

4.3.2 Brazil (Simples Nacional)

4.3.2.1 Synopsis

"Simples Nacional" is an optional simplified regime that unifies taxes and contributions to the federal union, the state and municipalities. This regime is targeted at micro and small enterprises. Similarly to the case of the presumptive profits ("lucro presumido"), under "simples nacional" the tax to be paid is determined mainly on the basis of the gross receipts and no deductions are allowed.

The Brazilian tax system is complex and the magnitude of the compliance costs often act as a deterrent to start up enterprises and to micro and small enterprises in general. The introduction of "Simples Nacional" was hence based on granting a simplified and less costly way for smaller enterprises to comply with the administrative requirements.

Similarly to what happened in the case of "Lucro Presumido", given that only micro and small enterprises may opt for the "Simples Nacional", some taxpayers split their business into various small legal persons in order to be able to avail themselves of the regime. However, as a counter measure the range of enterprises that may opt for the regime were restricted further.

The tax rates are criticised as they are too high and do not apply progressively but cumulatively. There were concerns in this regard as the rates are not updates as often as desired. In addition, businesses argued that this regime should be extended in scope to include more enterprises.

The tax akin to the "Lucro Presumido" is highly popular with the eligible enterprises, however, when comparing the revenues from "Simples Nacional" to the total revenue of the Brazilian government this just represents a small portion. Notwithstanding, since "Simples Nacional" has met its main aim of reducing the compliance burden it is considered to be a successful regime.

4.3.2.2 ACE or CBIT as alternatives to Simples Nacional

ACE and CBIT were not considered as alternatives to the "simples nacional".

4.3.2.3 Motivations for implementation Simples Nacional

The main motivation for introducing Simples National was the aim of meeting the constitutional requirement of providing a differential treatment to micro and small enterprises in the tax area. This is because the complexity of the Brazilian tax system and the magnitude of the compliance costs often act as a deterrent to start up enterprises and to micro and small enterprises in general.

4.3.2.4 Design of Simples Nacional

4.3.2.4.1 General

"Simples nacional" is an optional special unified regime of levying taxes and contributions owed by micro and small enterprises. This simplified regime comprises taxes and contributions to the Union, the states and the municipalities.

The comprised taxes are:

- at federal level: corporate income tax ("imposto de renda da pessoa jurídica" – "IRPJ"), social contribution on the net profits ("contribuição social sobre o lucro líquido" – "CSLL"), contribution to the programs of social integration ("PIS") and of building of the public officer's estate ("Pasep") and contribution to the financing of the Brazilian social security ("Cofins"), contribution to the social security destinated to the social insurance borne by the legal person ("Contribuição para a Seguridade Social destinada à Previdência Social a cargo da pessoa jurídica" – "CPP"); tax on industrialized products ("imposto sobre produtos industrializados" – "IPI");
- at state level: state tax on circulation of goods and on the provision of interstate and inter-municipal transport services and on the provision of communication services – "ICMS");
- at municipal level: services tax ("imposto sobre serviços" – "ISS").

The "simples nacional" was announced in 2006 and entered into force in 2007 replacing the so-called "simples federal". This was a simplified regime similar to the "simples nacional", but covering only federal taxes and contributions.

The main objective of the "simples nacional" is to meet the constitutional requirement of granting the micro and small enterprises a differential legal treatment with the aim of incentivizing them by simplifying, reducing or eliminating their administrative, tax, social security and credit obligations (cf. art. 179 of the Brazilian Federal Constitution).

In 2014 the "simples nacional" was substantially altered, especially with regard to the following points:

- Broadening of its coverage: law firms, clinics of physiotherapy, insurance brokers, physicians, architects, and journalists, for example, are now allowed to opt for the "simples nacional";
- Broadening of the state and municipal competences to set up fixed values of "ICMS" (state tax on circulation of goods and on the provision of interstate and inter-municipal transport services and on the provision of communication services) and "ISS" (municipal services tax);
- Enlargement of the legal possibilities of granting exemptions on essential products regarding micro and small enterprises that opt for the "simples nacional";
- Reduction of the cases in which the obligation to levy "ICMS" may be legally transferred from the taxpayer – micro or small enterprise – to a third person (so-called "substituição tributária"). The legal transfer of the obligation to pay

"ICMS" has as consequence a taxation outside the regime "simples nacional", i.e., a higher taxation.

With regard to the indirect taxes and contributions levied on products and services exported, one can say that the "simples nacional" is destination based. In fact, the law foresees the separate consideration of receipts from export, so as to exclude the indirect source taxation on exported goods ("ICMS", "IPI", "Pis-Pasep", "Cofins") and services ("ISS", "Pis-Pasep" and "Cofins").

4.3.2.4.2 Scope

The "simples nacional" is targeted at so-called micro and small enterprises. Under this category fall enterprises that derived from the internal market in the previous tax year receipts up to 3,600,000 BRL (approx. 1,068,000 EUR) and, additionally, receipts deriving from the export of goods and / or services, provided that the export's receipts equally do not surpass 3,600,000 BRL (approx. 1,068,000 EUR).

The option for the "simples nacional" is not allowed to micro and small enterprises in the follow cases:

- when the enterprise has received in the previous or receives in the present tax year gross receipts from the internal market exceeding 3,600,000 BRL (approx. 1,068,000 EUR) or when its receipts from exports of goods and /or services in the previous or in the present year exceed 3,600,000 BRL (approx. 1,068,000 EUR);
- when another legal person has a participation in its capital;
- when the enterprise is a branch, affiliate, agency or representation in Brazil of a legal person with business seat abroad;
- when a participation in the enterprise's capital is held by an individual that is registered as entrepreneur or is partner of another enterprise that falls under the scope of "simples nacional", provided that the global gross receipts exceed the limit of 3,600, 000 BRL (approx. 1,068,000 EUR);
- when the owner or partner of the enterprise owns more than 10% of the capital of another enterprise that is not entitled to opt for the "simples nacional", provided that the global gross receipts exceed the limit of 3,600, 000 BRL (approx. 1,068,000 EUR);
- when the owner or partner of the enterprise is manager of or exerts a comparable function regarding another legal person that pursues the objective of making profits, provided that the global gross receipts exceed the limit of 3,600,000 BRL (approx. 1,068,000 EUR);
- when the enterprise is established as a cooperative society, with exception of consumers' cooperative societies;
- when the enterprise holds a participation in the capital of another legal person;
- when the enterprise carries out the activity of commercial bank, investment bank, development bank, or other similar financial institutions;

- when the enterprise carries out the activity of a credit, financial or investment society; or the activity of securities and currency brokers; or the activity of leasing; or of private insurance or of private pension fund;
- when the enterprise results or remains from a splitting or any other form of demerger of a legal person that occurred in one of the five previous tax years;
- when the enterprise is established as a business corporation ("sociedade por ações");
- when the owners of the enterprise providing services are subordinated to the services' receiver and additionally the relationship between them is both personal and habitual (these are characteristics of an employment relationship);
- when the enterprise carries out the activities of cumulative and continuous provision of following services: credit advisory, market advisory, management of credit, selection and risks, management of debts and receivables, factoring;
- when the enterprise has a partner domiciled abroad;
- when an entity of the public administration – federal, state or municipal – holds a participation in the capital of the enterprise;
- when the enterprise is a debtor of the Brazilian Institute of Social Insurance ("INSS"), or of the federal, state or municipal tax offices;
- when the enterprise provides services of interstate and inter-municipal transport of passengers, except when the transport is done by rivers or when it has characteristics of urban or metropolitan transport or when it is organized as continuous freight ("fretamento") that takes place in a metropolitan area with the aim of transporting students or workers;
- when the enterprise generates, transmits, distributes or commercializes electricity;
- when the enterprise's activity consists in importing or producing automobiles and motorcycles;
- when the enterprise's activity consists in importing fuel;
- when the enterprise's activity consists in producing or selling at wholesale cigars, cigarettes, cigarettes' filters, guns, munitions and powder, explosives and detonators, alcoholic beverages and alcohol-free beer;
- when the enterprise carries out the activity of workforce's ceding or renting;
- when the enterprise is devoted to the allotment and incorporation of immovable property;
- when the enterprise's activity resides in renting own immovable property, except when consisting in a services provision on which the "ISS" (municipal services tax) is levied;
- when the enterprise is not registered or whose situation is not regular with respect to the federal, municipal and / or state register(s).

4.3.2.4.3 Tax Calculation

The tax base is composed of the following items:

Gross receipts ("receita bruta"), defined as encompassing the results from the sales of goods on own account, the price of services rendered and the results from operations on someone else's account (i.e. commissions), excluding the cancelled sales and the discounts granted without the imposition of conditions. The tax rates to be applied on these gross receipts are foreseen in annexes I to VI of the Complementary Law ("Lei complementar") n. 123/2006. The applicable annex is determined depending on the activity carried out by the taxpayer.

Receipts deriving from the following activities, which should be considered separately:

- resale of merchandise, which shall be taxed according to the table in annex I of the Complementary Law ("Lei complementar") n. 123/2006;
- sale of merchandise that has been industrialized by the taxpayer, which shall be taxed according to the table in annex II of the Complementary Law ("Lei complementar") n. 123/2006;
- provision of certain services enumerated by law (among others crèche, kindergarten, school, post offices, travel agencies, Municipal transport of passengers) and provision of services related to renting of immovable property and brokerage of immovable property, which shall be taxed according to the table in annex III of the Complementary Law ("Lei complementar") n. 123/2006;
- provision of construction services and of civil engineering services in general, which shall be taxed according to the table in annex IV of the Complementary Law ("Lei complementar") n. 123/2006;
- provision of security, cleaning and conservation services, which shall be taxed according to the table in annex IV of the Complementary Law ("Lei complementar") n. 123/2006;
- lawyer's services provisions, which shall be taxed according to the table in annex IV of the Complementary Law ("Lei complementar") n. 123/2006;
- management and renting of third party's immovable property; carrying out of fitness centres and similar activities; elaboration of computer programs; licensing or cession of rights of use computer programs; planning, creating, maintaining and updating electronic sites; enterprises assembling stands to trade fairs; laboratories of clinical analysis; tomography, magnetic resonance and X-ray services; services related to prosthesis in general. Receipts from these activities shall be taxed according to the table in annex V of the Complementary Law ("Lei complementar") n. 123/2006;
- communication services and services of interstate and inter-municipal transport of goods and in certain cases of passengers. Receipts from these activities shall be taxed according to the table in annex III of the Complementary Law ("Lei complementar") n. 123/2006, deducting the amount correspondent to the "ISS" (municipal services tax) and including the amount correspondent to the

"ICMS" (state tax on circulation of goods and on the provision of interstate and inter-municipal transport services and on the provision of communication services) foreseen in annex I of the Complementary Law ("Lei complementar") n. 123/2006;

- other services provisions not expressly excluded from the "simples nacional" shall be taxed according to the table in annex III of the Complementary Law ("Lei complementar") n. 123/2006, unless there is a more specific legal provision foreseeing their taxation according to another annex;
- medical services, dentist services, psychological services, and other similar services expressly enumerated by law, which shall be taxed according to the table in annex VI of the Complementary Law ("Lei complementar") n. 123/2006;
- translation and interpretation services, architecture, engineering and other similar services expressly enumerated by law, which shall be taxed according to the table in annex VI of the Complementary Law ("Lei complementar") n. 123/2006;
- commercial agency and other activities of commercial and service's intermediation, which shall be taxed according to the table in annex VI of the Complementary Law ("Lei complementar") n. 123/2006;
- expertise, auction and evaluation services, which shall be taxed according to the table in annex VI of the Complementary Law ("Lei complementar") n. 123/2006;
- audit, economy, consultancy, management, organization, control and administration services, which shall be taxed according to the table in annex VI of the Complementary Law ("Lei complementar") n. 123/2006;
- journalism and publicity, which shall be taxed according to the table in annex VI of the Complementary Law ("Lei complementar") n. 123/2006;
- mediation, except of workforce, which shall be taxed according to the table in annex VI of the Complementary Law ("Lei complementar") n. 123/2006;
- other activities in the services sector that have as scope the provision of services deriving from the exercise of activities of an intellectual, technical, scientific, sportive, artistic or cultural nature, which shall be taxed according to the table in annex VI of the Complementary Law ("Lei complementar") n. 123/2006, unless a more specific legal provision foresees their taxation according to another annex;
- renting of movable goods, which shall be taxed according to the table in annex III of the Complementary Law ("Lei complementar") n. 123/2006, deducting the amount correspondent to the "ISS" (municipal services tax);
- activities simultaneously subject to "IPI" (federal tax on industrialized products) and to "ISS", which shall be taxed according to the table in annex II of the Complementary Law ("Lei complementar") n. 123/2006, deducting the amount correspondent to the "ICMS" and adding the amount corresponding to the

"ISS" foreseen in annex III of the Complementary Law ("Lei complementar") n. 123/2006;

- commercialization of medicines produced by compounding pharmacies when individually produced according to a specific medical prescription, which shall be taxed according to the table in annex III of the Complementary Law ("Lei complementar") n. 123/2006. The remaining cases of commercialization of medicines produced by compounding pharmacies shall be taxed according to the table in annex I of the Complementary Law ("Lei complementar") n. 123/2006.

Following receipts should also be considered separately:

- from transactions or provisions subject to single stage tax (tributação monofásica) and also, with regard to "ICMS", when the tax has already been collected by another taxpayer (on his behalf);
- on which "ISS" has been already collected (in given cases expressly mentioned by law);
- subject to tax at a fixed value or that have been subject to exemption or reduction of "ISS" and "ICMS" on the terms of the Complementary Law ("Lei complementar") n. 123/2006;
- deriving from export;
- receipts on which "ISS" is due to a municipality other than the one in which the establishment of the service provider is located.

Similarly to the case of the presumptive profits ("lucro presumido"), under "simples nacional" the tax to be paid is determined mainly on the basis of the gross receipts. In view of this, no deductions are allowed.

4.3.2.4.4 Rate

The taxes are paid on a monthly basis and the taxpayer has to fill in a unified form comprising all the taxes. The taxes are levied on the gross receipts and the applicable tax rates depend on the business branch carried out by the taxpayer and also on the type of receipts. The business branch and the type of receipts determine the applicable annex to the Complementary Law ("Lei complementar") n. 123/2006, i.e., the applicable table of tax rates that vary according to the amount of receipts. The tables according to which the tax rates are calculated are reproduced in Annex 3 to this report.

4.3.2.4.5 Treatment of financial expenditure in R-based CFT

Enterprises acting in the financial sector are not allowed to opt for the "simples nacional".

4.3.2.4.6 Exemptions

The "simples nacional" is an optional system of taxation for micro and small enterprises. Enterprises are forbidden to opt for the "simples nacional" mainly in following situations:

(a) when the amount of their gross receipts surpasses the legally established threshold;

(b) when they act in strategic and / or strongly regulated sectors – such as financial, energy, insurance, and munitions sectors;

(c) when they have foreign capital – i.e. one or more partners residing abroad;

(d) when they result from a demerger recently occurred or when another legal person have a participation in their capital.

The prohibitions under (d) show that the legislator wants to avoid that big enterprises are split into diverse small enterprises with the sole or main objective of availing themselves of the "simples nacional".

4.3.2.4.7 Net-refund position

Taxes paid in excess in the context of the "simples nacional" may be credit against tax due in the future, provided that the future tax duty also arises in the context of the "simples nacional" and refers to the same taxes or contributions due to the same federative member (i.e. to the Union, or to the same state or to the same municipality in relation to which the taxes were paid in excess).

4.3.2.4.8 Carry forward of losses

Due to the fact that no deductions are allowed under the "simples nacional", no losses are ascertained. Nevertheless, if a taxpayer that has opted for "simples nacional" decides to return to the general non-simplified assessment method (so-called "lucro real"), he is allowed to compensate the losses that have been ascertained in the balance sheets. According to the general rule for loss compensation, losses may be charged against up to 30% of the taxable profits and there is no temporal limitation to the right of carry forward.

4.3.2.4.9 Administrative provisions

Specific information on the administrative provisions was not obtainable.

4.3.2.4.10 Qualitative and quantitative benefits and problems

The "simples nacional" reduces the taxpayers' compliance costs and is easy to administer.

It affects the choice of the organisational form in that business corporations ("sociedades por ações") are not allowed to opt for the "simples nacional". Location choices inside Brazil are slightly affected in that the law gives a certain leeway to the states and municipalities with regard to taxes under their competence, i.e., "ICMS" (states) and "ISS" (municipalities). The decision as to whether to invest inside or outside Brazil is also affected as far as the "simples nacional" is only available for micro and small enterprises with residence inside Brazil. Given that no deductions are

allowed, one could say that this tax system is neutral as to whether costs are incurred in the present or in the future. “Simples nacional” acts as an incentive for individuals to create micro and small enterprises and in this sense fosters investment.

Akin to what occurs under the “lucro presumido”, from the perspective of the legal person being financed through debt or equity and opting for the “simples nacional”, both debt and equity payments are not deductible. From the perspective of the person receiving dividends or interests, however, there is a bias towards equity. This is because dividends received are exempt from corporate and personal income tax, whilst interests are subject to tax (up to 22.5% income tax in the case of individuals and up to 25% corporate income tax + 9% social contribution on net profits in the case of legal persons).

4.3.2.4.11 Transitional rules

Given that the “simples nacional” does not replace the general system, but coexists with it, it cannot be said that there was a transition from one regime to another. Similarly to the “lucro presumido”, the enterprises eligible to opt for the “simples nacional” may opt in or out every year. The option for the “simples nacional” has to be exercised until the last working day of January and is valid for the whole year.

4.3.2.4.12 International recognition

Specific issues were not identified with respect to international recognition.

4.3.2.4.13 Avoidance schemes

As under “lucro presumido”, big enterprises are tempted to split their business into small legal persons in order for them to benefit from the special regime. In this context, potential tax avoidance strategies were prevented by limiting the range of enterprises that may opt for the “simples nacional”.

4.3.2.5 Effects

4.3.2.5.1 Economic Effects

The regime was successful in reducing the costs of compliance making it possible for start-up enterprises to be able to sustain their businesses without excessive burdens.

4.3.2.5.2 Revenue implications

See section 4.3.1.5 for details of the “lucro presumido” revenue implications.

4.3.2.6 Criticized aspects

There are some voices that plead for an even greater extension of the “simples nacional” as to which sectors of activities shall be able to opt for this regime. Moreover, some criticize the lack of an automatic or more frequent update of the gross receipts' threshold (for the enterprises to be able to opt for the regime) to counteract the effects of inflation.

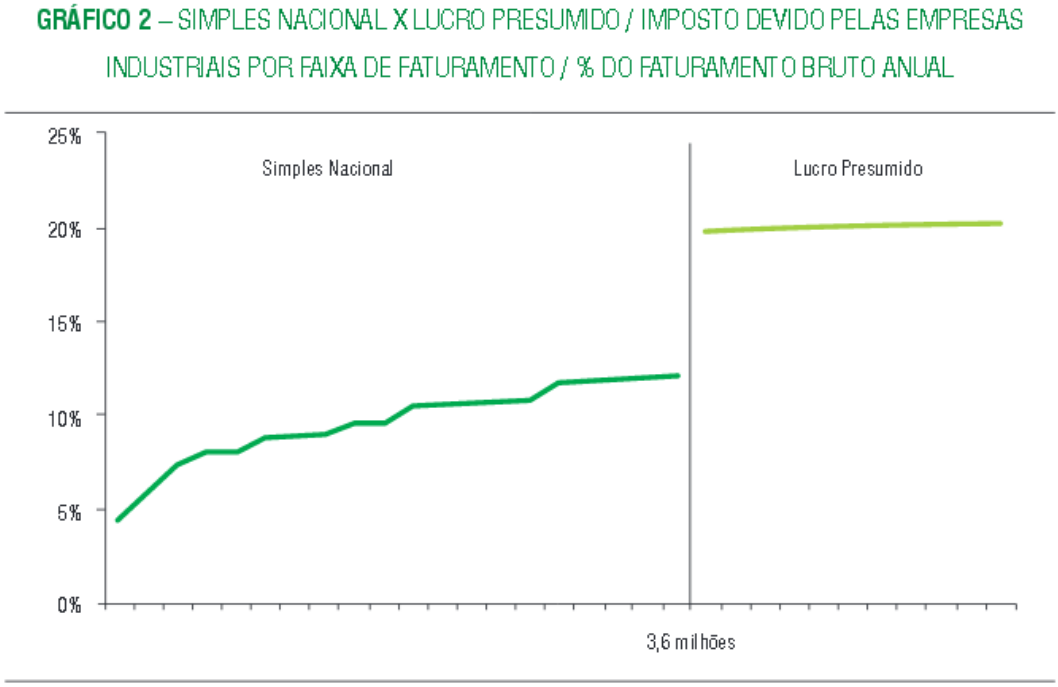
Furthermore, there is some criticism on how the tables of tax rates are structured, since when the gross receipts of the enterprise increase from a level “a” to a level “b”, the higher tax rate corresponding to level “b” is applicable to the totality of the income. The industrial sector argues that the system should be changed in order for

the higher tax rate to be applicable only to the amounts exceeding the level "a". This is because according to the current system the *net* receipts of legal persons subject to a higher tax rate are sometimes inferior to the *net* receipts of persons that earn less gross receipts but are subject to a lower tax rate.

4.3.2.7 Reasons for maintaining Simples Nacional

The "simples nacional" is perceived as being beneficial for micro and small enterprises thus accomplishing its main objectives. The following graphic compares the "simples nacional" with the "lucro presumido" in regard to how much of the gross receipts do the taxes represent.

Figure 5: Percentage of the gross receipts Simples Nacional and Lucro Presumido represent



Source: Confederação nacional da indústria – CNI (2014), p.16.

Figure 5 above shows how much of the enterprise's annual gross receipts, the taxes represent with regard to enterprises opting for the "simples nacional" as compared to enterprises opting for the "lucro presumido". The x-coordinate represents the annual gross receipts of the analysed enterprises. While the y-coordinate shows percentages of the annual gross receipts. The green curves show the percental relationship between the amount of tax paid by an enterprise in a given year and its total gross receipts. The darker green curve at left shows how much did enterprises with annual gross receipts up to 3.6 million BRL and opting for the "simples nacional" pay for taxes in relationship to their annual gross receipts. The curve at the right illustrates the relationship between taxes paid and annual gross receipts with regard to enterprises with annual gross receipts over 3.6 million BRL and opting for the "lucro presumido". One can notice that the enterprises opting for the "lucro presumido" spend a greater percentage of their gross receipts paying taxes than enterprises opting for the "simples nacional" do.

4.3.3 Brazil (Pis-Pasep and Cofins: non-cumulative regime)

4.3.3.1 Synopsis

"Pis-Pasep" and "Cofins" were introduced into the Brazilian legislation in 1970 and 1991 respectively. These taxes are federal social contributions that are levied on the enterprises' gross receipts. Originally, these contributions were levied at the rate of respectively 0.65% and 3% in a cumulative basis whereby crediting the contributions paid on the inputs was not possible. In order to avoid the cascade effect of such cumulative tax, since 2003 a non-cumulative regime is in force, allowing the credit of the contributions paid on inputs. The rates under the non-cumulative regime, however, are 1.65% and 7.6%, respectively.

The greatest problem of "Pis-Pasep" and "Cofins" on a non-cumulative basis are the complexity of their assessment by the taxpayer and also the high level of uncertainty concerning the interpretation of some legal provisions, e.g. what may be considered as "input" in a concrete situation.

The regime leads to a significant amount of revenues. According to a research[97] the nominal revenues from "Pis-Pasep" and "Cofins" would have increased from 65 billion BRL in the year 2002 to 221 billion BRL in the year 2012. Considering that this regime is a source of so much revenue for the Brazilian government, the tax is well established in the system and there are no plans to abandon this regime.

4.3.3.2 ACE or CBIT as alternatives Pis-Pasep and Cofins: non-cumulative regime

ACE and CBIT were not considered as alternatives to the "Pis-Pasep" and "Cofins" regime.

4.3.3.3 Motivations for implementing Pis-Pasep and Cofins: non-cumulative regime

Originally, the Pis-Pasep and Cofins contributions were levied at the rate of respectively 0.65% and 3% in a cumulative basis i.e. without the possibility of crediting the contributions paid on the inputs. There was thus a cascade effect.

Therefore, a non-cumulative regime was put in force, allowing the credit of the contributions paid on inputs.

4.3.3.4 Design of Pis-Pasep and Cofins: non-cumulative regime

4.3.3.4.1 General

Contribution to the Programs of Social Integration (PIS) and of Building of the Public Officer's Estate (Pasep) and Contribution to the Financing of the Brazilian Social Security (Cofins). (In original: "Contribuição para os Programas de Integração Social

[97] Brazilian National Federation of Accountancy Enterprises and of Enterprises of Consultancy, Expertise, Information and Research ("Federação Nacional das Empresas de Serviços Contábeis e das Empresas de Assessoramento, Perícias, Informações e Pesquisa" – "Fenacon"), (2013).

(PIS) e de Formação do Patrimônio do Servidor Público (Pasep) e Contribuição para o Financiamento da Seguridade Social – Cofins").

"Pis-Pasep" and "Cofins" are federal social contributions that are levied on the enterprises' gross receipts. "Pis-Pasep" exists since 1970, while "Cofins" is in place since 1991. Originally, these contributions were levied at the rate of respectively 0.65% and 3% in a cumulative basis i.e. without the possibility of crediting the contributions paid on the inputs. There was thus a cascade effect.

In order to avoid the cascade effect, since 2003 a non-cumulative regime is in force, allowing the credit of the contributions paid on inputs. Under the non-cumulative regime, however, these contributions are levied at the rates of 1.65% and 7.6%, respectively.

In the following the explanations deal exclusively with the "Pis-Pasep" and "Cofins" on a non-cumulative basis, which is mandatory for legal persons that assess their corporate income tax and social contribution on net profits under the general non-simplified regime (so-called "lucro real"). For legal persons opting for the "lucro presumido" or the "simples nacional", however, the cumulative system is still applicable. The reason for focusing on the non-cumulative regime is its similarity to cash-flow systems.

4.3.3.4.2 Scope

All legal persons (and individuals regarded as legal persons for tax purposes) domiciled in Brazil that earn the receipts on which the social contributions "Pis-Pasep" and "Cofins" are levied are obliged to pay these taxes.

4.3.3.4.3 Tax calculation

The tax base is the totality of the receipts received by the legal person in the period of one month, independently of their denomination and of their accounting classification. The totality of the receipts corresponds to the gross receipts and all other receipts earned by the legal person.

For the purposes of these contributions, the term "gross receipts" is to be interpreted as encompassing the results from the sales of goods on own account, the price of services rendered, the results from operations on someone else's account (i.e. commissions), and all other receipts from the activity or main enterprise objective of the legal person.

Following receipts shall be excluded from the tax base:

- those that are exempt or to which the applicable tax rate is zero;
- from the sale of goods that are part of the enterprise fixed assets, classified as investment, immovable or intangible;
- earned by a legal person that exerts resale activities, when reselling merchandise in relation to which the social contributions are levied by the selling person (due to a legal transfer of the tax liability);
- relating to:

        - cancelled sales and discounts that were granted without the imposition of conditions;
        - the reversal of provisions and the recuperation of credits registered as losses that do not represent new receipts, the positive result from the evaluation of investments according to the net assets' value and the profits and dividends deriving from participations in legal persons that have been registered as receipts;
    - deriving from the non-gratuitous transfer to other taxpayers subject to "ICMS" (state tax on circulation of goods and on the provision of interstate and inter-municipal transport services and on the provision of communication services) of ICMS-credits originated from exports;
    - financial receipts deriving from adjustment to present value of receipts that are excluded from the tax base of the contributions;
    - regarding the gains deriving from the evaluation of assets and liabilities on the basis of the fair value;
    - deriving from investments' subventions, including in the form of exemption or reduction of taxes that are granted as stimulus to the start-up or to the expansion of economic ventures and also receipts deriving from public donations;
    - relating to taxes that are not levied due to some specific exemptions and reductions set up by law;
    - relating to the premiums of a debenture issuance;
    - receipts deriving from merchandise export;
    - receipts deriving from the provision of services to an individual or a legal person that is resident or domiciled abroad, when the payment represents inflow of foreign currency;
    - sales to export trading companies with the specific aim of export.

The amount of tax to be paid is calculating according to the following steps:

First, the tax rates (7.6% in the case of Cofins and 1.65% in the case of Pis-Pasep) are applied to the tax base, leading to a "taxable amount before credit". Secondly, the taxpayer has to calculate the amount of credit that may be deducted from the taxable amount before credit. The creditable amount is calculated by applying the tax rates to the following values:

- goods acquired to be resold, except with regard to:
    - merchandise acquired by a reselling enterprise in relation to which the social contributions are levied by the selling person (due to a legal transfer of the tax liability);
    - gasoline – not including airplane's gasoline, diesel fuel and liquefied petroleum gas –; pharmaceutical products; products of personal care; some specified machines and automobiles; some specified automobile parts; new automobile tires; air inner tubes; aviation kerosene;

containers made for water, soft drinks, beer, and some other specified beverages; and alcohol;

- goods and services used as inputs to services provisions and to the production or fabrication of goods or products to be sold, including fuel and lubricating oil, with some specific exceptions set up by law;
- electricity and thermal energy, inclusive in the form of steam, consumed in the establishments of the legal person;
- rents of buildings, machines and equipment paid to a legal person, when referred goods are employed in the enterprise's activities;
- the values paid to legal persons as remuneration for leasing operations, except when the person receiving the payments opts for the "simples nacional";
- machines, equipment and other goods that are part of the fixed assets, acquired or fabricated with the objective of being rented to third parties or to be used in the production of goods to be sold or in the provision of services;
- edification, improvements and betterments in the taxpayer's or third parties' immovable properties that are employed in the enterprise's activities;
- goods received in return, when the receipts deriving from the sale of these goods have been part of a previous month receipt on which the contributions "Pis-Pasep" and "Cofins" have already been levied;
- merchandise storage and transport in the sales' operation, when the costs have been supported by the seller;
- transportation vouchers, meal vouchers or food vouchers, regimentals or uniforms granted to employees by legal persons that provide cleaning, conservation, and maintenance services;
- goods that are part of the intangible assets and have been acquired to be employed in the production of goods to be sold or in the provision of services.

Following amounts are not credited:

- payments to a physical person in exchange to workforce;
- the acquisition of goods or services on which the contributions "PIS-Pasep" and "Cofins" are not levied.

The right of credit is only applicable with regard to:

- goods and services acquired from a legal person domiciled in Brazil;
- costs and expenses incurred, paid or credited to legal person domiciled in Brazil;
- goods and services acquired and costs and expenses incurred as from the entry into force of the law that sets up the rules on the assessment of "Pis-Pasep" and "Cofins" on non-cumulative basis.

4.3.3.4.4 Rate

The rates for Cofins and Pis-Pasep are 7.6 % and 1.65% respectively.

4.3.3.4.5 Treatment of financial expenditure in R-based CFT

Financial institutions are excluded from the taxation of “Pis-Pasep” and “Cofins” on a non-cumulative basis. They are subject to the cumulative system with some adaptations.

4.3.3.4.6 Exemptions

The law foresees some subjective and objective exemptions. When a person or receipt is excluded from the non-cumulative system, the person or receipt is subject to the payment of these contributions according to the so-called “cumulative regime”. Under the cumulative regime no credits are allowed and the applicable rates are lower (3% for Cofins and 0.65% for Pis-Pasep).

Subjective exclusions include:

- Commercial banks; investment banks; development banks; credit, funding and investment societies; real-estate funding societies; broker societies; securities distributors, leasing enterprises; credit cooperative societies, private insurance and capitalization societies; autonomous agents of private insurance and credit; and open and closed private pension funds.
- Legal persons that have as business purpose the securitization of real estate credits, financial credits and agricultural credits;
- Legal persons that operate health care plans;
- Legal persons that pay corporate income tax and social contribution on net profits according to the “lucro presumido”;
- Legal persons that have their amount of corporate income tax estimated / arbitrated by the tax authorities (“lucro arbitrado”);
- Legal persons that opt for the “simples nacional”;
- Legal persons not subject to taxes;
- Public bodies, autarchies, and federal, state and municipal public foundations, as well as foundations whose creation has been authorized by law and that fulfil some requirements set up by law;
- Cooperative societies, except those dedicated to agricultural production and the consumer cooperative societies.

Objective exclusions include:

- Receipts deriving from:
  - operations in relation to which the obligation to pay “Pis-Pasep” and “Cofins” is legally transferred to another person;
  - buying and selling used automobiles;
- Receipts from the provision of telecommunication services;
- Receipts from the sale of journals and reviews and from the services provisions of journal and radio enterprises;

- Receipts of legal persons that are part of the “wholesale electricity market” and because of this are able to opt for a special tax regime with regard to the social contributions “Pis-Pasep” and “Cofins”;
- Receipts related to contracts concluded before 31October 2003:
    - with duration of more than one year, of legal persons that act as managers of consortia of movable and immovable goods;
    - with duration of more than one year, of construction (in the form of a contract for work and labour – “construção por empreitada”) or supply, at a pre-determined price, of goods and services;
    - of construction (in the form of a contract for work and labour – “construção por empreitada”) or supply, at a pre-determined price, of goods or services contracted with a legal person of public law, a public enterprise, a semi-public company (“sociedade de economia mista”) or its subsidiaries, as well as the contracts concluded afterwards and deriving from proposals presented in bidding processes by that date;
- Receipts from the provision of collective transport of passengers by road, metro, train and water.
- Receipts deriving from services:
    - provided by hospitals, medical clinics, dental clinics, clinics of physiotherapy and speech therapy, laboratories of pathological and cellular anatomy, or of clinical analysis;
    - of dialysis, X-ray, radio diagnostic and radiotherapy, chemotherapy and blood bank;
- Receipts deriving from the provision of education services;
- Receipts arising from sales of merchandise by duty free stores at airports and ports;
- Receipts deriving from the collective transport of passengers, undertaken by enterprises of domestic airlines, and deriving from the provision of aero-taxi transport services;
- Receipts deriving from the provision of services with dirigibles used for agricultural purposes and inscribed in the Brazilian Aeronautic Register (“Registro Aeronáutico Brasileiro” – RAB);
- Receipts deriving from the provision of services by call centre enterprises, telemarketing enterprises, enterprises of tele requests for payment, and enterprises that provide tele services in general;
- Receipts deriving from the construction of buildings;
- Receipts derived by theme parks, and those deriving from hotel services and from organization of fairs and events, according to joint act of the Ministers of Finance and Tourism;

- Receipts arising from the provision of mail and telegraphic services provided by the Brazilian Post and Telegraph Corporation ("Empresa Brasileira de Correios e Telégrafos");
- Receipts arising from the provision of public services by concessionaires that operate roads;
- Receipts deriving from the provision of services by travel and tourism agencies;
- Receipts earned by enterprises that provide informatics services, deriving from activities of development and licensing of software or transfer of right to use, as well as deriving from analysis, programming, installing, configuring, providing consultancy services, technical support and maintenance or updating of software, being electronic sites included in the concept of software. This provision is not applicable to the commercialization, licensing and transfer of right to use of imported software;
- Receipts relating to activities of real estate resale, real estate allotment, building construction with the aim of sale, when deriving from long-term contracts concluded after 31 October 2003;
- Receipts deriving from commercialization of crushed rock, sand for building constructions and gravel sand;
- Receipts deriving from the alienation of company shares.

4.3.3.4.7 Net-refund position

The taxpayer is allowed to credit taxes unduly paid against present or future debts regarding federal taxes and/or contributions.

4.3.3.4.8 Carry forward of losses

The social contributions "Pis-Pasep" and "Cofins" are due on gross receipts, so that no losses are taken into consideration. The amounts to be credited, however, may be carried forward.

4.3.3.4.9 Administrative provisions

Specific information on the administrative provisions was not obtainable.

4.3.3.4.10 Qualitative and quantitative benefits and problems

"Pis-Pasep" and "Cofins" is neutral with respect to the choice between present and future investment, given that the inputs / expenses give rise to credits in the same month in which the investment was made. They affect the choice of the organisational form in the sense that this regime is not applicable to cooperatives and is mandatory to business corporations ("sociedades por ações"). Additionally, they can influence the size of a legal person. This is because the "Pis-Pasep" and "Cofins" on a non-cumulative basis are only applicable to enterprises that assess their corporate income tax and social contribution on net profits according to the general non-simplified regime (so-called "lucro real"). Therefore, a legal person could escape this system by splitting its business into small legal persons in order to opt for the "lucro presumido" or the "simples nacional". In this case, they would be subject to "Pis-Pasep" and "Cofins" according to the cumulative regime.

The social contributions “Pis-Pasep” and “Cofins” are due by legal persons that have residence in Brazil. Therefore, the decision of locating the enterprise in Brazil or abroad is affected. Concerning where to locate inside Brazil, however, the contributions are neutral.

Financial institutions are excluded from the taxation of “Pis-Pasep” and “Cofins” on a non-cumulative basis. They are subject to the cumulative system with some adaptations.

The “Pis-Pasep” and “Cofins” on a non-cumulative basis are applicable only to legal persons with residence in Brazil, independently of whether the receipts derive from inside or outside Brazil. If, however, the foreign receipts derive from exports they are excluded from the tax base (as a consequence of the destination principle). With regard to the credits, however, the scope is national, since only goods and services acquired from legal persons domiciled in Brazil and the costs and expenses paid or credited to legal persons domiciled in Brazil shall give rise to credits.

4.3.3.4.11 Transitional rules

No specific transitional issue or rules were identified.

4.3.3.4.12 International recognition

Specific issues were not identified with respect to international recognition.

4.3.3.4.13 Avoidance schemes

The majority of the controversies between tax authorities and taxpayers are not on specific tax avoidance schemes, but on what can be considered as an “input” and therefore credited in concrete cases. Moreover, there are controversies as to whether a legal person may be allowed to restructure its business with the objective of increasing the creditable amounts – for example by outsourcing part of the production to a related enterprise. Whilst the tax authorities tend not to accept this, there are some administrative fiscal decisions recognizing such schemes as legitimate.

Furthermore, as stated above, big enterprises may split their business into small enterprises in order to be able to opt for the “lucro presumido” or the “simples nacional” and consequently be subject to the “Pis-Pasep” and “Cofins” on a cumulative basis.

The social contributions “Pis-Pasep” and “Cofins” are due on gross receipts, so that no losses are taken into consideration. The amounts to be credited, however, may be carried forward.

4.3.3.5 Effects

4.3.3.5.1 Economic effects

The “Pis-Pasep” and “Cofins” contributions are highly complex and may act as investments’ deterrents (see section 4.3.3.6.)

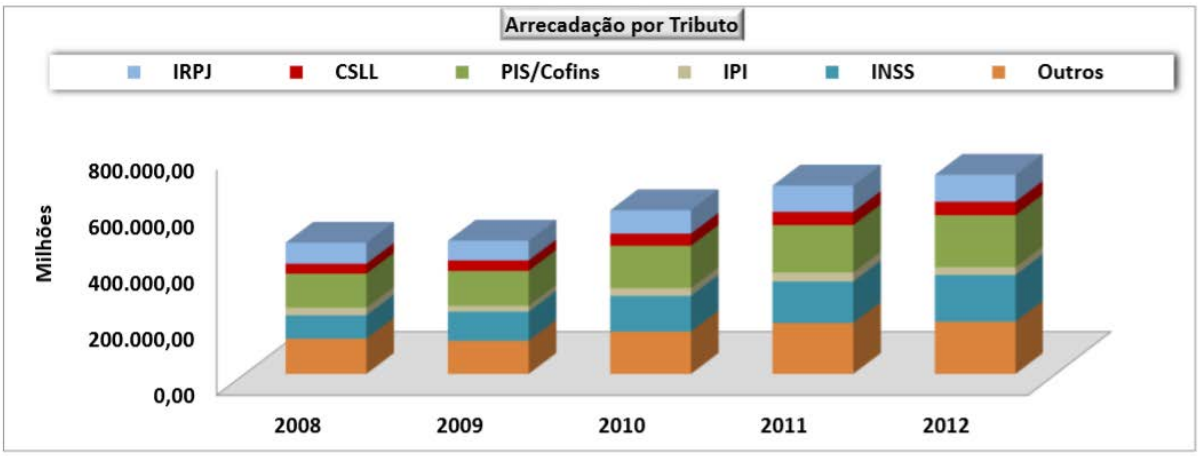
4.3.3.5.2 Revenue implications

According to a study of the Brazilian Federal Tax Authorities (“Receita Federal do Brasil”), the “Pis-Pasep” and “Cofins” have been representing about 26% of the

federal fiscal revenues at least as from 2008 (see figure 8). This report, however, does not differentiate between federal revenues from "Pis-Pasep" and "Cofins" according to the cumulative and the non-cumulative methods.

It is fair to assume, however, that about 80% of the fiscal revenues from Pis-Pasep and Cofins derive from the non-cumulative regime. This is because the non-cumulative regime is mandatory for enterprises that assess their corporate income tax and contribution on net profits according to the general non-simplified regime ("lucro real"). And the enterprises subject to the "lucro real" account for about 80% of the federal fiscal revenues.

Figure 6: Federal revenues from "Pis-Pasep" and "Cofins"



R$ milhões

	2008		2009		2010		2011		2012	
IRPJ	74.564	15,99%	69.880	14,76%	83.096	14,29%	93.326	13,95%	95.685	13,52%
CSLL	35.439	7,60%	37.107	7,84%	43.224	7,43%	46.910	7,01%	47.885	6,77%
PIS/Cofins	120.918	25,94%	124.195	26,24%	150.135	25,81%	168.742	25,22%	184.792	26,12%
IPI	27.111	5,82%	20.923	4,42%	27.766	4,77%	31.606	4,72%	27.747	3,92%
INSS	82.693	17,74%	103.351	21,84%	126.831	21,81%	147.286	22,01%	165.845	23,44%
Outros	125.453	26,91%	117.848	24,90%	150.576	25,89%	181.240	27,09%	185.596	26,23%
Total	466.178	100,00%	473.304	100,00%	581.629	100,00%	669.110	100,00%	707.550	100,00%

Source: Brazilian Ministry of Finance (2014), p. 4

The perception of the taxpayers, however, is that these contributions have exponentially increased in the last decade. In this sense, the nominal revenues from "Pis-Pasep" and "Cofins" would have increased from 65 billion BRL in the year 2002 to 221 billion BRL in the year 2012 according to studies of the Brazilian National Federation of Accountancy Enterprises and of Enterprises of Consultancy, Expertise, Information and Research ("Federação Nacional das Empresas de Serviços Contábeis e das Empresas de Assessoramento, Perícias, Informações e Pesquisa" – "Fenacon"), as shown in the following graphic. Also these studies do not segregate fiscal revenues from "Pis-Pasep" and "Cofins" calculated on a cumulative basis from those calculated on a non-cumulative basis.

Figure 7: Nominal revenue increase of "Pis-Pasep" and "Cofins" from 2002 to 2012

Source: FANACON (2013), p. 30

4.3.3.6 Criticized aspects

In principle, the contributions are relatively easy for the tax authorities to administer given that the burden of tax assessment is to a great extent shifted to the taxpayer. If the tax authorities, however, want to verify whether each amount deducted as "input" really corresponds to an input in light of the concrete enterprise's activity, the administration of the tax may become burdensome. From the taxpayer point of view the compliance costs are very high.

From the perspective of the financed company paying dividends or interests, debt and equity are treated in a similar way given that both dividend and interest payments are not deductible from the tax base. However, for the company receiving the payments and subject to "Pis-Pasep" and "Cofins" there is a bias towards equity financing. This is because dividends received are exempt from "Pis-Pasep" and "Cofins", whilst interests are included in the tax base. There is, however, a discussion as to whether the so-called "interests on own equity" ("juros sobre o capital próprio") i.e. the Brazilian allowance for corporate equity should be included in the tax base of the "Pis-Pasep" and "Cofins".

On the one side, the taxpayers argue that interests on own equity (juros sobre o capital próprio) payments correspond to equity payments, i.e., to dividend distributions that for the purposes of the corporate income tax and the social contribution on net profits are treated as interest distributions. The tax authorities, however, consider that interests on own equity payments shall not be excluded from the tax base of "Pis-Pasep" and "Cofins" due to the lack of specific legal provision in this sense. There is a pending judgement on this subject before the Superior Court of Justice (Superior Tribunal de Justiça).

The non-cumulative system is criticized for its complexity and for the high compliance costs that it imposes on the taxpayers. Moreover, it is argued that the high tax rates in force under the non-cumulative regime may render it more costly than the cumulative regime.

4.3.3.7 Reasons for maintaining Pis-Pasep and Cofins: non-cumulative regime

The reason for maintaining this CFT is because these contributions bring a significant amount of revenues.

4.4 Country with FAT/Production-type VAT showing essential elements of a CFT

4.4.1 Hungary (KIVA)

4.4.1.1 Synopsis

In 2013, Hungary introduced Small Business Tax ("KIVA") regime replacing the previous corporate income tax, social security contribution and vocational training contribution. The regime applies solely to Hungarian small businesses.

The tax base is calculated by using the difference in the cash position at the end of the year compared to the cash position at the end of the previous year and including employment-related personal costs[98]. The law allows for certain other specific adjustments which increase or decrease the tax base in order to reflect better the actual position of the businesses' performance.

Taxpayers that are taxed under KIVA may adjust their tax base to exclude those profits that are taxed abroad. However, companies opting for the KIVA are rather smaller ones without active international presence. Hence, in practice this adjustment to the tax base is not being availed of.

Immediate expensing of investments, reducing compliance and administration cost were among the motivations for the introduction of the tax. However, the most important reason was to promote the growth of small enterprises.

KIVA generates less tax revenue as it is an optional regime. The Hungarian tax authorities currently observe that Accountants are hesitant to advise taxpayers to switch to KIVA and to offer it as an option to their clients because it was difficult to compare the expected tax obligation of KIVA with the tax obligation under the standard CIT.

As KIVA is still a new tax more time is needed to fully understand the effects for businesses applying this regime.

4.4.1.2 ACE or CBIT considered as an alternative to the KIVA

ACE or CBIT were not considered as an alternative to KIVA.

The prevailing view is that ACE is theoretically a good solution, it does not help reducing the administrative burden and calibrating the fair rate also is very difficult (especially for high-risk activities – such as start-up enterprises – which cannot ever

[98] Personal costs refer to all payments which are included in the tax base for social security contribution purposes. Generally, this covers all remuneration received for dependent and independent activities which are included in the consolidated tax base for personal income tax purposes. In case of regular employment relationship, this covers the basic wage of the employee. The Hungarian Act on Social Security Contributions defines what items are to be included in the base of the social security contributions.

make use of the allowance if they fail). Eliminating the debt/equity bias was not an important factor behind the introduction of KIVA.

4.4.1.3 Motivations for implementing the KIVA

Neutrality between debt and equity financing was not an aim of the introduction as the regime targets small enterprises (headcount is not extending 25 employees, and sales and balance is not extending 500 million HUF) which are less likely to apply tax shield techniques.

Immediate expensing of investments was one of the main motivations behind introducing KIVA. Hungary was looking for an alternative and more neutral solution of incentivizing investment instead of a preferential tax rate on capital gains.

Although it was not the main aim, restructuring income taxes so that their design gets somewhat closer to that of a consumption tax was the main idea behind KIVA.

Reducing compliance and administration cost was an important aim as the regime intends to promote the growth of small enterprises.

The general motivation was to promote the growth of small enterprises. Besides KIVA seeks an alternative solution to foster investments instead of a levying lower tax rate on profits than on employment, it aims to ensure a tax environment which is neutral on the labour intensity of production by equalizing tax rates on wages. It also aims to eliminate tax avoidance by labelling de facto labour income as capital income.

4.4.1.4 Design of the KIVA

4.4.1.4.1 General

Hungary introduced KIVA as from 1 January 2013. The regime replaces the corporate income tax, social security contribution and vocational training contribution. The tax should be classified as a source base tax as the tax base does not differentiate between foreign or local-sourced income.

From an economic perspective of the tax base, the KIVA is an FAT 1 (see section 3.2.4.3). Essentially, the value added is captured in the business by following the cash-inflows and outflows, and tax the difference. The KIVA therefore closely resembles an FAT 1.

4.4.1.4.2 Scope

The tax applies to small businesses. Companies and certain other bodies (e.g., law firms, foreign persons with their place of effective management in Hungary) are entitled for CFT if their headcount does not exceed 25 employees and their revenues and balance sheet total does not exceed HUF 500 million (approximately 1650 000 EUR).

4.4.1.4.3 Tax Calculation

Under KIVA the tax base is the change of the cash position at the end of the year compared to the cash position at end of the previous year. In addition, employment-related personal costs (e.g. wages) on which social security contribution is also due are also part of the tax base. Thus, the employment-related costs are generally taxable and form a minimum tax base.

The cash position can be reduced by the amounts received in the course of the transactions below:

a) sums borrowed whether in the form of loan or credit;

b) sums received as repayment of previously lent loan or credit in proportion the previous lending was taken into account as a tax base increasing item (see below);

c) issuing bonds or securities;

d) redemption and sale of debt securities, and the sale of equity securities, the amount shown as an increment to the financial result in cash-flow accounting at the time of purchase of the debt securities and equity securities sold or redeemed in proportion to the amount taken into account as a tax base increasing item;

e) capital contribution (in particular the increase of registered capital);

f) dividend or interim dividend received;

g) repayment of previously fulfilled prepaid;

h) refund of KIVA.

The cash position is increased by the amounts performed in the course of the transactions below:

a) repayment of a loan or credit provided to the taxpayer in proportion to the amount which was previously taken into account as a tax base decreasing item;

b) loan or credit provided;

c) redemption or repurchase of own bonds and debt securities, the amount shown as a reduction of the financial result in cash-flow accounting at the time of issue of the securities redeemed or sold, as commensurate;

d) purchase of debt securities and equity securities;

e) capital decrease (in particular the reduction of registered capital);

f) dividend (excluding any dividend paid during the period of eligibility for the small business tax scheme from the profit and from the retained earnings of the tax years prior to the time of entering the small business tax scheme), interim dividend paid;

g) prepaid;

h) the KIVA tax and tax advance paid.

The following payments and expenses are not considered to serve the revenue-generating activities, therefore, should not be deductible for calculating the cash position under the KIVA:

a) non-repayable transfer of cash;

b) services received or assets purchased in excess of 50,000 forints, if - by evidence of the prevailing circumstances (such as the taxpayer's business activities, revenue, the type and value of the service) - it is determined beyond reasonable doubt that use of the service or the purchase of assets contradicts the requirements of reasonable management;

c) certain payment of health insurance contribution;

d) the expenditures incurred in connection or associated in any way or form with:

   i. any infringement of certain provisions of Act IV of 1978 on the Criminal Code in force until 30 June 2013, specifically, corruption, abuse of a function, bribery in international transactions and abuse of a function in international transactions,

   ii. any infringement of certain provisions of Act C of 2012 on the Criminal Code, specifically, corruption, accepting a bribe, bribery of public officials, accepting a bribe in official proceedings, corruption in court or regulatory proceedings, accepting a bribe in court or regulatory proceedings or abuse of a function;

   if so determined by final court verdict;

e) payments made to a controlled foreign company;

f) tax payments made during the period of eligibility for small business tax for any period before the time of entering into the small business tax scheme, furthermore, any financial penalty, surcharge imposed and paid during the application of the scheme;

g) the interest (with the exception of interests paid on sums owed to financial institutions), in an amount in excess of three times the amount of the daily average of the registered capital, capital reserve, retained earnings and tied-up reserve, as proportionate to the part of such liabilities determined on the basis of such daily average, also if this is shown in the taxpayer's books as part of the cost of the asset, where, in the application of this provision, liability shall mean outstanding loans, outstanding debt securities offered privately and bills payable (with the exception of bills payable on account of suppliers' debts), and any other liability other than loans, debt securities and bills payable as shown in the balance sheet.

h) forgiveness of debts which are not shown as bad debts, except if they are forgiven to a private individual, to a foreign person or a non-related domestic entity;

i) transfer of non-repayable assets;

j) services provided without consideration;

k) the book value of missing assets, if it is determined beyond reasonable doubt that the shortfall would not have occurred if properly cared for (particularly, with regard to the physical attributes, value of the asset, and storage conditions), or if the taxpayer - in view of the requirements of reasonable management - failed to act within his powers to prevent such losses and/or shortages;

l) assumption of any debt obligation without consideration.

Related interest incomes/expenses are taken into account (i.e. are taxable). Interest paid on debts decrease the tax base while interest received for borrowed amounts increase the tax base. On the other hand, amounts borrowed and repayment of past borrowings does not change the tax base. Similarly, amounts received from repayments of loans and amounts lent, do not affect the tax base. Capital expenditures are immediately expensed, i.e. purchases of assets (buildings, equipment, inventories) are deducted from the tax base. Inflows from the sale of

assets increase the tax base (rather than the difference between book value and the sales price).

The taxpayers taxed under the small business tax scheme shall adjust their tax base in determining the small business tax to exclude the income which should not be taxable in Hungary.

4.4.1.4.4 Rate

KIVA is charged at a rate of 16% on the net cash change and the specific personal costs.

4.4.1.4.5 Treatment of financial expenditure in R-based CFT

Treatment of financial expenditure in R-based CFT is not an issue as the KIVA base is rather an R+F base (although with some modifications).

4.4.1.4.6 Exemptions

There is no particular exemption. For deduction that are not allowable please see section 4.4.1.4.3.

4.4.1.4.7 Net-refund position

Surpluses are not refunded and a loss carry forward is available (see below)

4.4.1.4.8 Carry forward of losses

Inasmuch as the financial result in cash-flow accounting is negative in any tax year, the taxpayer may deduct such amount of loss from its financial result in cash-flow accounting spread out in the following ten tax years (i.e., loss-carry forward). By way of derogation, from the amount of the deferred loss the payments made during the tax year in connection with previously unused tangible assets (investments) purchased or produced, intellectual products and the capitalized value of experimental development may be fully deducted from tax base in the following tax years at the tax payer's discretion. An option for loss carry forward is available, however, previous losses can only be utilized against the net cash change. Consequently, the personal costs serve as a minimum tax base.

4.4.1.4.9 Administrative provisions

Taxpayers shall assess the small business tax base and the tax payment for each tax year and shall declare it by 31 May of the following year.

The taxation of the net revenue takes place only upon actual receipt of payments; GAAP-rules on relevance of a transaction for profit determination are irrelevant.

4.4.1.4.10 Qualitative and quantitative benefits and problems

KIVA seeks an alternative solution to foster investments instead of a levying lower tax rate on profits than on employment. It reduced costs of compliance and administration due to reduced complexity of tax return.

4.4.1.4.11 Transitional rules

No information could be obtained on the design of the transitional rules however these were criticised for being too complex (see section 4.4.1.6).

4.4.1.4.12 International Aspect

According to Section 1 paragraph (2) of the Act "Where an international agreement promulgated in Hungary contains any provisions in derogation from this Act, they shall override the provisions of this Act." And according to Section 24 (Elimination of double taxation) of the KIVA Act "The taxpayers taxed under the small business tax scheme shall adjust their tax base in determining the small business tax to exclude the tax base that can be taxed abroad as defined in this Act."

If a company choosing KIVA has a PE in another state, the above rules apply. The income attributable to that PE is taxable in the other state and it is exempted from Hungarian tax according to the Hungarian treaties. The exemption is limited; income attributable to the permanent establishment, but tax base calculated according to the Hungarian rules is exempted. The differences in calculating the tax base abroad and in Hungary cannot be taken into consideration, no special rules apply. But this is generally true in all other cases as well; double tax conventions cannot handle this problem.

Though it has to be added that the Hungarian authorities are not facing many questions because of this (no court cases, no disputes). Companies choosing KIVA are rather smaller ones without active international presence. Hence, in practice no major issues with respect to international aspects of the KIVA came up.

4.4.1.4.13 Avoidance schemes

One of the motivations for implementing KIVA is to tackle tax avoidance (see section 4.4.1.2).

4.4.1.5 Effects

4.4.1.5.1 Economic effects

Since the tax was recently introduced it is too early to assess the economic effects of the tax.

4.4.1.5.2 Revenue implications

KIVA generates less tax revenue as it is an optional regime. Due to the short term of existence of the tax -"KIVA" was introduced in 2013 - more time is needed to collect information and set-up any reform agenda of the current system.

4.4.1.6 Criticized aspects

Switching difficulties:

- It was difficult to compare the expected tax obligation of KIVA with the obligation of CIT. As the default option was not to switch, many accountants did not take the risk of proposing the new option for their clients (although according to our simulations the large majority of the firms could decrease their tax liability).
- Accountants were less motivated to attain the new rules, so they did not offer it for their clients.
- Although the tax itself is simple, the rules of transition are complicated due to the different logic of the tax.

Another critic was that due to uncertainties regarding the timing of payments, the planning of the tax liability became difficult.

4.4.1.7 Reasons for maintaining KIVA

Since KIVA was introduced only in 2013 it is too early to evaluate the pros and cons for maintaining or abandoning the tax system.

4.5 Countries with essential elements of a CFT system applied to the extraction industry

4.5.1 Australia (MRRT)

4.5.1.1 Synopsis

Australia introduced the Minerals Resource Rent Tax (MRRT) in 2012 to ensure an appropriate return from the development of its non-renewable petroleum resources located offshore, i.e. to elevate tax revenue, to provide a more efficient mechanism for collecting a share of these returns and to remove impediments to mining investment and production, especially in the light of other resource-rich countries. It is a tax whose basic structure derives from CFT. It was opted for a CFT model for its very characteristics, e.g. to reach neutrality between debt and equity-financing. Tax revenue in 2013/4 was AUD 0.1 billion. With 40% tax rate, it is a project-based tax on profits generated from certain mining activities. MRRT is levied before corporate

income tax and is deductible for income tax purposes. It is levied on the positive cash-flows, or profits, of a project. A negative cash-flow does not result in a refund position but entails a loss carry-forward and an 'uplift' of losses by an interest rate. The difference between the amount of revenue and expenditures results in the mining profit. The mining profit gets amended by deductions of certain allowances which eventually results in the MRRT tax base. If the profit does not cross a certain ceiling the mining operator is tax exempt. The MRRT harmed investment and increased compliance costs. Eventually, the MRRT tax revenue trails estimations.

4.5.1.2 ACE or CBIT as alternatives to the MRRT

No specific information on whether ACE or CBIT was considered as an alternative could be obtained.

4.5.1.3 Motivations for implementing the MRRT

Australia has large endowments of non-renewable resources. With sustained growth of China and India, demand and prices for Australia's non-renewable resources are likely to remain strong. Given the size of Australia's non-renewable resource stock and expected continued strength in commodity prices, the imperative for the community to share properly in the returns from the sale of its resources has become more acute.

The original RSPT was intended to ensure the community receives a more consistent share in returns from non-renewable resources. It was also intended to provide a more efficient mechanism for collecting a share of these returns and remove impediments to mining investment and production, noting that other developed countries, with significant resource endowments (such as Canada, Norway and the United States) have moved towards tax systems based on resource rents or super profits.

It was also conceived at a time when the mining sector was experiencing unprecedented profitability and record high commodity prices, in particular the iron ore and coal sectors.

Other reasons for implementation a CFT included: neutrality between debt and equity-financing, does not affect choice of organisational form, it is immune to inflation, promotes investment and it provides additional tax revenue to fund spending measures.

4.5.1.4 Design of the MRRT

4.5.1.4.1 General

The Minerals Resource Rent Tax (MRRT), like the Petroleum Resource Rent Tax, has its origins in the recommendations of the Henry Report[99].

Originally proposed as a Resource Super Profits Tax (RSPT) (outlined in the 2010 Government paper 'The Resource Super Profits Tax: a fair return to the nation), it was intended to be a 40 per cent tax on the realised value of resource deposits, measured as the difference between the revenues generated from resource extraction and associated costs. The Australian Government would also provide resource entities with a refundable credit for state royalties paid and for the value of their extraction and exploration costs when a project winds up. However after strong opposition by industry groups, the final detailed design of the MRRT was based on the recommendations of the Policy Transition Group in its December 2010 paper 'New Resource Taxation Arrangements'.

The MRRT is a type of resource rent tax based on the Garnaut — Clunies Ross model. The Garnaut — Clunies Ross resource rent tax is levied on the positive cash-flows, or profits, of a project, but there is no refund when the cash-flow is negative or the taxpayer is making a loss. Instead, losses are carried forward and 'uplifted' by an interest rate, so that they can be used as a deduction against positive cash-flows in later years.

The MRRT applies to miners i.e. entities that have a mining project interest in respect of an area in Australia (e.g. production right relating to iron ore, coal, and gas extracted as a necessary incident of coal mining). However if the total mining profits of the miner and certain connected entities is AUD 75 million or less, the low profit offset ensures that there is no MRRT liability. The offset is phased out for profits between AUD 75 million and AUD 125 million.

The Australian CFT taxes (MRRT as well as the PRRT – see 4.4.2) are based on the academic models proposed by Anthony Clunies Ross and Ross Garnaut. These are the leading academics in this area and their work goes back to the early 80s. Under a Garnaut and Clunies Ross resource rent tax, the government imposes a cash-flow tax levied at a constant percentage of the annual positive net cash-flow from the project.

"The effects of a tax on investment and production cannot be ascertained by examining only the amount of revenue that it collects. As Anthony Clunies Ross and I said on the first page of our book (Garnaut and Clunies Ross, 1983):

Many people believe that the only important characteristic of a tax is how much it takes. This is far from true. The form of the tax may have extremely weighty effects in encouraging some activities or discouraging others. It is easy to assume, as governments often seem to have done in meeting the question of taxing mining companies, that there is a simple dilemma between heavy taxation, which discourages

[99] The Australia's Future Tax System Review, informally known as the Henry Tax Review was commissioned by the Rudd Government in 2008 and published in 2010. The review was intended to guide tax system reforms over the following 10 to 20 years.

mining, and light taxation, which yields little in the way of revenue. On the contrary, provided that the form of the tax regime is chosen prudently, it is possible to improve the trade-off considerably...

The more that taxation can be concentrated on economic rent rather than on transaction, income, consumption and other tax bases that in varying degrees introduce distortions, the less the economic burden of taxation."[100]

4.5.1.4.2 Scope

The MRRT applies to entities that have a mining project interest in respect of an area in Australia.

4.5.1.4.3 Tax calculation

The MRRT is a project-based tax introduced in July 2012 on profits generated from certain mining interests (iron ore, coal, gas extracted as a necessary incident of coal mining) located in Australia. MRRT is levied before income tax and is deductible for income tax purposes.

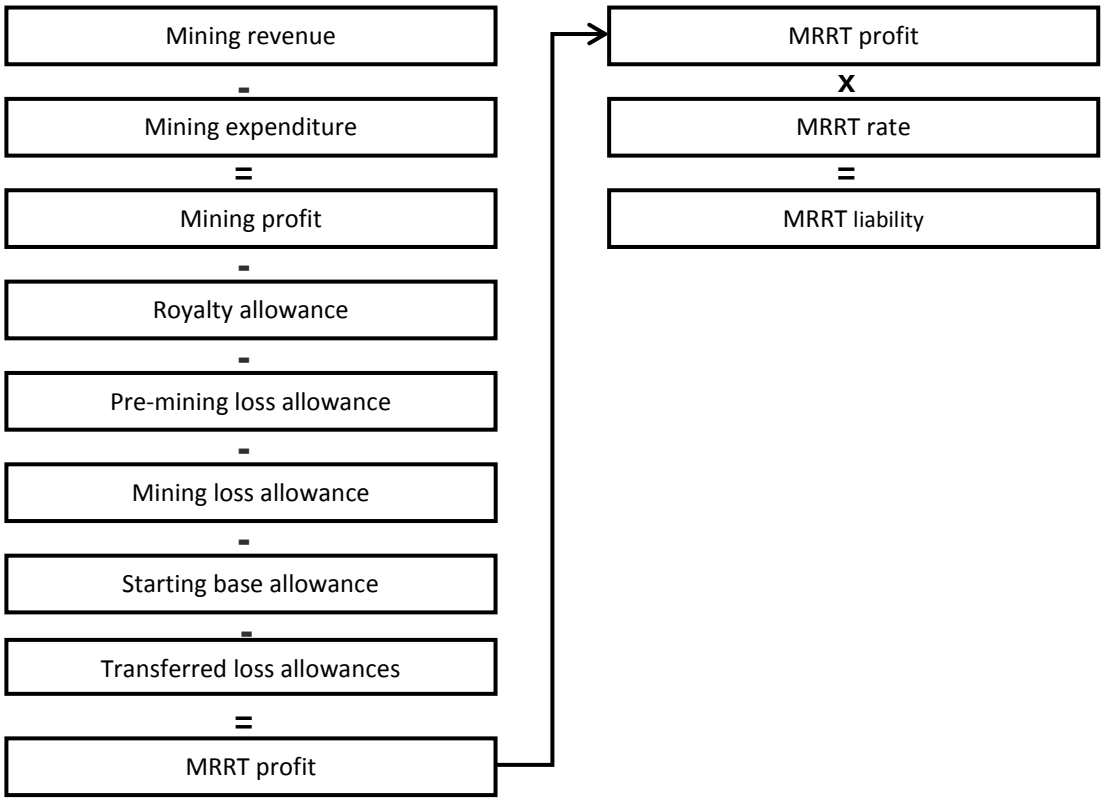
A miner's mining revenue for a mining project interest may consist of revenue from:

- taxable resources e.g. iron ore, coal and coal seam gas extracted, to the extent that the revenue is reasonably attributable to the taxable resources in the form and place they were in when they were at their valuation point; and
- recoupment of mining expenditure relating to the mining project interest; and
- compensation for loss of taxable resources for the mining project interest; and
- amounts for supply of taxable resources if the amounts are not attributable to particular taxable resources.

The following diagram illustrates the formula for calculating the MRRT profit that is taxed:

[100] Garnaut R., (2010).

Figure 8: Formula for calculating the MRRT profit



'Mining profit' is confined to profits 'upstream' of the valuation point on a mining project interest i.e. profits relating to mining operations that occur just before the taxable resource leaves the run-of-mine stockpile (also called the ROM stockpile or ROM pad) or, where there is no run of mine stockpile, at the point it enters the first beneficiation process.

To calculate the upstream profits, the final sales proceeds of the resource are reduced by an amount that recognises the arm's length value of the downstream operations (i.e. operations that occur downstream from the valuation point) using the most appropriate and reliable method. Allowable upstream capital and operating expenditure is then directly and immediately deducted.

A simplified method for calculating profit is available for eligible low profit miners who elect to apply it. Broadly, under the simplified method the entity's profit is determined in accordance with general accounting principles, and adjusted for interest, taxation, royalties and exceptional items. If the profit is below certain alternative thresholds in a particular year the entity will have no MRRT tax liability however certain carry forward MRRT allowances are also extinguished.

The mining profit of a mining project interest for an MRRT year must be reduced by any available MRRT allowance. MRRT allowances are taken into account in the following order:

- **royalty allowances** - this ensures that mining royalties and the MRRT do not double tax the mining profit by providing a credit for mining royalties paid to

Australian Government authorities. Any unused portion is uplifted by interest and carried forward to be applied in a later year.

- **transferred royalty allowances**- unused royalty credits transferred from other eligible project interests.
- **pre-mining loss allowances** – where a loss is generated by exploration or prospecting activities in respect of the project area. Any unused portion is uplifted by interest and carried forward to be applied in a later year.
- **mining loss allowances**- where mining expenditure exceeds mining revenue. Any unused portion is uplifted by interest and carried forward to be applied in a later year.
- **starting base allowances** – provides an allowance for investments in assets (starting base assets) relating to the upstream activities of a mining project interest that existed before the announcement of the resource tax reforms on 2 May 2010. Also provides an allowance for certain expenditure on such assets made by a miner between 2 May 2010 and 1 July 2012. The starting base for a mining project interest may be calculated using a choice of two methods (market value or book value).
- **transferred pre-mining loss allowances** – pre-mining loss allowances transferred from other eligible project interests.
- **transferred mining loss allowances-** pre-mining loss allowances transferred from other eligible project interests.

4.5.1.4.4 Rate

The MRRT rate is a tax rate of 30 per cent, reduced by 25 per cent to recognise the knowhow and capital that mining companies bring to mineral extraction (the extraction factor). The effective MRRT rate is therefore 22.5 per cent.

4.5.1.4.5 Treatment of financial expenditure in R-based

Specific information on the treatment of financial expenditure could not be obtained. For general treatment of expenditures please see the section on tax calculation (see section 4.5.1.4.3).

4.5.1.4.6 Net-refund position

There is no refund when cash-flow is negative or the taxpayer is making a loss. Taxpayers can carry forward and uplift losses with interest for use as a deduction against positive cash-flows in later years (MRRT allowance).

4.5.1.4.7 Carry forward of losses

Please see aforementioned (see section 4.5.1.4.7).

4.5.1.4.8 Exemptions

Low-profit miners are exempted from paying MRRT. They also have the option to exempt themselves from the compliance obligations associated with calculating mining profit. This is to ensure that only larger resource groups generating 'super profits' are taxed.

4.5.1.4.9 Administrative provisions

Administrative obligations on taxpayers affected by the MRRT include:

- Registering for MRRT to receive information on the MRRT from the Australian Taxation Office (ATO)
- Consideration of whether to lodge a starting base return to enable claiming of starting base allowance for future income years
- Lodging quarterly MRRT instalment liability notices and paying quarterly MRRT instalments
- Pay MRRT and lodge annual MRRT returns
- Notifying the ATO of certain choices, such as choosing the simplified MRRT method for an MRRT year
- Record keeping to support MRRT claim
- Economic analysis and modelling of the value chain to value the resource at the valuation point

Upon introduction the MRRT provided for an allowance for past investment in the starting base as a transitional measure.

4.5.1.4.10 Qualitative and quantitative benefits or problems

Please see, among others, 4.5.1.4.4, 4.5.1.4.5 and 4.5.1.4.6.

4.5.1.4.11 Transitional rules

In particular, upon introduction the MRRT provided for an allowance for past investment in the starting base as a transitional measure.

4.5.1.4.12 International recognition

No specific information on international recognition could be obtained.

4.5.1.4.13 Avoidance schemes

No specific information on avoidance schemes could be obtained.

4.5.1.5 Effects

4.5.1.5.1 Economic effects

Due to the regime there were complicated Federal and State tax interaction issues. This was due to the credits available for royalties paid at the State level. It was argued that because of lack of cooperation between the Commonwealth and States, States could simply increase mining royalties so no MRRT revenues are raised by the Commonwealth.

4.5.1.5.2 Revenue implications

The net revenue raised from the MRRT according to the 2012-13 Budget Outcome Financial Statements was AUD 0.2 billion while in the same document for the period between 2013 and 2014 it was AUD 0.1 billion. The figures for the 2014-15 Budget Outcome are still awaiting release. Receipts for the tax were low and this is generally attributed to existing miners at the date the tax was implemented (1 July 2012) being entitled to offset against their assessable receipts an allowance (starting base allowance) based on the value of their mining investment prior to 1 July 2012.

4.5.1.6 Criticized aspects

It is believed MRRT harmed investment in the resources sector and the economy and it increased compliance costs for both the ATO and taxpayer. It was also perceived to deter investment in Australia and encourage investment elsewhere since it represents an additional tax on Australian mining projects.

The MRRT failed to raise the significant revenues projected due to global instability, commodity price volatility and a high AUD and also the inherent design of the tax e.g. the starting base allowances which were available in the early years of the MRRT for expenditure incurred prior to 1 July 2012.

Notwithstanding that the MRRT was a revenue raising measure, it was linked to a number of spending measures which exceeded the revenue raised – the Liberal party argued that repealing the MRRT package would bring savings to the budget.

4.5.1.7 Reasons for abandoning the MRRT

The prime minister of the Labour party, Kevin Rudd, who proposed the initial RSPT, was subjected to a hefty media campaign by the mining industry and a few weeks later he was ousted by his own party. The RSPT was replaced by the MRRT after industry consultation by the new Labour Prime Minister, Julia Gillard. However the tax still proved to be unpopular and the then opposition Liberal party successfully based its 2013 election campaign on the repeal of the carbon tax and carbon pricing mechanism, as well as the repeal of the MRRT.

The fact the MRRT raised only a fraction of its estimated receipts was seized upon by the Liberal Government as evidence of the flawed nature of the tax.

4.5.2 Australia (PRRT)

4.5.2.1 Synopsis

Australia introduced the Petroleum Resource Rent Tax (PRRT) in 1987 to ensure an appropriate return from the development of its non-renewable petroleum resources located offshore, i.e. to elevate tax revenue. It is a tax whose basic structure derives from CFT. Tax revenue was AUD 1.368 billion in 2013/4. With a 40% tax rate, it aims to receive an appropriate return from the development of its non-renewable petroleum resources. It is deductible for income tax purposes. The PRRT was extended in 2012 to take into account the developments in the oil and gas industry during the time since the introduction of the tax. Tax base is the profit generated from the sale of marketable, i.e. ready for sale, commodities. Generally, the profit within this meaning is the margin amount between receipt and expenditures being associated with the exploration undertaking. In case that the expenditures' amount exceeds the PRRT provides for a carry-forward concept. Since it is an additional tax it generates additional tax revenue. Over the years the PRRT got amended in certain aspects to encourage investment, lower compliance costs and introduce certain anti-avoidance measures with respect to gas exploration and processing business.

4.5.2.2 ACE or CBIT as alternatives to the PRRT

No specific information on whether ACE or CIT was considered as an alternative could be obtained.

4.5.2.3 Motivations for implementing the PRRT

The tax was initially introduced to ensure that the Australian community receives an appropriate return from the development of its non-renewable petroleum resources located offshore.

The motivation of the extension of the PRRT in 1 July 2012 to encompass all Australian onshore and offshore petroleum projects, including the North West Shelf and coal seam methane projects was to capture the increased diversity of the oil and gas industry compared to what was contemplated when the PRRT was first put in place in 1987.

4.5.2.4 Design of the PRRT

4.5.2.4.1 General

The Petroleum Resource Rent Tax (PRRT) was introduced in 1987. The tax is designed to ensure that the Australian community receives an appropriate return from the development of its non-renewable petroleum resources located offshore. PRRT is levied before income tax and is deductible for income tax purposes.

Unlike the previous royalty and excise regimes, the PRRT applies to the profits derived from a petroleum project and not the volume or value of the petroleum produced. Through providing immediate deductions for all allowable expenditure (whether capital or revenue in nature), together with uplifts for carry forward losses, the PRRT taxes the economic rent generated from a petroleum project.

The legislation was first applied retrospectively to exploration permits in all offshore areas except Bass Strait and the North West Shelf awarded on or after 1 July 1984,

and recognised expenditures incurred on or after 1 July 1979. Production in Bass Strait switched from the Royalty/Excise regime to PRRT in the fiscal year 1990–91. On 1 July 2012, the scope of the tax was extended to all Australian onshore and offshore petroleum projects, including the North West Shelf and coal seam methane projects. The extension of the PRRT operates in addition to existing government resource taxes in offshore areas and the North West Shelf.

The PRRT does not apply to projects in the Joint Petroleum Development Area which is governed by the Timor Sea Treaty between the Government of Timor-Leste and Australia. Broadly the taxing rights for this area are split between Timor-Lest and Australia on a 90:10 basis.

4.5.2.4.2 Scope

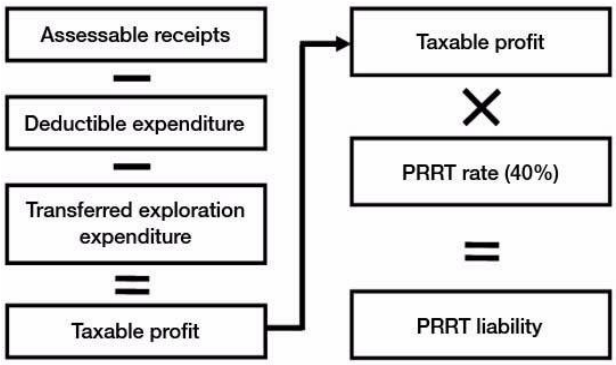
PRRT affects any entity that has an interest in an Australian offshore or onshore exploration permit, retention lease or production licence, or an interest in the North West Shelf project or the Bass Strait project.

4.5.2.4.3 Tax calculation

The PRRT is generally applied to profits generated from the sale of marketable petroleum commodities (MPCs). An MPC is broadly oil and gas ready for sale stored adjacent to the production facility but does not include a commodity produced from the MPC.

The following diagram illustrates the formula for calculating the PRRT taxable profit:

Figure 9: Formula for calculating the PRRT profit



Assessable receipts include receipts of the following kinds, whether of a capital or revenue nature, derived by the person in the financial year in relation to the project:

- petroleum receipts
- tolling receipts
- exploration recovery receipts
- property receipts
- miscellaneous compensation receipts
- employee amenities receipts

- incidental production receipts

Deductible expenditure (eligible real expenditure) includes:

- exploration expenditures (e.g., exploration drilling costs, seismic survey). Eligible exploration expenditure can also be transferred from another project.
- general project expenditures (e.g., development expenditures, costs of production)
- closing-down expenditures (e.g., environmental restoration, removal of production platforms)
- resource tax expenditure (e.g., state royalties and excise)

In addition, onshore projects and the North West Shelf which transitioned into the PRRT regime from 1 July 2012 can also claim the following expenditure:

- acquired exploration expenditure
- starting base expenditure – designed to recognise investments entities had in certain projects before 1 July 2012. An entity that holds a petroleum interest that existed before 2 May 2010 can choose the book value, market value or look-back approach to work out a starting base amount that will be deductible against its PRRT assessable receipts

An entity that holds an interest in two or more petroleum projects can apply to have them combined and treated as a single project for PRRT purposes, provided certain criteria are met.

4.5.2.4.4 Rate

The PRRT rate is 40%.

4.5.2.4.5 Treatment of financial expenditure in R-based

No specific information on the treatment of financial expenditure could be obtained. Generally, with regard to the treatment of expenditure please see section 4.5.2.4.3.

4.5.2.4.6 Net-refund position

Where a taxpayer's expenditure in relation to a project exceeds their receipts in a year, the excess is 'carried forward' and augmented on a yearly basis until it can be absorbed against assessable receipts from the project, or transferred to another project. The uplift rate applied to augment non-deducted expenditure depends on whether it is exploration or general project expenditure, and the time at which it is incurred.

4.5.2.4.7 Carry forward of losses

Please see section 4.5.2.4.6.

4.5.2.4.8 Exemptions

The PRRT does not apply to projects in the Joint Petroleum Development Area which is governed by the Timor Sea Treaty between the Government of Timor-Leste and Australia (see section 4.5.2.4.1).

4.5.2.4.9 Administrative provisions

Administrative obligations on taxpayers affected by the PRRT include:

- Registering for PRRT to receive information on the PRRT from the Australian Taxation Office (ATO)
- Lodging a starting base return for starting base expenditure for an entity that holds an interest in a petroleum project, exploration permit or retention lease that existed just before 2 May 2010 that is transitioning into the PRRT regime from 1 July 2012
- Lodging quarterly PRRT instalment liability notices and paying quarterly PRRT instalments
- Pay PRRT and lodge annual PRRT returns
- Notifying the ATO of certain choices, such as transfers of expenditure, PRRT instalments or interests between projects, combining projects, or consolidation
- Record keeping to support PRRT claim

4.5.2.4.10 Qualitative and quantitative benefits or problems

Please see sections 4.5.2.5, 4.5.2.6 and 4.5.2.7.

4.5.2.4.11 Transitional rules

No specific information on transitional rules could be obtained.

4.5.2.4.12 International recognition

No specific information on international recognition could be obtained.

4.5.2.4.13 Avoidance schemes

Please see section 4.5.2.6.3.

4.5.2.5 Effects

4.5.2.5.1 Economic effect

Refer to sections 4.5.2.6 and 4.5.2.7.

4.5.2.5.2 Revenue implications

The Budget outcome figures for the past 10 years of this tax are as follows:

Table 9: PRRT budget outcome tax revenue

Budget outcome	Revenue*
2003-04	1.165 billion
2004-05	1.465 billion
2005-06	1.991 billion
2006-07	1.594 billion
2007-08	1.871 billion
2008-09	2.099 billion
2009-10	1.297 billion
2010-11	0.806 billion
2011-12	1.463 billion
2012-13	1.6 billion
2013-14	1.368 billion
2014-15	Awaiting release

*AUD

There is no pattern in the revenue figures of the PRRT but since it is an additional tax to income taxes it generates additional revenue for the Australian government.

4.5.2.6 Criticized aspects

4.5.2.6.1 Encourage investment

PPRT represents an additional tax on the Australian petroleum projects and hence it could discourage inbound investment. However, the PRRT certainly did not affect the recent investment boom into liquefied gas which may be mainly attributed to the falling commodity prices and cost of production.

To encourage exploration an immediate uplift to 150% on PRRT deductions was introduced in 2004 for exploration expenditures incurred in designated offshore frontier acreage areas released by the federal government between 2004 and 2009, where the purpose is not related to evaluating or delineating a previously discovered petroleum pool. There have been no further announcements or enacted incentives regarding acreage releases beyond 2009.

4.5.2.6.2 Reduce compliance costs/burden

Following the introduction of the PRRT there was an increase in compliance costs for ATO and taxpayers. In this regard, in May 2005 the government announced policy changes to the PRRT designed to reduce compliance costs, improve administration and remove inconsistencies in the PRRT regime. These changes, which became effective from 1 July 2006, included:

- allowing deduction of transferable exploration expenditure when calculating quarterly instalments and of fringe benefits tax for PRRT purposes
- allowing deduction of closing-down costs when moving from a production to an infrastructure license
- the PRRT in the self-assessment regime

- providing roll-over relief for internal corporate restructuring
- introducing a transfer notice requirement for vendors disposing of an interest in a petroleum project
- extending the lodgement period for PRRT annual returns from 42 to 60 days.

4.5.2.6.3 Anti-avoidance

In October 2001 legislative amendments allowed the Tax Commissioner to apply a gas transfer price formula in the absence of an arm's length sale in an integrated gas to liquids project. In 2005 the government introduced the Petroleum Resource Rent Tax Assessment Regulations 2005, known as the Gas Transfer Regulations.

The objective of the Regulations is to provide a framework to determine the price for gas in the case of an integrated gas-to-liquids (GTL) project. For gas that is to be further processed in an integrated GTL operation, the PRRT taxing point is where a marketable petroleum commodity (sales gas) is produced (i.e. the upstream component) and not where the gas is liquefied (i.e. the downstream component). GTL operations may have the same ownership of the upstream production component and the downstream processing component. The downstream component of an integrated GTL operation is not subject to PRRT.

The framework enables a PRRT liability to be calculated in the upstream component of an integrated GTL project where there is no arm's length price or comparable uncontrolled price. These Regulations allow for a gas transfer price to be determined by the Commissioner of Taxation either by an advanced pricing arrangement agreed with the PRRT taxpayer, an uncontrollable comparable price, or by a Residual Pricing Mechanism (RPM). In the circumstances where an advanced pricing arrangement or uncontrollable comparable price does not exist, the RPM prevails. The Gas Transfer Pricing Regulations took effect from 20 December 2005.

4.5.2.7 Reasons for maintaining the PRRT

The PRRT has been operational for 30 years and therefore is part of existing and future project models. The PRRT also had a track record of raising revenue. There was no resistance to the expansion of the PRRT but there was more bipartisan political support for this. Australian experienced and investment and export agreement boom at the time and the commodity pricing was stronger too. The Bureau of Resource and Energy Economics (BREE) estimated in 2013 that Australia's LNG exports by value were to reach AUD 60.95 billion in 2018/2019 compared with AUD 11.95 billion in 2011/12.

4.5.3 Canada (British Columbia ("BC") Mineral Taxes)

4.5.3.1 Synopsis

Provinces and territories in Canada apply various taxes which feature certain CFT elements in order to tax the extraction industries. The basic structure of these taxes derives from CIT but is amended by CFT elements. For example, the British Columbia Mineral Tax Act (hereinafter: BCMTA) was introduced in 1990. Tax revenue was ca. 111 million CAD in 2013/4. This tax was primarily introduced for reasons of administrative and compliance simplification and entails two-step taxation.

First, there is a 13% tax on an operator's profit that is in excess of a normal return on investment over the life of a mine (Net Revenue Tax – "NR tax"). NR Tax is a cumulative amount that reflects all revenues and expenditures, including capital costs, from the commencement of a mine. The province does not receive this share until the producer's investment and a reasonable return on it have been recovered. If the tax base is a negative amount, the balance is carried forward to future years. The specific legal rules provide for certain categories of costs and expenses which are regarded deductible and non-deductible.

Secondly, a tax of 2% is levied on the operating income from production (Net Current Proceeds Tax – "NCP tax"). NCP tax can be credited against the NR tax. It provides for a "minimum" taxation unless the mine is not even recovering its operating costs. Operating costs for each period are deducted from revenue from the sale of mineral products. Certain costs and expenditures are considered to be on account of capital and thus, cannot be deducted as operating costs. If there is generally a net refund position with respect to NCP tax no tax is liable.

4.5.3.2 ACE or CBIT as alternatives to the BCMT

Specific information on whether ACE or CBIT were considered as alternatives was not obtainable.

4.5.3.3 Motivations for implementing the BCMT

Since 1976 four provincial tax regimes had been in place. Coal mines on Crown land paid a royalty under the Coal Act's Royalty Regulation of 3.5% of the net mine head value of coal sold. Coal mines on freehold land paid a tax under the Mineral Land Tax Act of about 2.7% of the net mine head value of coal sold. In addition, all coal mines paid a profit-based tax under the Mining Tax Act. Metallic mineral mines paid a profit-based tax only under the Mineral Resource Tax Act. In the spring of 1988, the British Columbia government launched a review of taxes and royalties paid by the mining industry in the province. The review identified the need for a mineral tax system that would reduce administration and compliance problems and improve the climate for mining investment in the province. The review resulted in the BCMTA. The BCMTA was passed on July 14, 1989 and became effective on 1 January 1990.

4.5.3.4 Design of the BCMT

4.5.3.4.1 General

At the federal level Canada does not have a CFT. However, at the provincial and territorial level certain businesses are taxed using a CFT concept. Mining, oil and gas (exploration, Liquefied Natural Gas (LNG) etc.) industries are subject to tax that contains elements of a CFT. Below is a broad overview of two regimes applicable in the Alberta and British Columbia provinces. Before providing a more in-depth picture of the regime in place in British Columbia a brief description of the Alberta regime shall be outlined. Resources are an important aspect of the Canadian economy. This is supported by newly introduced legislation regarding the taxation of LNG at the provincial level. There is various tax legislation enacted which address the taxation of mining in each province or territory. Though, they show similarities they differ as well in detail and their respective peculiarities. Newly introduced LNG tax-legislation is realized by a CFT-like concept. Information discovery regarding the mineral tax regime

in British Columbia and its roughly 25 years of experience contribute to the choice of this tax regime as a showcase of a Canadian CFT-concept.

Alberta's project-based generic oil sands royalty (OSR) regime also operates on the principle of net revenue. Royalty is paid at one of two rates, depending on the OSR Project's financial status. The deciding factor is the OSR Project's pay-out status.

An OSR Project has "reached pay-out" when its cumulative revenues exceed its cumulative eligible costs, for the first time. Before the pay-out date, the applicable royalty is 1% to 9% of the OSR Project's gross revenue, depending on oil prices. This low gross rate recognizes the high costs, long lead times and high risks associated with oil sands investment. It avoids imposing high royalty payments during the critical start-up stages of the OSR Project. After the pay-out date, the applicable royalty is the greater of: the OSR Project's gross revenue multiplied by the gross royalty rate, or the OSR Project's net revenue multiplied by the net royalty rate. The net royalty rate varies from 25% to 40% depending on oil prices.

In *British Columbia*, the BC Mineral Tax ("BCMT") imposes tax on income earned from mining operations in the province of British Columbia. Though, this tax scheme may not be considered a CFT as amounts are deductible when incurred not necessarily when paid it may exhibit some characteristics of a CFT concept. The BCMT was enacted under the BC Mineral Tax Act ("BCMTA") and became effective 1 January 1990.

4.5.3.4.2 Scope

The BCMT applies to impose a revenue based tax on all operators of all mines in British Columbia. An operator must pay a tax on a mine-by-mine basis in respect of each fiscal year of the mine. An operator means, for each mine, the person that, either alone or with another person, is or was the owner, lessee, licensee, tenant or other holder of a right to win minerals from the mine. An operator does not include a person that, under an arm's length agreement has a right to receive only royalties paid or payable in cash; therefore, royalty income is not generally subject to mineral taxes.

4.5.3.4.3 Tax calculation

Depending on the respective tax base, the BCMT provides for the province's financial share of mineral production in two ways. The first tax is a 13% levy on an operator's profit that is in excess of a normal return on investment over the life of the mine (**net revenue tax – "NR tax"**). To minimise a disincentive to an investment, the province does not receive this share until the operator's investment and a reasonable return on it have been recovered. The second tax is levied at a 2% of the operating income from production in each year (**net current proceeds tax – "NCP tax"**). It is intended to provide compensation for depletion of the resource when production yields less than a reasonable profit for the producer. So that only one or the other tax is paid, NCP tax can be deducted as a credit against the 13% net revenue tax in the current year or in future years. Thus, NCP tax provides for a "minimum" tax in the sense that any mine that is more than covering its current operating costs will pay some tax at the low rate. However, if a mine is not recovering its operating costs, NCP is zero and no tax is payable.

NCP are determined as follows: the NCP from the operation of a mine are defined as the operator's proportionate share of gross revenue from the operation of a particular mine for the fiscal year less the operator's proportionate share of prescribed costs and expenses incurred for the purpose of earning gross revenue from the operation of the mine, and any reclamation cost transfer (excluding any costs that are on account of capital) — typically referred to as operating costs.

Gross revenue from the operation of a mine is the aggregate of the following items: (i) the transaction value of the mineral product disposed of or consumed in the fiscal year of the mine, (ii) grants, subsidies, or other forms of assistance received from a government, municipality, or other public body, proceeds of an insurance policy, and any other amount that may reasonably be regarded as a recovery of costs and certain other expenses detailed in the BCMTA in any fiscal year of the mine and (iii) the amount of the operator's prescribed reclamation recovery.

Transaction action value of a mineral product within the above mentioned meaning is the price paid or payable for the mineral product. However, the BCMTA does provide for circumstances where the transaction value may be modified to reflect the arm's length value of the mineral product (in particular, in the case where the purchaser and vendor are not dealing at arm's length).

In determining the prescribed operating costs, the following costs and expenditures are considered to be on account of capital and cannot be included in the determination of current costs and expenditures:

- exploration costs;
- research costs;
- pre-production discovery costs;
- costs incurred, before the mine came into commercial production, for the purpose of bringing it into commercial production, including costs for clearing, removing overburden, stripping, sinking a mine shaft, and constructing an adit or other underground entry;
- amounts paid or payable to acquire capital assets or the use of (or the right to use) capital assets, excluding costs for sinking a mine shaft, constructing an adit or other underground entry, removing overburden, stripping, clearing, and other similar activities if these costs are incurred after the mine came into production and for the purpose of maintaining the mine in commercial production; and
- the cost of inventories of parts, supplies, and products.

NR is a cumulative amount that reflects all revenue and expenditures, including capital costs, from the commencement of activities at a mine site. It is determined by comparing two aggregate amounts.

The first amount is the sum of:

- gross revenue from the operation of a particular mine for the fiscal year,
- the aggregate of amounts receivable in the fiscal year that are government grants, subsidies, or other forms of assistance, proceeds of insurance policies,

or actual or deemed proceeds on disposition of assets and that are related to capital assets whose cost is to be (or has been) included as a prescribed cost or expense in any fiscal year, and

- any amount receivable from the sale, lease, or licensing of rights for use of technology, to the extent of the amount of any expenditure related to the development of that technology that has been deducted in the calculation of net revenue.

The second amount is the sum of:

- the cumulative expenditure account at the end of the previous fiscal year,
- the operator's proportionate share of prescribed costs and expenses incurred in the mine operation,
- the operator's proportionate share of the new mine allowance,
- the investment allowance, and
- any reclamation cost transfer.

NR derived from the operation of a mine is defined as the amount by which the first amount exceeds the second amount. If the NR is a negative amount, the balance is carried forward to future years in the cumulative expenditure account (CEA). This can be carried forward indefinitely and applied to reduce net revenue of future years. Typically, during the discovery and development phases of a mine, no (or minimal) revenue is generated, resulting in a build-up of the CEA with no tax paid. The calculation of NR ignores the accounting and income tax principle of matching expenditures against revenue earned as a result of those expenditures. All current and capital costs are fully deductible in the year in which they are incurred or any subsequent year. The amount that is paid for a capital asset is the amount that may be deducted in any year, rather than a prorated amount based on its useful life.

Certain **costs and expenses** are generally **deductible** in computing the **NCP** and **NR**. The following costs and expenses are allowed as prescribed costs and expenses incurred for the purpose of earning gross revenue. In computing **NCP**, only costs that are not considered to be on account of capital will be allowed. In computing **NR**, all the costs listed below would be relevant, whether or not they are considered to be on account of capital:

- pre-production discovery costs;
- exploration costs allocated to the particular mine;
- the cost of capital assets, including amounts paid or payable under a capital lease or the rental cost of capital assets, acquired for the purpose of the production of minerals from a mine, or for the distribution of the mineral product from that mine, and used directly in the administration of that particular mine;
- costs incurred, before the mine came into commercial production, for the purpose of bringing it into commercial production, including the costs of clearing, removing overburden, stripping, sinking a mine shaft, and constructing an adit or other underground entry;

- costs for sinking a mine shaft, constructing an adit or other underground entry, removing overburden, stripping, clearing, or other similar activities if those costs are incurred after the mine came into commercial production and for the purpose of maintaining the mine in commercial production;
- current costs incurred in the operation of the mine, including, for greater certainty, administrative or corporate costs (including management fees) that are directly related to the operation of the particular mine;
- current costs incurred for the operation of processing facilities used to process minerals extracted or obtained from the mine;
- current costs of distribution of the mineral product of the mine, including marketing expenses and related sales commissions;
- the transaction value of mineral products consumed or used at the mine;
- any amounts paid as a repayment of amounts in the current or any preceding fiscal year of the mine;
- the cost of surface rights and surface lease costs incurred for the purpose of obtaining access to the mine;
- fees paid to a bank to provide a security bond acquired to satisfy the security guarantee required under the Mines Act for reclamation;
- costs of reclamation, including the required contribution made to the mine reclamation fund account and interest earned in the fund account less any amount elected to be added to the reclamation cost account; and
- research costs that are incurred by a person on scientific research and experimental development undertaken during fiscal years of the mine in which the person is an operator of a mine in commercial production and that are related to the mineral activities of that person, provided the results of the research or development are public property.

Where a cost or expense in respect of a mine is incurred by a person under an agreement entered into with an operator whereby the sole consideration for incurring the cost or expense is for shares of the capital stock of the operator or an interest in a partnership, or for an interest in or right to the shares or partnership interest, the cost or expense may be claimed as a cost for that mine.

A detailed description of the concepts of pre-production discovery costs, exploration costs, new mine allowance and reclamation costs is beyond the scope of this report. However, the BCMTA and its regulations provide further details of these concepts.

Although the BCMTA does not allow actual interest expense, it provides for an allowance for a return on capital invested in a mine, called an Investment Allowance. The Investment Allowance is calculated as a certain percentage of the average CEA balance for the year. The investment allowance is calculated using a notional interest factor (125% of the federal bank rate) that is applied to the average exploration account balance. It is based on the average of the opening balance in the exploration account and the balance after adding exploration expenditures incurred in the current year and deducting the grants, subsidies, and other forms of assistance, actual or deemed proceeds of disposition, and amounts allocated by an operator mentioned

above. The investment allowance is designed to approximate the cost of capital to the industry, regardless of the manner in which costs are funded. Equity capital is treated the same as borrowed capital. The NR tax is designed not to discourage investment in marginal operations. The investment allowance is designed to approximate the cost of capital to the industry, regardless of the manner in which costs are funded. Equity capital is treated the same as borrowed capital. The NR tax is designed not to discourage investment in marginal operations.

Certain **costs and expenses** are regarded as **non-deductible**. In computing the **NCP** and **NR**, generally no deductions may be claimed for any amount paid, payable, or incurred related to the following:

- consideration to any person other than the Crown in right of the province for the right to win minerals from a mine, including the cost of a royalty or similar payment, whether or not dependent on (i) the amount or value of the mineral products produced from the operation of the mine, or (ii) the profits or cash-flow derived from the operation of the mine;
- consideration for services to be rendered or goods to be delivered after the end of the fiscal year of the mine;
- interest;
- financing costs;
- dividends;
- incorporation or reorganization costs;
- costs or losses on hedging transactions;
- taxes payable under the BCMTA, the Income Tax Act (British Columbia), or the Income Tax Act (Canada);
- salaries, wages, fees, or benefits paid to a significant shareholder of the corporation or an affiliated corporation in excess of CAD 75,000 in a fiscal year, prorated for short fiscal years of the mine;
- any costs or expenses incurred with respect to the mineral product after the point at which the transaction value is determined; or
- any amount as a reserve, contingency, allowance, or bad debts expense.

4.5.3.4.4 Rate

The tax rate is 2% or 13%. If the 2% tax is applied jointly with the 13% tax, then the former is creditable against the latter (see section 4.5.3.4.3).

4.5.3.4.5 Treatment of financial expenditure in R-based

No specific information on the treatment of financial expenditure could be obtained. Generally, with regard to the treatment of expenditure please see section 4.5.3.4.3.

4.5.3.4.6 Net-refund position

If there is a **net-refund position** in determining NCP tax if the operating costs of the mine exceed gross revenues from the mine for the fiscal period, NCP is zero and no

tax is payable. Whereas, in determining NR tax if the resulting amount of deducting operating expenses and capital expenses from gross revenue is negative, it is carried forward, with an allowance for a return on investment, to the next year in the CEA. This can be carried forward indefinitely and applied to reduce NR of future years.

4.5.3.4.7 Carry forward of losses

Please see section on net-refund position with regard to CEA (see section 4.5.3.4.6). Generally, with respect to the treatment of expenditures please section on tax calculation (see section 4.5.3.4.3).

4.5.3.4.8 Exemption

First Nation[101] groups are not subject to BCMT under certain conditions.

Generally, with respect to the treatment of expenditures please aforementioned outline (see section 4.5.3.4.3).

4.5.3.4.9 Administrative provisions

Generally, each operator of a mine is required to file, in the prescribed form, a separate annual return for each fiscal year of each mine that is in operation on or before the last day of the sixth month following the fiscal year-end. Generally, unless demanded by the commissioner, an operator of a mine does not need to file a return

- if the operator is an individual (i.e., not a corporation or partnership) and expenditures for all operators of the mine did not exceed CAD50,000 during the fiscal year of the mine; or
- the mine was not in commercial operation and (i) the operator was not engaged in any reclamation activities, and (ii) all mineral products derived from the mine and all assets used in the operation of the mine have been sold or otherwise disposed of.

If a partnership operates a mine and all members of the partnership jointly elect in the prescribed form, the partnership may file a single return on behalf of all the partners in respect of each mine operated by the partnership, and the operators that constitute the partnership are not required to file a return with respect to that mine.

Generally, operators of mines are required to pay monthly instalments on account of tax payable. The tax instalment for a particular month must equal the annual tax payable for the fiscal year multiplied by the number of days in that month divided by the number of days in the fiscal year. Interest with respect to instalment payments is subjection to certain conditions.

4.5.3.4.10 Qualitative and quantitative benefits or problems

[101] First Nation is defined in the Treaty Commission Act [RSBC 1996] Chapter 461 of the British Columbian's laws as *"an aboriginal governing body, however organized and established by aboriginal people within their traditional territory in British Columbia, that has been mandated by its constituents to enter into treaty negotiations on their behalf with Her Majesty in right of Canada and Her Majesty in right of British Columbia".*

Specific information on qualitative and quantitative benefits or problems was not obtainable.

4.5.3.4.11 Transitional rules

Specific information on transitional rules was not obtainable.

4.5.3.4.12 International recognition

Specific information on international recognition was not obtainable.

4.5.3.4.13 Avoidance schemes

Specific information on avoidance schemes was not obtainable.

4.5.3.5 Effect

4.5.3.5.1 Economic effect

Refer to sections 4.5.3.3 and 4.5.3.5.2.

4.5.3.5.2 Revenue

The Mineral tax was introduced in 1990; prior to 1990 the province had a Mineral Resource Tax and a system of Coal Royalties. The supplement contains the total revenue raised since 1990 up to 2014 from the Mineral Tax. Essentially, revenue from mining taxation upon introduction of the BCMTA fell by approximately more than 50% in the subsequent years, i.e. from 62,000,000 CAD in 1989/90 to 28,570,000 in 1991/2, but rose in the years afterwards. Revenue peaked in 2010/1 at 368,080,000 CAD but has declined again since then. In the year 2013/4, revenue was almost double the amount of the tax revenue in the year prior to introduction of the BCMT at 111,603,000 CAD.

4.5.3.6 Criticised aspects

No data was available on the criticised aspects of the BCMT.

4.5.3.7 Reasons for maintaining the BCMT

No political discussions about abandoning the tax.

4.5.4 Poland (Special Hydrocarbon Tax)

4.5.4.1 Synopsis

Taking effect in 2016, a new law provides for a taxation of the extraction of hydrocarbons - Special Hydrocarbon Tax (SHT). It is a tax whose basic structure derives from CFT. Goals are to support competiveness of Poland and to provide a consistent, transparent and as simple as possible taxation. The SHT addresses the debt-equity-bias. However, it cannot be considered as fully immune to inflation. In the period 2016-2029 it is expected to raise PLN 10 – 16,1 bln. The tax rate is subject to a so-called R-factor, i.e. the ratio of cumulative revenue to cumulative eligible expenses. Thus, eventually, only if the cumulative revenue corresponds to at least 150% of cumulative eligible expenses tax will become chargeable at the rates ranging from 12.5% to 25%.

In order to determine the tax base, revenues and expenditures have to be calculated. Revenues are generally made up by the consideration received in return for the supply extracted hydrocarbons. Eligible expenditures are to be deducted. The SHT provides for a conclusive list of non-eligible expenditures. The date when revenue arises is to be the date when a given sum is received. However, the cash method of accounting will not be applicable in any circumstances. Correspondingly, eligible expenditures are to be deducted on a cash basis, i.e. at the point of being paid/settled in any form. In case of acquisition of assets in the form of a contribution in kind, the expenditures are deductible as of the date of contribution. In a net refund position a loss carry-forward concept applicable. With respect to methane a tax exemption applies.

The SHT provides for transitional design, especially a four years tax holiday or for specific taxpayers. To tackle avoidance measures certain expenses are deemed to be non-eligible respectively, for example. Aggressive tax planning, e.g. under-pricing, is also addressed by anti-avoidance rules.

However, it is not clear at this stage how the SHT will be treated for treaty purposes. The SHT is challenged on several issues: it would not reflect the real return attributable to the state. Also, the hybrid tax system designed for the extraction industries sector composing of the SHT the tax on mining certain minerals and common income tax might be regarded as complex, inconsistent and non-transparent. These taxes are interconnected in a complex way. This might result in administrative burden and complexity.

4.5.4.2 ACE or CBIT considered as alternatives to the SHT

There is no information available that may suggest that either ACE or CBIT were considered as alternatives to the SHT for extraction companies.

4.5.4.3 Motivations for implementing the SHT

As according to reliable researches the large deposits of the shell gas were identified in Poland, the Polish government took steps to implement the new tax regime that, from one hand, provide the society with an appropriate share in profits generated from the extracting of natural resources, and, on the other hand, establish the flexible tax system which would make Poland competitive among other countries extracting natural resources and guaranty an appropriate rate of return for investors.

The state, as the owner of underground mineral deposits (being the non-renewable energy resources), has the right to a part of the resource rent, which may be received in a form of e.g. taxes or other state charges. According to the calculations performed by the Ministry of Finance, the share of the state in the resource rent from hydrocarbons mining activity before introducing the SHT and the tax on mining the certain minerals was about 21%, including CIT, the real estate tax and other state charges. Whereas, the level of the resource rent for example in the UK, Norway and Australia was respectively 62%, 72% and 56%. The target level of government take set by the Polish government was 40% (calculated based on the non-discounted cash-flows).

The proposed system of taxation of hydrocarbon production was designed with the purpose of being a competitive among other tax jurisdictions (investment incentive), consistent, transparent and as simple as possible, especially in its early stages. In

addition, the presented tax system was aimed to provide the effective and rational use of natural resources as well as to ensure stable economic development of Poland.

4.5.4.4 Design of the SHT

4.5.4.4.1 General

Special Hydrocarbon Tax (SHT) will be chargeable on profits from the extraction of hydrocarbons, i.e. oil, natural gas and related natural compounds, except for methane present in hard coal deposits and methane obtained as an incidental mineral. Profit corresponds to the excess of revenue from the extraction of hydrocarbons over the eligible expenditures incurred in a given year.

The extraction of hydrocarbons means an activity of obtaining hydrocarbons from deposits, including exploration and appraisal of hydrocarbons.

SHT is scheduled to take effect on 1 January 2016, yet liability to pay SHT will not apply for revenue earned prior to 1 January 2020. However, revenue and expenses have to be computed from the date of implementation of the new act for the purpose of determining the correct amount of cumulative revenue and expenses affecting the ratio of cumulative revenue to cumulative eligible expenses applicable from the point when SHT becomes chargeable (i.e. from the year 2020), and to fulfil the reporting duties scheduled to come into force from 2016.

The SHT is a source based tax which will be chargeable on profits from the extraction of hydrocarbons, i.e. oil, natural gas and related natural compounds, except for methane present in hard coal deposits and methane obtained as an incidental mineral.

The extraction of hydrocarbons means activities related to the mining of hydrocarbons from deposits, including searching and exploration of hydrocarbons conducted on the territory of Poland or its exclusive economic sea zone. The activity is deemed to be started beginning from the date of obtaining one of the concessions as specified in the Geological and Mining Law or filing the project of the geological works to the competent authority.

4.5.4.4.2 Scope

Obligation to pay the SHT will apply to every entity that carries on extraction of hydrocarbons, including individuals, all types of companies and partnerships, and if the business is carried on by cooperation (consortium), taxpayers will be all parties to the cooperation agreement in the meaning of the Polish Mining and Geological Law.

4.5.4.4.3 Tax calculation

The taxable base will include only revenue earned after the date when the law takes effect, i.e. from 2016 onward. As a rule, revenue will include monies received, monetary values and the value of receivables settled in kind from the supplies of the extracted hydrocarbons. The date when revenue arises is to be the date when a given sum is received (date of receipt of things, rights or other benefits in kind). However, the cash method of accounting will not be applicable in any circumstances; for

example, if a payment is not transferred within 3 months from the date of supply of hydrocarbons[102], no revenue will arise until the last day of the 3-month period. Provisions related to the date when revenue arises are applicable also in the situation of partial payments for the supplied hydrocarbons.

The taxable base will be influenced by the foreign exchange differences resulted from the long period of settlement of the transaction denominated in the foreign currency. In such situations, the taxpayer shall increase the income by foreign exchange gains or reduce the income by the foreign exchange losses.

The taxable base will generally reflect eligible expenses incurred after the date when the law takes effect, i.e. from 2016 onward. However, in the first tax year taxpayers will also be entitled to increase their eligible expenses by expenses incurred over four years prior to the date of implementation of the act (i.e. expenses incurred since 1 January 2012), the value of fixed assets linked with the extraction of hydrocarbons not depreciated as at 1 January 2016 and the value of fixed assets under construction as at 1 January 2016.

Eligible expenses will be all expenses incurred to generate revenue or retain/ secure a source of revenue, including expenses to explore, appraise, extract, store or supply hydrocarbons and to wind up the hydrocarbon extraction business. The Act provides an open catalogue of eligible expenses, which will include but will not be limited to the following:

- expenditure on researching the geological site, seismic studies and their interpretation, drilling exploratory wells
- expenses to design, prepare and develop infrastructure for the hydrocarbon extraction business and the accompanying infrastructure
- environment protection expenses linked with the hydrocarbon extraction business
- expenses needed to wind up the hydrocarbon extraction business and for land reclamation
- income tax to the extent that it applies to the hydrocarbon extraction business and royalty tax (on natural gas and oil)
- the exploitation fee and the mining usufruct fee
- expenditures related to the creation of wells
- expenditures related to the transportation of the mined hydrocarbons to the place where they are introduced into the transmission network
- corporate income tax in the part which applies to the hydrocarbon mining activities

The bill provides an extensive (closed) catalogue of expenses not qualifying as eligible expenses, which will include in particular:

[102] Based on the SHT Act, the date of supply of hydrocarbons is the day of issuing invoice or other document regarding the supply.

- expenditures on the purchase of intangible assets, including patents and licenses, excluding certain intangible assets linked closely with the hydrocarbon extraction business (e.g. expenses to buy geological documents, software to interpret geological data)
- investment and financial expenditures, including expenses to buy stock/ shares, derivatives, insurance, expenses to repay loans/ credits or interest on loans/ credits
- expenditures on the purchase of land or rights of perpetual usufruct of land, except for charges for perpetual usufruct of land (with some exceptions)
- expenditures on charges for the use of assets used under lease agreements: (i) in whole - in the event that this applies to land and intangible assets; (i) in the part which exceeds the repayment of their initial value - in the case of other assets (with respect to which expenditure on their acquisition qualifies as eligible expenditure)
- expenditure on the repayment of borrowings (bank loans), interest and other commissions and fees on those borrowings (bank loans)
- expenditure incurred on the purchase of the taxable person's tangible assets - in the event that it is found that these assets are not used in practice for the purposes of the taxable person's hydrocarbon mining activities
- penal fees (penalties, damages, compensation, late payment interest etc.)

Eligible expenditures[103] are to be deducted on a cash basis, i.e. at the point of being paid/settled in any form. In case of acquisition of assets in the form of a contribution in kind, the expenditures are deductible as of the date of contribution. In the latter case, value of assets to be recognised as the eligible expenditures, shall be determined:

1) in the case of ingredients classified as fixed assets or intangible assets -in the amount of the initial value less amortization specified in records of fixed assets and intangible assets of the entity contributing - made at the date of acquisition
2) in the case of the other ingredients - in the amount used for tax purposes and the resulting from tax records of the contributing entity at the date of acquisition.

Income tax is calculated only with relation to hydrocarbon mining activities on the basis of the reported accounting records. If the determination of the amount of income tax in this way is not possible, the taxpayer determines the income tax in part relating to mining activities in such proportion of hydrocarbons in which revenues received in the tax year in respect of the supply of hydrocarbons extracted correspond to the total amount of income of the taxpayer, under the provisions of the Income Tax Act, obtained in given fiscal year.

For the purpose of the SHT, only income from supply of extracted hydrocarbons is subject to taxation. Income generated from other activities remains out of scope of

[103] This refers only to tangible and intangible assets with respect to which expenditure on purchase would be recognised as eligible.

the SHT. Therefore, the ring fence is necessary to separate income related to the supply of extracted hydrocarbons.

In case of disposal of fixed assets or piece of equipment, if the expenditure for the acquisition was previously reported as eligible expenses, current eligible expenditures shall be reduced by an amount equal to the eligible expenses disclosed for tax purposes at the time of acquisition of such assets. Such rules also apply in the case of transfer of the fixed asset to another entity to use under the lease, rental, leasing or similar agreements, unless the total period of the lease, rental, leasing or similar agreements with respect to a given asset exceeds 5% of amortization period adopted for income tax purposes.

4.5.4.4.4 Rate

The rate of SHT will be determined by the so-called 'R' factor, i.e. the ratio of cumulative revenue to cumulative eligible expenses. Cumulative revenue/ expenses should be understood as the sum of revenue/ expenses earned/ incurred from the date of inception of the hydrocarbon extraction business, and in the case of entities carrying on extraction of hydrocarbons prior to the implementation of the act cumulative revenue does not include revenue received earlier than that for the year 2016 and cumulative expenses incurred earlier than that for the year 2016 (for details with respect of treatment of expenses incurred before 2016 please refer to the point 4).

As a result, if the 'R' factor is:

- lower than 1.5 the SHT rate is 0%;
- equal to or higher than 1.5 and lower than 2, the SHT rate will be computed using the following formula (25 x 'R' factor – 25)/ 100;
- equal to or higher than 2, the rate of SHT is 25%.

This means that SHT will not be chargeable unless cumulative revenue corresponds to at least 150% of cumulative eligible expenses. If this threshold is exceeded, tax will become chargeable at the rates ranging from 12.5% to 25%.

4.5.4.4.5 Exemptions

As mentioned before, the SHT is not chargeable on profits from the extraction of methane present in hard coal deposits and methane obtained as an incidental mineral. The rationale behind the exemption are (i) the reasons of safety of miners extracting hard coal deposits, i.e. introduction of SHT should not affect the expenditures incurred for security purposes to remove methane during extraction process of hard coal deposits, (ii) the reasons of protection of natural environment, i.e. methane obtained as an incidental mineral used to produce energy for own purposes is not set free to the air.

4.5.4.4.6 Net-refund position

Taxable persons are required to calculate (and present in the monthly tax returns) the level of profit (loss) achieved since the beginning of the tax year and to pay advances on the SHT each month at the amount of the difference between tax due on profit generated from the beginning of the tax year and the sum of advances due for the

previous months. Therefore, if the taxpayer is in net-refund position taking into consideration the revenues and expenditures achieved since the beginning of the tax year, it is not obliged to pay advances on the SHT since its tax base is negative. The loss reported for the given year can be deducted in the following years (there are no restrictions on the period when the deduction is applicable).

4.5.4.4.7 Carry forward of losses

The losses reported in the given year for the purposes of the SHT can be deducted in the following years (there are no restrictions on the period when the deduction is applicable).

4.5.4.4.8 Treatment of financial expenditure in R-based

Some of the categories of expenses (such as costs of financing) were excluded from the eligible expenses in order to prevent using such instruments for aggressive tax planning. However, the exclusion of some expenses was compensated by increasing the level of R-factor.

4.5.4.4.9 Administrative provisions

The SHT system will require additional administrative obligations for the entities operating in the E&P of hydrocarbons sector since they will be required to apply the ring fencing in determining revenues and eligible expenses being solely in relation to hydrocarbon mining activities. The revenues and eligible expenditures will have to be recognised according to rules that are specified strictly for SHT purposes, i.e. in general on the cash basis, that differ significantly from the rules applicable for accounting or other taxes purposes, i.e. CIT or VAT. In addition, the new rules are applied to determine the amount of eligible expenditures incurred over four years prior to the date of implementation of the SHT. In effect, initially the SHT will result in additional administrative burden to properly meet the new tax obligations. However, in the future the ease of administration should be achieved due to no need of compliance.

Giving the administrative obligations, taxable persons will be required to submit tax returns monthly without a demand, in accordance with the defined template, presenting the level of profit (loss) achieved since the beginning of the tax year, together with the level of cumulative revenues and cumulative eligible expenditures and to pay advances to the account of the competent tax office each month at the amount of the difference between tax due on profit generated from the beginning of the tax year and the sum of advances due for the previous months.

The taxable person will be obliged to pay advances for the given month using the rate calculated using the provided formula (tax rate based on R-factor) on the last day of the month for which the advance is paid.

Moreover, taxable persons will be required to submit tax returns to the tax offices in accordance with the defined template, presenting the level of profit (loss) achieved in the tax year, the level of the cumulative revenues and cumulative eligible expenditures - by the end of the third month of the following year and, within this time, to pay the tax due or the difference between the tax due on profit presented in

the tax return and the sum of advances due for the period since the beginning of the year.

4.5.4.4.10 Qualitative and quantitative benefits or problems

One of the reasons behind introduction of the SHT as a cash-based tax was to simplify administrative procedures for calculation of the tax. It was assumed that only revenues earned and expenditures incurred in a given period will determine the tax base and no adjustments, in particular for depreciation write-offs, will complicate the tax computations.

However, due to the fact the new rules of recognition of revenues and expenditures have to be incorporated into the internal systems of taxpayers, which differ from the rules already applied for accounting and taxation purposes, initially the assumed ease of administration may not be achieved in practise. However, in the future the ease of administration should be achieved as the new system requires less cumbersome compliance work.

The SHT treats the debt and equity financing in a similar way as the costs of the financing (interest, financial charges) are not considered as eligible expenses. The SHT should be perceived neutral with respect to the choice between present and future consumption.

The SHT cannot be considered as fully immune to inflation due to the mechanism of calculation of R-factor. Considering that the R-factor is calculated using the cumulative revenues and eligible expenditures from the beginning of the hydrocarbon mining activities, rising of the inflation, the tax rate determined by the inflated R-factor will be applicable to the profit for the current tax year.

Imposing the SHT should not affect the choice of the organisational form, the choice of the location as all entities (irrespectively of their organisational form or location in Poland) are subject to taxation on the same basis.

4.5.4.4.11 Transitional rules

According to the transition rules included in the SHT Act, the tax is effective beginning from 1 January 2016 giving the future taxpayer the time for preparation to the new tax obligations. The further four year tax holiday is granted with respect to payment obligations, however reporting and compliance requirements with respect to the SHT are applicable since 1 January 2016.

Additional transitional measures were provided for specific taxpayers who on the day of coming into force of the Act as a part of their business makes supply of both imported natural gas and natural gas extracted from deposits located on the Polish territory, whereas the share of natural gas produced from deposits on the Polish territory in the total natural gas supplied by the taxpayer is not higher than 50%, and who because of the manner and profile of hydrocarbon mining activities are not able to settle the tax on general principles laid down in the Act (i.e. cash basis). Those taxpayers are entitled to determine in the period ended 31 December 2019 the revenue on the basis of the proportion of the quantity of natural gas from deposits located on the Polish territory to the total amount of the natural gas provided in the year preceding the tax year (adjusted to the amount of high-methane gas). After the

year end, the taxpayer is obliged to correct the tax using the proportion of quantity of natural gas from deposits located on the Polish territory to the total amount of the natural gas provided in the relevant tax year.

In such a case the taxable revenues are recognised as of the day of supply of natural gas but not later than at the day of issuing an invoice or settle the payment in any form. In case the supply of natural gas is settled over periods, the taxable revenue is recognised as of the last day of the settlement period defined in the invoice or in the agreement, but at least once a year.

Treatment of past investments
No special measures are designed with respect to the past investment. Nonetheless, the mechanism of setting the R-factor based on the cumulative revenues and expenditures should provide with the flexible tax rate that fallow the decreasing profitability of the project in the phasing out period. It should be noted that expenditures incurred to wind up the hydrocarbon mining business will affect both the tax base and the R-factor. In effect, the tax rate in the last phase of mining activity should be respectively lower due to the additional expenditures and falling revenues affecting the R-factor.

Treatment of future investment
In case of taxpayers that carry out the hydrocarbon mining activities as of the date of introduction of the SHT, in the first tax year they will also be entitled to increase their eligible expenditures by expenditures incurred over four years prior to the date of implementation of the Act (i.e. expenses incurred since 1 January 2012), the value of fixed assets linked with the extraction of hydrocarbons not depreciated as at 1 January 2016 and the value of fixed assets under construction as at 1 January 2012.

The mechanism of setting the R-factor based on the cumulative revenues and expenditures should also provide with the flexible tax rate that fallow the profitability of the project. In effect, the tax rate in the first phase of production of hydrocarbons, when revenues starts to be generated, should be low due to the R-factor that is mainly determined by the expenditures accumulated before the production phase started.

4.5.4.4.12 International recognition

It is not clear how the SHT will be treated on the grounds of the international tax regulation. However, it is likely that the SHT will not be considered as deductible in countries other than Poland in the light of the double tax treaties based on the OECD convention.

4.5.4.4.13 Avoidance schemes

The Act also sets out a mechanism designed to prevent under-pricing of hydrocarbons for the purpose of computing taxable revenue. The reason is that if the prices are set at a level lower than 90% of reference prices (i.e. the natural gas quotation at Towarowa Giełda Energii S.A. and the price of oil agreed by OPEC), the revenue will be determined by reference to those prices and the volume of extracted natural gas or oil.

Additionally, in order to prevent the under-pricing of hydrocarbons, the tax authority can investigate the exchange rate used to calculate foreign exchange differences (if

the actually used exchange rate is higher or lower respectively, by more than plus or minus 5% of the exchange rate announced by the Polish National Bank).

Moreover, some of the categories of expenses (such as purchase costs of intangible assets) are excluded from the eligible expenditures in order to prevent using such instruments to aggressive tax planning.

Finally, in case of the transaction conducted between related entities, the transfer pricing rules as specified for the income tax purposes are applicable to determine the taxable revenues and eligible expenditures. In particular, the sale and purchase transaction should be carried on in line with the arm's length principle.

4.5.4.5 Effects

4.5.4.5.1 Economic effects

The tax is not yet in place so the economic effects cannot be analysed yet.

4.5.4.5.2 Revenue

Based on the estimations of the Ministry of Finance, the expected state revenues from the SHT in years 2016-2029 should amounted to PLN 10 – 16,1 bln (estimation made before introduction the tax holiday for the period 2016-2020).

4.5.4.6 Criticized aspects

Main criticized aspects included:

Resource rent calculated by the Polish government

According to the calculations performed by the sector's representatives the government share in profits from the hydrocarbon mining activities will be higher than 40% (that is estimated by the Polish government). In addition, the sector criticizes that the calculations of the Ministry of Finance were based on the non-discounted cash-flows and, thus, do not reflect the real return attributable to the state.

Complexity of new tax regime

The hybrid tax system designed for the O&G sector composing of the SHT and the tax on mining certain minerals may be deemed by the sector's representatives and potential investors as complex, inconsistent and non- transparent. It should be added that the ordinary income tax is also due on the regular basis with respect to entities caring out mining activities. Furthermore, both new taxes and CIT are interconnected in complex way. Moreover, state charges based on the Mining and Geological Law are still applicable to the O&G sector.

Additional administrative burden

The SHT imposes requirements for a completely new recording solution, instead of using as much as possible of the standards developed in the current tax system (VAT/CIT). In addition, it was highly criticised that the new rules of recognition of the eligible expenditures are applicable to determine the amount of eligible expenditures incurred over four years prior to the date of implementation of the SHT when the rules were not know to the taxpayers. This creates administrative burden and complexity for both the government and industry, and adverse tax consequences for some foreign investors.

4.5.4.7 Reasons for maintaining the SHT

The tax is yet to come in force. There are no political discussions about abandoning the tax at this stage.

4.5.5 Norway (Petroleum tax)

4.5.5.1 Synopsis

The Petroleumsskatt (Petroleum tax - PT) was introduced in 1975. It is a tax whose basic structure derives from CIT but is amended by CFT elements. It aims at fostering investment by making use of the peculiarities of a CFT model, i.e. creating a special petroleum tax which only taxes rent and being able to capture much of the resource rent without creating distortions in addition to those created by the CIT. Oil companies who carry out exploration but have no currently ongoing production are given an immediate refund of the tax value of the deduction for exploration costs, currently 78 percent of exploration expenditures. It is regarded to provide stability, predictability, simplicity and the fact that it is profit based. Applying an aggregate tax rate of 78%, a tax revenue of 165,8 billion NOK (approximately 19,5 billion EUR) was raised in 2014. The PT is actually not a real tax but an umbrella term since the tax burden under the PT is made up by two taxes: the ordinary CIT and the so-called special tax. Such special tax is applicable on revenues from production on the Norwegian continental shelf as well as substitutes for such revenues, but not financial income such as interest receivable or gains on derivative agreements, even if such income is clearly linked to the production activities. Financial income is taxable according to the general tax only. Both of the tax bases are amended by certain specifics due to the PT, e.g. industry-specific allowances, uplifts etc. Eventually, the PT is based on depreciation plus uplift. A claim for a cash refund of the tax value of direct and indirect exploration costs is available on an annual basis under the PT excluding finance costs. This is an alternative to carrying the losses forward. It makes the PT similar to a CFT. In case of a net-refund position or a loss position a repayment of the tax value, where applicable, respectively a carry-forward is available. Doubts regarding the US interpretation of a CFT model originated led to choose CIT as the base for the PT. PT is regarded to have been successful in promoting investment and new entrants on the market. Thus, it will be maintained.

4.5.5.2 ACE or CBIT considered as alternatives to the PT

ACE and CBIT were not considered as alternatives to the Petroleum tax, however, they were considered as an alternative to the classical CIT system in place. More details are included in section 4.5.5.5 below.

4.5.5.3 Motivations for implementing the PT

Primary motivation: “CFT systems foster investment. Unlike the conventional CIT, a CFT system taxes economic rents i.e. profit over and above the normal rate of return for an investment. As such it is said that it does not distort the scale of investment by companies.”

The current Norwegian petroleum tax system only has some of the elements of a CFT. Most importantly, the oil companies who carry out exploration, but have no currently ongoing production (and thus no income, and thus negative yearly net cash-flows), are given an immediate refund of the tax value of the deduction for exploration costs,

currently 78 percent of exploration costs. This is motivated by the need to make a level playing field for all companies, so that entrants have the same advantage of deductions as incumbents. The combination of high tax rates, high uncertainty, and long-time-lags between exploration and production (if anything is found, at all) has made this particularly relevant in the petroleum sector. Without this refund, if there is only, e.g., 40 percent chance of making a commercial discovery (large enough to earn the tax value of deductions, eventually), and the time lag is, e.g., eight years, the 78 percent is reduced (in expected terms) to 78 percent x 0.4 /(1+r)8, where r is the company's after-tax discount rate. This used to be a serious obstacle to entry of new firms.

The Special Petroleum tax is only partly a CFT, but is intended to have the same economic effects as a CFT. The petroleum sector has high rents, and it has been important to capture much of these for the state via the rent tax system. But oil companies also pay the CIT. In an open economy the CIT will distort equity financed investments, and the idea has been that the rent tax (the Special Petroleum tax) should not introduce additional distortions, but also, not compensate for those that result from the CIT.

In summary: the most important reason for the actual CFT element, i.e., the refund for exploration (see above), was to create a level playing field (see above). Most important reason for mimicking a CFT, i.e., create a Special Petroleum tax which only taxes rent, was to be able to capture much of the resource rent without creating distortions in addition to those created by the CIT.

4.5.5.4 Design of the PT

4.5.5.4.1 General

The Norwegian petroleum tax system is not a pure CFT. However, the oil companies who carry out exploration, but have no currently ongoing production (and thus no income and negative yearly net cash-flows), are given an immediate refund of the tax value of the deduction for exploration costs, currently 78 percent of exploration costs. The tax applies to so-called "Upstream Activity" of the petroleum business on the Norwegian continental shelf/territorial waters and adjacent sea territories.

Petroleumsskatt (Petroleum tax) was introduced in 1975. It is governed by the Petroleum Taxation Act (PTA) - Act of 13 June 1975 No. 35 relating to the Taxation of Subsea Petroleum Deposits, etc.

4.5.5.4.2 Scope

The tax applies to taxpayers who are engaged in the so-called "upstream activity" of the petroleum business on the Norwegian continental shelf/territorial waters and adjacent sea territories.

4.5.5.4.3 Tax calculation

The petroleum tax is a special resource rent tax which is added to the ordinary business tax system. For the purpose of calculating ordinary petroleum tax (subject to general business tax) and special tax, gross income includes revenues from production on the Norwegian Continental Shelf (NCS) as well as substitutes for such revenues,

but not financial income such as interest receivable or gains on derivative agreements, even if such income is clearly linked to the production activities. Financial income is taxable according to the general tax only (as “onshore income”).

Costs incurred in order to obtain income of a taxable nature are deductible with some limitations.

The special petroleum tax shall be assessed on such income from the activities as forms the basis for the assessment of the ordinary income tax. This means that the tax base is taxed twice. Deductions are not granted for any loss resulting from other activities than extraction and pipeline transportation.

The taxable income is gross income minus deductions (net income) corrected by uplift. The uplift shall be 7.5 percent of the cost price of operating assets. The cost price of the operating asset shall be included when calculating the taxable income for 4 years, beginning with the first year of depreciation thereof. The uplift shall be deducted when calculating the special tax.[104]

The taxpayer shall, upon the realization of operating assets, calculate the uplift which is to be recorded as income or to be deducted upon the calculation of special tax. The base for the calculation of uplift upon realisation shall be equal to the realisation consideration less the historical cost price, multiplied by an adjustment factor. The adjustment factor shall be equal to the ratio between the remaining uplift period and the total uplift period. The uplift shall be 7.5 percent of the calculation base, and shall be included in the calculations for 4 years as from the realisation year. If the calculation base is negative, uplift shall be deducted upon the calculation of special tax.[105]

If uplift exceeds net income, any excess shall be deducted in subsequent years upon the assessment of special tax.

Calculation for general tax:
+ Sales income (set with norm prices)
- Operating costs
- Capital depreciation (16,66 % over 6 years)
- Financial costs
- (Deficits from previous years)
= Ordinary tax base liable to 27% Tax

Calculation for special tax:
+ Ordinary tax base
- Uplift (investment based extra depreciation, 7,5 % over 4 years)
- (Excess uplift from previous years)
= Tax base liable to 51% tax

[104] Norwegian Petroleum Taxation Act, (2007), section 5.
[105] Ibid.

The PTA requires that when calculating taxable income, all petroleum transactions are calculated using a "norm price" which is set by the Ministry of Finance.[106] The norm price should correspond to an arm's length price on a free market. The norm price is set discretionarily based on evaluation of different market conditions.

Consequently, a company will have different revenue figures for tax and accounting purposes. This difference is treated as a permanent difference.

Gross income and the value of petroleum inventories shall therefore be determined on the basis of the norm price when such a price has been set.[107] The value of operating assets that are depreciated shall, for purposes of calculating taxable wealth, be set equal to their value net of tax depreciation. [108]

Gains and losses upon the realization of operating assets acquired for use in activities relating to extraction and pipeline transportation of petroleum shall be deemed to constitute income from such activities.[109] Gains upon the realization of operating assets shall be recorded as income at a minimum rate of 16 2/3 percent per annum. Corresponding losses are deductible at a maximum rate of 16 2/3 percent per annum. Upon the realization of operating assets any gain shall be recorded as income at a minimum rate of 33 1/3 percent per annum, and any loss shall be deductible correspondingly. Withdrawal of an operating asset from activities that are liable for special tax shall be deemed equivalent to realization. The same shall apply when the operating asset does no longer, for other reasons, qualify for depreciation. The gain or loss shall be the amount that would have been included in taxable income if the transaction had been carried out at market value.

The following is considered as income for the purposes of the Norwegian Petroleum tax.

Sale of capital goods (such as real estate)

Sale of assets are generally subject to 78% tax. A "Section 10"-approval may be required for sale of fixed assets on the NCS. According to Section 10 the Ministry may, when granting consent for a specific transaction, reduce the tax that would normally follow the transaction.

Sale of intangible assets

Sale of production licenses are subject to special conditions as set out in "Section 10"-approval. According to Section 10 the Ministry may, when granting consent for a specific transaction, reduce the tax that would normally follow the transaction.

Sale of goods

Gross income and the value of petroleum inventories shall be determined on the basis of the norm price when such a price has been set. Gains and losses upon the realization of operating assets acquired for use in activities relating to extraction and

[106] Norwegian Petroleum Taxation Act, (2007), section 4.
[107] Norwegian Petroleum Taxation Act, (2007), section 3a.
[108] Norwegian Petroleum Taxation Act, (2007), section 3.
[109] Norwegian Petroleum Taxation Act, (2007), section 3f.

pipeline transportation of petroleum shall be deemed to constitute income from such activities.[110]

Contribution from the government (subsidy)

According to Section 5 of the PTA, grants pursuant to the general tax act are not deductible in the calculation of the special petroleum tax.

Interest received on bank surplus

A proportion of net financial income corresponding to the deductible amount of financial costs (see below deductibility of financing costs) shall be recorded as income if foreign exchange gains exceed the sum of interest costs and foreign exchange losses pertaining to interest-bearing debt.[111]

Financial income

Financial income shall be recorded as income or deducted in the onshore district.[112]

Income received from the sale of shares in subsidiaries

Sales of company shares are generally exempted from tax. Section 10 approval by Ministry of Finance may be required

Costs incurred in order to obtain taxable income are generally deductible. Therefore, as a starting point, all exploration costs are deductible.

Companies may also claim a cash refund of the tax value of direct and indirect exploration costs on an annual basis under the ordinary petroleum tax and the special tax excluding finance costs, with the amount of the refund limited to the tax value of the net tax losses. This is an alternative to carrying the losses forward and makes the petroleum tax similar to a CFT which would offer immediate deductions.

It should be noted that costs may be deductible against income taxable according to the PTA even if the costs are actually incurred onshore in Norway or elsewhere as long as the costs relate to taxable activities in accordance with the PTA. This will typically be relevant with respect to administrative costs, but may also for instance apply for tax depreciation of assets located onshore.

Deductions shall not exceed one half of the loss resulting in any given year from other activities than the abovementioned. Deductions are not granted for any loss resulting from activities outside the areas mentioned in Section 1 or outside the realm.

Regarding the special petroleum tax, an additional and accelerated capital allowance is granted on capital expenditure. This additional depreciation spreads over four years.

Capital allowances for investments made in productions facilities and pipelines and installations which are part of such production facilities and pipelines are calculated on a straight line basis over six years at a rate of 16.66% per year from the date the capital expenditure was incurred. The capital allowances are granted both when calculating the basis for ordinary petroleum tax and special tax.

[110] Norwegian Petroleum Taxation Act, (2007), section 3f.
[111] Norwegian Petroleum Taxation Act, (2007), section 3d.
[112] Norwegian Petroleum Taxation Act, (2007), section 3.

Expenses incurred in acquiring pipeline and production facilities, including the installations which form part of, or are related to, such facilities, may be depreciated at a maximum rate of 16 2/3 percent per annum, with the first year of the depreciation period being the year in which such expense was incurred. Expenses incurred in acquiring operating assets as mentioned in the preceding sentence may be depreciated at a maximum rate of 33 1/3 percent per annum, with the first year of the depreciation period being the year in which such expense was incurred, provided that the purpose, according to an approved plan for development and operation as well as a special permission for facility and operation pursuant to the Petroleum Act, is production, transportation by pipeline and processing of gas to be liquefied by cooling in a new large-scale cooling facility located in certain areas.[113]

A share in a license to explore for or extract petroleum is deductible in the same way as expenses related to operating assets i.e. at a maximum rate of 16.66%

Net financial costs incurred on interest-bearing debt are deductible and calculated as the sum of interest costs and foreign exchange losses, less foreign exchange gains, pertaining to such debt.

However, limitations apply to the deductibility as regards the special petroleum tax.

The deductible amount equals the proportion of the net financial costs of the company as corresponds to 50 percent of the ratio between the value (net of tax depreciation as per 31 December of the tax year) of relevant assets (production facilities and pipelines, capitalized R&D, fixed assets, intangibles) attributed to the upstream activities and the average interest-bearing debt over the tax year.[114]

Net financial costs x 0.5 x (tax value of relevant assets)/(average interest-bearing debt)

Other interest expenses/income is allocated onshore and thus subject only to general tax.

4.5.5.4.4 Rate

The rate of ordinary petroleum tax is 27% for profits taxable according to the PTA (ordinary corporation tax). The special tax is charged at 51% as an additional tax on these same profits. It should be noted that these taxes are calculated independently of each other. It is not possible to make a deduction for the ordinary tax paid against the taxable income for the special petroleum tax.

Normal CIT 27% + Special tax 51% = total tax rate 78%

4.5.5.4.5 Exemption

Sales of company shares are generally exempted from tax see section 4.5.5.4.3.

4.5.5.4.6 Treatment of financial expenditure in R-based

[113] Norwegian Petroleum Taxation Act, (2007), section 3b.
[114] Norwegian Petroleum Taxation Act, (2007), section 3d.

Since the PTA does not provide for a CFT the R-based concept is not applicable. In general, with respect to the treatment of expenditures please see sections 4.5.5.4.3 and 4.5.5.4.5.

4.5.5.4.7 Administrative provisions

No specific information on administrative provisions could be obtained.

4.5.5.4.8 Net-refund position

If uncovered loss remains at the time of discontinuation of activities liable for special tax, the taxpayer may claim payment from the State of the tax value of such loss. The tax value is determined by multiplying the uncovered loss in ordinary income in the shelf district and in the special tax base by the rates applicable on the discontinuation date.[115]

The taxpayer may claim payment from the State of the tax value of direct and indirect expenses (with the exception of financial expenses) incurred in the exploration for petroleum deposits, to the extent that the amount does not exceed the annual loss in ordinary income in the shelf district and in the special tax base, respectively. The tax value of the exploration expenses shall be determined by multiplying the deductible expenses in ordinary income and in the special tax base by the applicable tax rates for the year in which the exploration expenses are incurred.[116]

This means that companies may claim an annual cash refund of the tax value of direct and indirect exploration costs under ordinary petroleum tax and special tax (this amounts to 78% of such costs), with the exception of finance costs, with the amount of the refund limited to the tax value of the net tax losses. This is an alternative to carrying the losses forward.

4.5.5.4.9 Carry forward of losses

Losses may be deducted from income in subsequent years without time-limit. Losses incurred in the tax year 2002 or subsequent years may be carried forward with the addition of interest to be added to the balance as per the end of the tax year.[117]

Companies without taxable income get:

- Carry forward of losses with interest
- Tax refund (pay out) of exploration costs
- Final losses can be sold or tax reimbursed from the state

4.5.5.4.10 Qualitative and quantitative benefits or problems

Efficient tax administration has been pointed out as a benefit by the Ministry of Finance.[118]

[115] Norwegian Petroleum Taxation Act, (2007), section 3c.
[116] Norwegian Petroleum Taxation Act, (2007), section 3c.
[117] Norwegian Petroleum Taxation Act, (2007), section 3c.
[118] Semmingsen L., (2010).

The idea has been that the rent tax (the Special Petroleum tax) should not introduce additional distortions, but also, not compensate for those that result from the CIT distortion of equity financed investments. Unfortunately the Ministry of Finance and the parliament (the Storting) never implemented the neutrality between debt and equity in the Norwegian petroleum tax system. There is a combination of deduction for actual interest payments on debt and an uplift deduction (approximately for the normal rate of return) for the whole amount of invested capital (equity plus debt). This means a double deduction for the return on debt. This is so unreasonable that it was assumed away in the analysis of the Norwegian petroleum tax system by Mintz and Chen[119].

The immediate refund of the tax value of the deduction for exploration costs is motivated by the need to make a level playing field for all companies, so that entrants have the same advantage of deductions as incumbents. This appears to have stimulated the market for new entrants. The number of companies that are active in the sector has increased from 30 to 50 in the years following the reforms (after 2002), so the intended encouragement of entry seems successful.

The ministry of finance points out the following additional benefits; stability, predictability, simplicity and the fact that it is profit based.[120]

4.5.5.4.11 Transitional rules

No specific information on transitional rules could be obtained.

4.5.5.4.12 International recognition

There has been uncertainty over the reaction in the US, and in particular, Norwegian authorities have not been sure whether a full-blown CFT in the petroleum sector would be creditable as a tax in the US. This has been a reason why the current Special Petroleum tax is based on depreciation plus uplift, not cash-flows, and also a reason for keeping the deduction for reported interest expenses on debt (although limited by thin capitalization rules and probably also some limitation on the allowable interest rates).

4.5.5.4.13 Avoidance schemes

No specific information on avoidance schemes could be obtained.

4.5.5.5 Effects

4.5.5.5.1 Economic effects

The Sheel committee[121] delivered its proposal[122] on 2 December 2014. In the report the introduction of a general CFT system as a replacement of the corporate income tax

[119] Mintz J. and Chen D., (2012), p. 15.
[120] Semmingsen L., (2010).
[121] The Scheel Committee was appointed by the Norwegian Government on 15 March 2013. The Committee's mandate was to assess whether the Norwegian corporate income tax system is structured to meet the international development of increased cross-border investments and ownership, and prepared for the challenges relating to increased international tax planning and tax competition among states.

system was discussed. The committee found that it could not be recommended based on the following reasons. First, the tax revenues would to a greater degree than presently vary. Tax revenues will in isolation fall in good times with major investments and increase in bad times with low investments. This can be disadvantageous out of consideration to economic stability.

Second, a CFT would deviate from the present system and international standards most commonly applied. This will result in major practical challenges with regard to taxation of cross-border operations.

The committee provides the example that different treatment of income and costs between countries increase the extent of double taxation and non-taxation. Such a tax model can also be difficult to implement within the framework of the current tax treaties and Norway's international obligations. The committee concludes that although cash taxes equally treats debt and equity and has good properties with regard to investment incentives, these taxes do not solve challenges as regards profit shifting identified in the report. Considering also the major practical challenges of cross-border investments the committee finds that it cannot recommend replacing the current corporate tax with a general and pure CFT.

"The Scheel-committee considers all the three form of CFT (the R-CFT, R+F-CFT and the S-CFT). There is also a discussion of destination based Cash-flow taxation (of the VAT-type). However, the Scheel-committee does not recommend that the current corporate income tax system should be replaced with any of these models of CFT. One reason for this is related to the taxation of cross border investments. For instance, different treatment of income and costs in different countries can increase the extent of double taxation and double non-taxation. According to the committee the CFT-models have attractive features, but may cause problems for a small, open economy if implemented unilaterally on a general basis. The committee does however recommend (any form of) neutral taxes on sources to immobile pure profits such as petroleum, hydro power, fisheries and sea farming. Currently Norway levies special taxes on economic rent from both petroleum and hydro power. These tax models are based on the theoretical principles of the CFT. The tax models are described in more detail in chapter 2 of the budget proposal on taxes 2015, see pp. 10-12.[2]

In addition the Scheel-committee also considers the ACE-model and the CBIT-model which also creates neutrality between debt and equity on the company level. However, the models differ substantially with respect to effects on investments and tax planning. The committee advises against implementing the CBIT. Regarding the ACE-model the committee believes it is feasible, but it will be difficult to design the model to prevent tax planning. The model could be an alternative if one wishes to strengthen the incentives to invest. However, the committee recommends that Norway maintain an ordinary corporate income tax.

[122] The report by the Scheel Committee contained proposals regarding the country's tax system. The Committee's main recommendations include a reduction in the Norwegian corporate income tax rate and implementation of specific restrictions to the transfer of profits from Norway to other countries. In addition, several changes to the Value Added Tax (VAT) system and the taxation of individuals have been proposed. However, it is anticipated that several parts of the proposal will not be implemented and that any implementation will take place in 2016 at the earliest.

The Scheel-committee also discusses whether the ACE-model and the CBIT-model treat debt and equity equally when considering both personal and corporate taxes. For example the ACE-model would create lock-in effects if the normal rate of return is not taxed in the corporate income tax, but is taxed on the personal level, e.g. through an ordinary dividend tax. In a closely held company the owner would have incentives to postpone dividends to reduce the present value of the dividend tax. The Scheel-committee develops different models to counter this lock-in effect. This is discussed in appendix 5.1 in the report, see pp. 157-163. " [123]

4.5.5.5.2 Revenue implications

"Through the petroleum tax system and the State's Direct Financial Interests (SDFI), the state secures a large proportion of the substantial revenues from the continental shelf without hampering investment which is profitable from a socioeconomic perspective. SDFI functions as a cash-flow tax, but the revenues are not treated as tax revenues."[124]

The revenue raised from petroleum taxation amounts to 200 billion NOK per year (approximately 23 billion EUR). In 2014, the revenue from tax on petroleum income was 165,8 billion NOK (approximately 19,5 billion EUR).

4.5.5.6 Criticized aspects

The compatibility of the tax with the international tax framework has been a problem. There has been uncertainty over the reaction in the U.S., and in particular, Norwegian authorities have not been sure whether a full-blown CFT in the petroleum sector would be creditable as a tax in the U.S. This has been a reason why the current Special Petroleum tax is based on depreciation plus uplift, not cash-flows, and also a reason for keeping the deduction for reported interest expenses on debt (although limited by thin capitalization rules and probably also some limitation on the allowable interest rates).

The Ministry of Finance and the parliament (the Storting) never implemented the neutrality between debt and equity in the Norwegian petroleum tax system. There is a combination of deduction for actual interest payments on debt and an uplift deduction (approximately for the normal rate of return) for the whole amount of invested capital (equity plus debt). This means a double deduction for the return on debt. This is so unreasonable that it was assumed away in the analysis of the Norwegian petroleum tax system by Mintz and Chen[125]

4.5.5.7 Reasons for maintaining the PT

It has been successful in promoting investment and new entrants on the market and the state has been able to retain its financial interests in the extraction of petroleum from the national continental shelf.

[123] Norwegian Ministry of Finance, (2014).
[124] Norwegian Ministry of Finance, (2012), p.4.
[125] Mintz J. and Chen D., (2012), p. 15

4.5.6 United Kingdom (Petroleum Revenue Tax)

4.5.6.1 Synopsis

The Petroleum Revenue Tax (PRT) was introduced in 1975. It is a tax whose basic structure derives from CFT. It is a ring-fenced tax since it taxes the revenues derived from each specific field of eligible resources. It aims at raising a fair share of the revenue for tax purposes. It allows a project to rapidly recover its costs, but taxes it at a relatively high rate, thus levying the economic rent. Applying a tax rate of 50% (for 2013/14) it raised tax revenue of GBP1.1 billion in 2013/14. Since its introduction it raised over GBP 66bn. PRT is deductible for Ring fence corporation tax and Supplementary charge purposes. The tax base is generally the cash-flow attributed to a specific field, i.e. consideration received in return for disposal of extracted resources and assets, as well as expenditures attributed to a specific field. This cash-flow base may qualify for certain specific amendments under a system of reliefs and allowances which enable a project to rapidly recover its costs. Losses can be carried forward and backward. If a field was granted development consent on or after 15 March 1993 it is exempted from PRT. There was no transition period as such. It is not covered by the majority of treaties. PRT is commonly criticised as being a complex tax due to the large number of reliefs and deductions available. It is administratively time consuming due to twice annual returns. PRT is subject to political discussion as to whether maintain or amend the tax.

4.5.6.2 ACE or CBIT considered as an alternative to the PRT

Interest is a non-deductible cost for PRT (and there have been no indications by the UK Government that they intend to change this rule). However, ACE and CBIT were not considered as alternatives to the PRT.

4.5.6.3 Motivations for implementing the PRT

PRT was intended to ensure fairer share of profits for the nation from the exploitation of the UK's continental shelf, while ensuring a suitable return on the capital investment by oil companies.

The main objectives behind PRT when it was introduced in 1975 were to[126]:

- Allow a project to rapidly recover its costs, then tax it at a relatively high rate,
- Ensure that tax due is payable as early as possible (first payments under PRT are made earlier than under Corporation Tax and there are other rules that tend to accelerate payment of tax),
- Ensure that projects where no economic rent was likely were protected from the tax.

4.5.6.4 Design of the PRT

4.5.6.4.1 General

[126] HMRC, (2011).

Income generated from UK oil & gas production is subject to a special tax regime which comprises up to three tiers of taxation levied on profits (note, no turnover taxes, royalties, etc. are imposed):

- Petroleum Revenue Tax ("PRT"),
- Ring Fence Corporation Tax ("RFCT"), and
- Supplementary Charge ("SC").

PRT is a field based tax and is only payable by certain fields. In particular, fields which received development consent after 16 March 1993 are not subject to PRT.

RFCT and SC are company level taxes payable in respect of profits generated from 'ring-fenced' UK oil and gas production and connected activities, for which the tax base starts with accounting profit (based on accruals). However, PRT assessments start with production revenues based on oil lifted and sold, then allows for certain deductions.

PRT is a CFT because it is assessed on each company's share of the cash-flow from each separate oil field. It is based on oil liftings, less a full deduction for all expenditure – there is no distinction between capital and revenue expenditure. The PRT profit or loss for a field was to be, broadly speaking, the difference between the field's income and expenditure.

Prior to the Oil Taxation Act 1975, there was no specific regime for the taxation of UKCS oil and gas companies. PRT was introduced by The Oil Taxation Act 1975, and was specifically targeted on the profits from oil production in the UK and from the UKCS. The central proposition was the use of the oil and gas lifted as the basis of taxation. PRT is a source based tax.

PRT is a field level tax rather than company based, and assessments start with production revenues based on oil lifted and sold, then allows for certain deductions. The tax base does not follow accounting profits/losses.

PRT is levied on fields extracting oil or gas in the UK or UK Continental Shelf.

4.5.6.4.2 Scope

PRT is charged separately on the cash-flow derived from every single oil field.

4.5.6.4.3 Tax calculation

PRT is charged on each participator's share of the cash-flow from each separate oil field. The tax is charged on profits calculated in accordance with specific statutory provisions, rather than on accounting profits. It represents the first tier of UK oil and gas taxation as it is a deductible expense for RFCT and SC purposes.

For the computation of PRT, incomings broadly include the following:

- Gross profit on disposal of oil and gas produced in a chargeable period (known as equity),
- Consideration received in return for use of assets and provision of services to participators in other fields (tariff receipts – see below), and
- Consideration received from disposal of certain assets (disposal receipts).

Broadly, oil and gas sales are brought into tax at their arm's length value.

Allowable expenditure

Most costs of exploring, appraising, developing, producing, measuring and selling oil won, and decommissioning a field will be deducted as qualifying costs. Relief is given in full in the first relevant period rather than writing down allowances and revenue deductions (other than for expenditure incurred on non-dedicated mobile assets or expenditure on remote associated assets). If the asset is non-dedicated, relief is only available for that part of the expenditure which relates to periods of use. Relief for the cost of remote associated assets is only available against the tariff income earned from that asset. There are also deductions for royalties and other licence payments.

No deductions are available for PRT purposes for finance costs, but to compensate for this, an additional deduction by the way of "Uplift" is available. Where costs are incurred partly for a qualifying field purpose and partly for another purpose then an apportionment must be made. Broadly, the costs of developing one field cannot be set against the profits of another field, though exceptions apply.

Deductions/reliefs

Various further deductions and reliefs, other than normal allowable expenditure, are available against income assessed for PRT. The extensive system of reliefs and allowances enables a project to rapidly recover its costs, and ensures that projects where no economic rent is likely are protected from PRT.

The reliefs and deductions include the following:

- **Uplift**: A supplement of 35% is given on past capital expenditure being carried forward to the pay-back period to compensate for interest and other finance costs being non-deductible against PRT. The pay-back period covers the time when the cumulative field income exceeds the cumulative costs (allowable expenditure, including uplift, royalty, and any advance petroleum revenue tax);

- **Oil Allowance**: This is intended to protect the economics of smaller fields, and allows for a certain amount of production to be earned PRT-free for at least the first 10 years of a field's life. The amount of PRT-free oil production is set in statute by volume and is then converted to a cash equivalent based on the company's taxable income for the chargeable period.

It applies after all other expenditure and allowances, with the exception of safeguard. If the oil allowance is not fully used in a chargeable period, the excess remains available for future use, subject to the maximum allowance available for the field.

- **Safeguard relief** may be set against the tax charge. In effect, safeguard is an overriding relief which is only applicable following deduction of all expenditure and other reliefs. It is designed to ensure the viability of smaller, more marginal fields by guaranteeing a specific return on capital before companies have to start paying PRT. It only applies for a certain number of periods and is now largely of historical interest.

Safeguard is available in chargeable periods up to pay-back and for half as many periods again. If, in any of these periods, the tax charge would otherwise reduce the return on a field for the period, before corporation tax, to less than 15% of the

cumulative "upliftable" expenditure measured on the basis of historical cost, the charge is cancelled. There is also a tapering provision which limits the charge to a maximum of 80% of the excess if the rate of return on the field exceeds 15% of the cumulative upliftable expenditure.

To determine the value of oil and gas sold, there is a distinction between arm's length and non-arm's length sales. For arm's length sales the actual sales proceeds are used. For non-arm's length disposals or appropriations (other than for production purposes), the market value, as determined by HMRC (LBS Oil & Gas), is brought in. Oil and gas sales are termed "gross profits".

Wages, purchase of goods sold and other direct costs are deductible as allowable expenses. PRT cost allowances essentially give relief in full for expenditure as incurred, regardless of whether the expenditure is of a 'revenue' or 'capital' nature. Claimed expenditure is only deductible against income once it has been determined as allowable by LBS Oil & Gas.

Non-deductible items include the cost of acquiring land or interests in land and certain buildings, e.g. administrative offices. Payments to obtain interests in oil, e.g. licence acquisitions from other licensees are included as non-deductible items. Where licence interests are sold the consideration for the transfer is ignored and the new owner will effectively stand in the shoes of the previous owner. Moreover, financing costs are non-deductible.

Other non-deductible items for PRT purposes include expenditure that depends on the results of the field, e.g. a royalty interest and expenditure met by subsidy. To the extent that costs are incurred to generate a taxable tariff this is treated as a qualifying PRT purpose. Costs associated with generating non-taxable tariffs are not allowable.

Research costs that do not become allowable with respect to a specific field within three years of being incurred but which have an application to taxable fields may be set against the participator's PRT profits from any field (but not those of an affiliate).

PRT is a field based, rather than a company based tax. Dividends paid to shareholders are accounted for at a company level rather than on a field basis and are therefore not brought into PRT assessments.

4.5.6.4.4 Rate

PRT is charged by way of a single rate, which is 50% in 2013/14.

Tax is charged on profits arising in each chargeable period, and the historic rates at which PRT has been charged are:

- 1975 to 1978 - 45%
- 1979 - 60%
- 1980 to 1982 - 70%
- 1983 to June 1993 - 75%
- from July 1993 - 50%

In itself the fixed rate cannot accommodate a range of profitability arising from major price volatility (compounded sometimes by the fact that oil and gas price movements are not always in the same direction) and significant variations in costs. However, the

complex allowances attached to PRT render the tax progressive, meaning the tax is based on achieved returns from the investment. This fiscal structure is often referred to as a resource rent tax.

4.5.6.4.5 Exemptions

PRT has been abolished for all fields for which development consent was granted on or after 15 March 1993. Fields granted development consent prior to 15 March 1993 are liable to PRT, unless it has been agreed with HMRC to treat the field as non-taxable on grounds that it will never pay PRT due to the availability of the reliefs outlined above. With effect from 1 July 2007, fields that have previously been decommissioned and are then decommissioned are not liable for PRT.

4.5.6.4.6 Treatment of financial expenditure in R-based

No specific information could be obtained in the treatment of financial expenditure. In general, for the treatment of expenditures please see sections 4.5.6.4.1 and 4.5.6.4.3.

4.5.6.4.7 Net-refund position

Losses may be carried forward indefinitely and set off against the first available future profits. Losses can also be carried back indefinitely and set off against previous taxable profits from the field. If there are insufficient assessable profits in earlier periods to absorb the loss, it may be possible to claim it as 'unrelievable field loss' in another field.

4.5.6.4.8 Carry forward of losses

Losses may be carried forward indefinitely and set off against the first available future profits.

4.5.6.4.9 Administrative provisions

Each licensee must produce a separate return for each field in which it has an interest, and the return will include only income and expenses for that field.

PRT is levied on a field by field basis by reference to six-monthly chargeable periods ending on 30 June and 31 December each year.

The responsible person for each taxable field must submit a return showing the total amount of oil and gas produced from the field within one month of the end of each chargeable period. This return gives details of each participator's percentage interest in the field and the amount of each participator's share of the total oil and gas produced.

Estimated PRT liabilities are payable on account two months after the end of the chargeable period, and adjustments are dealt with on formal assessment. There is a system of monthly instalment payments based on the prior period liability, whereby 1/8 of the previous period's liability is due at the end of the second month of the chargeable period, and at the end of each of the next five months. The sixth payment is followed a month later by a balancing payment of the outstanding liability for the half year based on the company's self-assessment of its liability for the period.

Assessments are issued by HMRC three months after they have received a company's self-assessment. Any repayment from the carry back of losses would be made subsequently.

4.5.6.4.10 Qualitative and quantitative benefits or problems

Many PRT paying companies see it as a complex tax which is administratively time consuming due to twice annual returns.

Treats debt and equity-financing in a similar way. Immediate relief for expenditure whether capital or operating in nature means neutrality with respect to the choice between present and future consumption. There is tax-driven distortion towards investment in fields that not pay PRT, as investment in more mature fields is seen as less worthwhile.

4.5.6.4.11 Transitional rules

There was no transition period as such for the introduction of PRT, except it is worth noting that the introduction occurred at the same time as the concept of 'ring fenced' corporation tax. The rate of PRT began at 45% in 1975, increasing to 75% by 1983 before dropping to 50% in 1993 (see Question 9 for more details).

4.5.6.4.12 International recognition

PRT is not creditable under the majority of double tax treaties as it is not a tax based on 'profits'.

4.5.6.4.13 Avoidance schemes

No specific information could be obtained on avoidance schemes.

4.5.6.5 Effects

4.5.6.5.1 Economic effects

PRT was abolished for fields given development consent on or after 15 March 1993, but continues to apply to older fields. In the early 1990s the outlook for the UK oil and gas industry was weak, and the measures to reduce PRT for existing fields and abolish PRT for new fields were introduced to decrease the marginal tax rates on new (smaller) discoveries with the aim of encouraging investment in the UKCS to increase companies' potential rates of return. However, the repeal of the cross-field allowance (a natural consequence of the abolition of PRT for new fields), meant that companies were less protected from exploration and appraisal costs. The effect of this was that following the 1993 reforms, the financial risks of exploration and appraisal activity was greater, but the potential gains to be made from successful developments would be significantly higher than before.

In its Green Budget in January 2001, the Institute for Fiscal Studies ("IFS") argued that the basic structure of North Sea taxation had always been flawed because it could not respond adequately to fluctuations in oil prices, and cited this flaw as a main reason for the abolition of PRT. The IFS argued:

When significant oil deposits were first discovered, the government had a clean sheet on which to design a tax system, unconstrained by the legacy of previous decisions. Rather than introducing a coherent rent tax that automatically adjusts tax liabilities to changing economic conditions, significant departures from this principle were introduced into petroleum revenue tax, in response to short-term revenue considerations. These have required successive governments to raise tax rates or

introduce new taxes when profits are high and to lower tax rates or abolish taxes when profits are low. This culminated in the arguably premature abolition of PRT itself for new fields after 1993.[127]

Aided by the perspective of hindsight, the abolition of PRT for new fields has received criticism as an example of an ad-hoc reform by the government, which has fuelled instability and led to distortions in investment behaviour – the result of the reform is that the current regime operates as a two tier system with some fields subject to higher taxes than others based on an arbitrary cut-off date. In turn, this distorts investment decisions and adds to the regime's complexity. However, at the time the measure was introduced, it was a welcome, if long awaited, change for the industry during the challenging period of the early 1990s.

In 2002, there were three main reforms to UK oil and gas taxation – introduction of supplementary charge, introduction of 100% first year allowances on capital expenditure for RFCT and SC and abolition of royalty (see separate RFCT & SC response for further details). When these new provisions were debated at the Committee Stage of the Financial Bill, then then Financial Secretary, Ruth Kelly, commented on why reintroducing PRT would be unrealistic:

In 1998, during the last Parliament, the Government proposed to consult on the choice between two options for tax reform—the extension of petroleum revenue tax and a supplementary charge on profits. That made sense at the time, but in due course, in an environment of low oil prices, it no longer made sense to proceed with any change. Four years on, the proposal to reintroduce PRT is unrealistic. It would require companies to rebuild records on income and expenditure in all fields that had come on-stream since 1993. Given that oil companies may have changed hands, that would be administratively very difficult—a bureaucratic nightmare.

As far as I know, no one in the industry has called for the reintroduction of PRT. We have opted for a simple, streamlined tax reform that promotes investment over the long term.[128]

PRT was abolished with effect from 1 July 2007 for fields that have previously been decommissioned and are then recommissioned. If part of a PRT field hasn't been developed, and PRT is making such development uncommercial then participators can ask for the agreement of the Department of Energy and Climate Change to re-determine the field to exclude that part. The part that is carved out is then a new field for fiscal purposes and no PRT is due in respect of it.

[127] Seely A., (2011), pp. 6-7.
[128] Ibid. p. 7.

4.5.6.5.2 Revenue implications[129]

Since PRT's introduction, it has raised GBP 66bn of tax revenues in the period from 1978/79 to 2013/14 in money of the day (over GBP 100bn in real terms 2014 prices)[130]. In the last two years PRT revenues have declined by 45%, falling from GBP 2 billion in 2011/12 to GBP 1.1 billion in 2013/14[131]. Much of this decline was a result of significantly lower production and increasing expenditure.

Potential revenue from PRT is typically lost when the profits of many fields are entirely offset by expenditure and allowances. For example, for the half year chargeable period to 31 December 2013, 67 fields had gross profits exceeding GBP 1 million however 38 of these fields paid no PRT for the period. Of the 29 fields paying PRT, the 18 with the largest PRT liabilities over GBP 10 million, accounted for the vast majority of tax liabilities at GBP 566 million (around 95%) out of a total of GBP 592 million[132].

Historically, the number of fields with gross profits above GBP 1 million have declined, from 79 in 2007 to 67 in 2013, however, the number of fields actually paying PRT have been broadly consistent over this period[133]. PRT is forecasted to raise GBP 1.2 billion in the year 2014/15[134].

The abolition of PRT for fields developed on or after 16 March 1993 has meant that whilst recent high oil prices have kept up PRT revenues to substantial levels, the steady depletion of fields liable to PRT coupled with the increase in SC (see RFCT/SC response) has led to a fall in the contribution of PRT to the makeup of oil and gas revenues.

4.5.6.6 Criticized aspects

PRT is commonly criticised as being a complex tax due to the large number of reliefs and deductions available. However, as explained above, the current Government has concluded not to abolish the tax entirely; instead it will consider reducing the rate from 50% in the future.

4.5.6.7 Reasons for maintaining the PRT

PRT was abolished for fields given development consent on or after 15 March 1993, but continues to apply to older fields. The regime has not been abolished entirely for a number of reasons, including:

- Concern from industry about the impact of the resulting removal of unlimited carry back of losses arising during decommissioning[135].
- Concern from the Government over altering the availability of decommissioning tax relief and the possibility of triggering the Decommissioning Relief Deed – meaning PRT relief for decommissioning

[129] HMRC, (2014); Annex 4.
[130] HMRC, (2014), p. 7; Annex 4.
[131] Ibid, p. 3.
[132] Ibid, p. 3.
[133] Ibid, p. 14.
[134] Pope T. and Roantree B., (2014), p. 33.
[135] Ripley P., (2011), p. 117.

would be payable from the Government while no more PRT would be payable by Industry[136].

More recently, there have been discussions between the UK Government and industry on maintaining the current 50% rate of PRT. In July 2014 the UK Government published a Consultation on the future of the UK's oil and gas fiscal regime to enable the UKCS to compete in the global race for investment. On 4 December 2014 it published its conclusions in a document entitled "Driving Investment: A plan to reform the oil and gas fiscal regime". Within the findings it concluded:

"*The government has looked closely at the case for making changes to the rate of PRT, but does not believe this is the most cost effective way of getting the right investment into key assets. Instead, the government will keep the rate of PRT under review and consider reducing the rate when fiscal conditions allow"*[137].

According to the Budget 2015 the rate will drop from 50% to 35%.

4.5.7 United Kingdom (Ring fence corporation tax and Supplementary charge)

4.5.7.1 Synopsis

The Ring Fence Corporation Tax (RFCT) was introduced in 1975. The Supplementary Charge (SC) was introduced in 2002. Also, the RCFT regime was amended in 2002 to allow many expenditures a 100% deduction in the first year. This tax regime is a tax whose basic structure derives from CIT but is amended by CFT elements. The "Ring Fence" to corporation tax was introduced in order to prevent oil companies from using worldwide losses to eliminate UK oil & gas profits. This tax regime aims at maximising the economic recovery of oil and gas reserves while ensuring a fair return for the nation taking into account the competitiveness of the opportunities on the UK continental shelf. The current RFCT tax rate is 30%. The current SC rate is 30%. Thus, by applying a combined rate of 60% overall (RFCT and SC) tax revenue of 3,556 million GBP was raised in 2013/4. The starting point for the computation of RFCT and SC is the company's accounting profits relating to its UK oil and gas production business and certain connected activities. Adjustments are then applied to determine the taxable profits chargeable to RFCT and SC. These adjustments result from the application of normal CIT rules and the ring fence concept. The basic premise of the ring fence concept is that a company should pay corporation tax on UK oil and gas extraction profits in full, undiluted by losses arising from any other business activities in the UK or elsewhere. In respect of a deductibility of finance costs the calculation of the SC tax base deviates from the calculation of the RFCT tax base since with respect to SC theses costs are not deductible. Thus, following this approach – in connection with the CFT-like concept – many expenditures are deductible in the first year at 100% if they are connected to the ring fenced activity. This does not apply for acquisition costs of an oil and gas license. Dividends paid to shareholders and other distributions of capital are not deductible for RFCT and SC purposes. Economically, the application of these allowances to RFCT (and SC) renders RFCT similar to a CFT. In

[136] HM Treasury, (2014), p. 35.
[137] Ibid, p. 26.

case of a net-refund position the tax regime provides for a carry forward or a carry back. No specific transition scheme was in place. However, qualifying expenditure incurred after the effective date was eligible to be relieved in full in the year incurred against taxable profits when it became possible to claim a 100% first year deduction of expenditures. Historic expenditure remained deductible at the original tax depreciation rates. When rates of the SC were amended transitional provisions have been in effect. Both RFCT and SC are generally creditable under existing tax treaties. There is some uncertainty as to whether SC is creditable for US federal tax purposes. Although, politics adheres to this tax regime in general there is discussion about the amount of the tax rate.

4.5.7.2 ACE or CBIT as alternatives to the RFCT and the SC

No specific information could be obtained on whether ACE or CBIT were considered as alternatives.

4.5.7.3 Motivations for implementing the RFCT and the SC

In 2002, the UK Government introduced SC, at 10% on adjusted RFCT profits. In recognition of the higher tax rate on oil and gas companies, the Government also introduced 100% first year allowances for capital expenditure[138].

During the debate in the House of Commons (UK Government) on 3 July 2002 at the time the legislation to implement these changes was being enacted, Ruth Kelly, the then Financial Secretary to the Treasury, emphasised how the 100% FYAs measure was to been seen as a package of measures along with the new SC. In this regard, Ruth Kelly noted,

"The industry differs over specifics, but broadly accepts that if we have a 100 per cent. Capital allowance—which makes new investment in marginal fields more profitable—and combine that with a supplementary charge, there can be a positive impact on investment."[139]

"In net present value terms, the benefit of the 100% allowance outweighs the additional tax for marginal projects. It is the effect on marginal projects that determines the effect on investment. Marginal projects will be encouraged by this change; the increased tax reduced the net present value of more profitable fields, as it is designed to do. But these are likely to go ahead in any event, so the combined package increases the incentive for oil companies to invest in marginal fields."[140]

In the same debate in the House of Commons, the Chancellor of the Exchequer was quoted as having said that the 100% allowance would, "make it more profitable to develop new oil fields", and that the UK' s tax regime would be "more favourable than that of other countries"[141].

[138] Oil and Gas UK, (2011).
[139] UK Parliament, (2002).
[140] Ibid, column 292
[141] Ibid, column 264

4.5.7.4 Design of the RFCT and the SC

4.5.7.4.1 General

Prior to the Oil Taxation Act 1975, there was no specific regime for the taxation of UK oil and gas production activities. The Oil Taxation Act 1975 introduced PRT and also introduced the concept of the "Ring Fence" to corporation tax in order to prevent oil companies from using worldwide losses to eliminate UK oil & gas profits. However, although Ring Fence Corporation Tax ("RFCT") was introduced in 1975, it did not amount to a CFT until 100% first year capital allowances were introduced in 2002.

In 2002 three reforms to UK oil and gas taxation were introduced:

- Royalty (which was then only paid by 30 or so pre-1982 fields) was abolished with effect from 2003.
- Supplementary Charge ("SC") was introduced at a rate of 10% in 2002, effective from 17 April 2002.
- The Government introduced 100% first year capital allowances for RFCT and SC for almost all qualifying capital expenditure incurred within the ring fence on or after 17 April 2002.With effect from 12 March 2008, the 100% first year allowance was extended to expenditure on plant and machinery long-life assets.

RFCT and SC are source based corporate income taxes. They are company level taxes payable in respect of profits generated from 'ring-fenced' UK oil and gas production and connected activities.

4.5.7.4.2 Scope

Subject to taxation is the income derived from oil and gas production business and certain connected activities.

4.5.7.4.3 Tax calculation

The starting point for the computation of RFCT and SC is the company's accounting profits relating to its UK oil and gas production business and certain connected activities. Adjustments are then applied to determine the taxable profits chargeable to RFCT. These adjustments are based on the normal UK corporation tax rules with a few notable exceptions listed below:

A company's UK oil and gas exploration and production activities are deemed for the purposes of the entity's corporation tax computation to be a separate "ring fence" trade, and taxed distinctly from the other business activities of the company outside the ring fence. The trading losses of a company arising from activities outside the ring fence cannot be offset against ring fence profits; however ring fence losses can be offset against non-ring fence profits. The basic premise of the ring fence is that a company should pay corporation tax on UK oil and gas extraction profits in full, undiluted by losses arising from any other business activities in the UK or elsewhere.

Relief for interest payments is only allowed in respect of interest accrued on money borrowed to finance genuine development and production activities.

Any transactions which cross the 'ring-fence' within a single company are treated as if they were transactions between associates. Transfer pricing rules apply to ensure such transactions are carried out on arm's length terms, thereby avoiding the leakage of profits from the ring fence.

100% first year allowances are available for all capital expenditure related to oil and gas exploration, appraisal and development. Economically, the application of these allowances to RFCT (and SC) renders RFCT similar to a CFT.

A Ring Fence Expenditure Supplement ("RFES") is in place to assist companies that do not yet have sufficient taxable income against which to set their exploration, appraisal and development costs for ring fence corporation tax purposes. The RFES increases the value of losses carried forward from one accounting period to the next by a compound 10% a year. For all accounting periods since 5 December 2013, the RFES may be used for a maximum of 10 years (previously 6 years), not necessarily consecutively.

Taxable profits for SC purposes are calculated in the same manner as profits chargeable to RFCT, but with the following exceptions:

- No deduction is allowed for finance costs (e.g. interest).
- Under certain circumstances a 'field allowance' can apply to exempt a certain amount of production income from a qualifying field from SC.
- Tax relief for decommissioning costs is restricted (i.e., there is a partial disallowance) such that the effective rate of relief for decommissioning costs for SC purposes is capped to 20%, rather than allowing relief at the full SC rate (currently 30%).

As noted above, the profits chargeable to RFCT and SC are computed based on the normal UK corporation tax rules with a few notable exceptions. The starting point for the computation is the company's accounting profits relating to its UK oil and gas production business, which may include income arising from:

- Sale of goods (egg, oil and gas produced from the fields)
- Sale of services (egg certain tariff income from use of certain pipelines/offshore processing facilities)
- The treatment of the sale of capital goods (egg plant and machinery and licenses) is more complex –income and gains from certain disposals may be either excluded from the scope of RFCT and SC and subject to main rate CT, included within the scope of RFCT and SC but exempt or deferred under specific reliefs or included within the scope of RFCT and SC. Please note, further details can be provided if requested but it would probably be most efficient to understand the basis for the enquiry in order that a relevant and succinct response can be provided.

The following specified items are generally not connected to the activity of UK oil and gas production and are thus not subject to RFCT and SC (but may be subject to main rate CT):

- Interest received on bank surplus

- Income received from financial placements in shares and bonds and the like
- Income received from the sale of shares in subsidiaries

Deductibility of expenses

Wages are deductible on accruals basis for RFCT and SC purposes if paid within 9 months of the year end. Purchase of goods sold and other direct costs are deductible on accruals basis for RFCT and SC purposes if trading/revenue in nature.

- Almost all capital expenditure incurred in respect of oil and gas exploration, appraisal and development qualifies for 100% first year allowances through one of the following capital allowance categories:
- Research and Development Allowance (RDA) - Most expenditure on oil and gas exploration and appraisal activity is allowed as a full deduction through RDAs in the year the expenditure is incurred.
- Mineral Extraction Allowance (MEA) - Expenditure on mineral exploration and access including costs of drilling appraisal and production wells etc. qualifies for 100% first year allowances as MEAs (note, there is some element of cross-over between MEAs and RDA, though expenditure can only be claimed under one heading).
- Plant and Machinery Allowance (PMA). – qualifying plant and machinery, including platforms, pipelines processing and other plant, machinery and equipment which is used for the ring fence activity of the company.
- It should also be noted that expenditure on decommissioning plant and machinery and plugging and abandoning wells, etc., is generally eligible for 100% capital allowances though PMAs or MEAs respectively. Companies only receive tax relief when decommissioning expenditure is incurred and decommissioning is actually carried out. For expenditure incurred on or after 22 April 2009 the conditions for relief were amended to ensure that companies cannot obtain relief for decommissioning costs for an accounting period earlier than that in which the work is actually carried out.

The acquisition costs of an oil and gas license are not immediately deductible for RFCT and SC purposes. The costs are treated as capital expenditure and attract MEA's at a rate of 10% per year (they are excluded from receiving 100% first year allowances).

For RFCT purposes, interest may generally be taxable/deductible on an accounting accruals basis (rather than cash basis) provided it meets certain conditions (including conditions around the purpose of the loan, the expenditure which the funds are used to meet and the arm's length nature of the debt and interest amount). For SC, no deduction is allowed for finance costs.

Dividends paid to shareholders and other distributions of capital are not deductible for RFCT and SC purposes.

4.5.7.4.4 Rate

The main RFCT rate is 30%. The RFCT rate was previously the same as the main rate of corporation tax ("CT") applicable to all other activities. The RFCT and main rate CT were "decoupled" in 2008, when the RFCT rate was not reduced to 28% along with the

main rate CT. Following successive reductions, the main rate of corporation tax was 21% and was further reduced to 20% from 1 April 2015.

SC is an additional tax on profits from UK oil and gas production and connected activities. The rate is 30% in 2013/14. The SC rate has been subject to some significant changes since the tax was first introduced in 2002. As noted above, supplementary charge was introduced at a rate of 10%. In response to high oil prices, the rate was raised to 20% in 2006 and again to 32% in 2011 before reducing to 20% from 1 January 2015.

4.5.7.4.5 Exemptions

Under certain circumstances a 'field allowance' can apply to exempt a certain amount of production income from a qualifying field from SC, please see section 4.5.7.4.3.

4.5.7.4.6 Treatment of financial expenditure in R-based

No specific information could be obtained in the treatment of financial expenditure. In general, for the treatment of expenditures please see sections 4.5.7.4.3 and 4.5.7.4.5.

4.5.7.4.7 Net-refund position

Tax losses arising in an accounting period may be carried back and offset against taxable profits from the previous accounting period. Where a tax loss is carried back in this manner, HMRC will credit the tax liability from the previous period which has been offset.

This loss carry back is extended to 3 years in the case of 'terminal losses' incurred in the company's final period of trading.

Perhaps more importantly for businesses, since 2008, losses arising in connection with decommissioning expenditure may be carried back and set against ring-fence profits dating back to 2002, on a 'last in, first out' basis.

As noted above, companies only receive tax relief when decommissioning expenditure is incurred and decommissioning is actually carried out. The relaxation of the carry back rules for decommissioning losses aimed to ensure that tax is not a contributing factor in bringing forward the decommissioning of mature fields during the final years of production.

Excess tax losses in a period which cannot be utilised by loss carry back can be carried forward indefinitely (subject to anti-loss buying rules which are relevant where there is a direct or indirect change in ownership of the company).

4.5.7.4.8 Carry forward of losses

If tax losses are created as a result of the 100% first year allowances, then these can be used as group relief to offset taxable profits in other ring-fenced companies, or the can be carried forward to use against future taxable profits.

4.5.7.4.9 Administrative provisions

No specific information could be obtained on administrative provisions.

4.5.7.4.10 Qualitative and Quantitative benefits or problems

Immediate relief for expenditure, whether capital or operating in nature, means neutrality with respect to the choice between present and future consumption. In this regard the taxes are also immune to inflation. They promote investment; this was cited by the Government as a key reason behind the introduction of 100% FYAs for capital expenditure.

4.5.7.4.11 Transitional rules

Qualifying expenditure incurred after the effective date was eligible to be relieved in full in the year incurred against taxable profits through the claiming of 100% FYAs. Historic expenditure remained deductible at the original tax depreciation rates.

There was no transition period as such for the introduction of 100% FYAs for qualifying capital expenditure, except it is worth noting that the introduction occurred at the same time as the royalty was abolished for royalty paying fields and the supplementary charge (SC) was introduced as a package of measures.

There was a transitional provision introduced in 2005 when the supplementary charge rate increased from 10% to 20%, with effect for accounting periods beginning on or after 1 January 2006. The transitional provision allowed companies to elect to defer 100% FYAs on expenditure incurred during 2005 into the following year to be claimed in 2006. The effect of this provision was to increase current tax in 2005 by GBP 40 if say capital expenditure was GBP 100 (30% RFCT & 10% SC), but then create a tax saving of GBP 50 in 2006 (30% RFCT & 20% SC) once the deferred tax relief was claimed.

4.5.7.4.12 International recognition

Both RFCT and SC are generally creditable under existing tax treaties. There is some uncertainty as to whether SC is creditable for US federal tax purposes. In particular the IRS may challenge creditability due to the lack of deduction for finance costs. Notwithstanding, this we do have experience of the IRS accepting credit relief for SC.

4.5.7.4.13 Avoidance schemes

The arm's length principle applies in order to avoid a ring fence leakage, please see section 4.5.7.4.3.

4.5.7.5 Effects

4.5.7.5.1 Economic effects

A record GBP 14.4 billion was invested in the UKCS in 2013, although how much of this is a direct result of obtaining 100% first year allowances on capital expenditure is unclear. There is still significant investment required existing infrastructure to extend their lives to extend the production of oil fields.

The UK Continental Shelf continues to have to compete for global investment capital. Numerous less mature basins overseas offer commercial opportunities, such as Norway, West Africa and North America.

4.5.7.5.2 Revenue implications

The revenue raised from RFCT and SC since 2002-2003 is as follows:

Table 10: RFCT and SC tax revenues

Year	RFCT	SC	Total
2002-2003	3369	293	3662
2003-2004	2291	766	3057
2004-2005	2790	1041	3831
2005-2006	5210	2097	7307
2006-2007	4919	1790	6709
2007-2008	3402	2326	5728
2008-2009	5716	4110	9826
2009-2010	2839	2159	4998
2010-2011	3810	3054	6864
2011-2012	4714	4126	8840
2012-2013	1908	2485	4393
2013-2014	1665	1891	3556

Source: HMRC (2014).

"The figures for 2012-2013 and 2013-2014 are provisional and subject to change in the future when payments originally made in respect of groups of companies for which some companies are within the ring fence oil and gas tax regime and some are not are subsequently re-allocated to individual companies within the groups."[142]

4.5.7.6 Criticized aspects

The main criticism of the current regime is around the combined effect of the fiscal regime which gives a marginal tax rate of 80% on income from PRT-paying fields and

[142] HMRC, (2014); Annex 4.

60% for non PRT-paying fields. Following the UK Government's review of the UK's fiscal regime in 2014 (as mentioned above), it was concluded that *"to maximise investment we need to reduce the overall tax burden facing the industry…The government is announcing an immediate cut in the rate of the Supplementary Charge from 32% to 30%, effective from 1 January 2015, and will aim to continue to reduce the rate further in an affordable way"*[143].

4.5.7.7 Reasons for maintaining the RFCT and the SC

The aim of the oil and gas fiscal regime is to maximise the economic recovery of the UK's oil and gas reserves while ensuring a fair return for the nation taking into account the competitiveness of the opportunities on the UKCS.

In July 2014 the UK Government published a Consultation on the future of the UK's oil and gas fiscal regime to enable the UKCS to compete in the global race for investment. On 4 December 2014 it published its conclusions in a document entitled *"Driving Investment: A plan to reform the oil and gas fiscal regime"*. Within the findings it concluded:

"The government's view when establishing this review was that the UK' approach, based on taxation of ring fenced profits, remained sound….The government has not received evidence that would suggest the UK should radically change its approach……Oil and gas production is highly capital intensive and so the tax treatment of capital expenditure is a key element of the regime. 100% first year capital allowances are available for virtually all capital expenditure, and it is clear that this remains a vital element of the regime."[144]

Based on the above, there is no indication that the Government is looking at abandoning the UK's current system. The Government further considers that to implement any radical changes would entail excessive disruption for taxpayers and create uncertainty at a time when supporting investment is paramount.

[143] Ibid, p. 24.
[144] HM Treasury, (2014), p. 16.

4.6 Countries having in-depth discussions on implementing a CFT systems or elements therefrom

4.6.1 Australia

4.6.1.1 ACE or CBIT considered as alternatives

ACE was considered as part of a separate tax review by a Business Tax Working Group announced following a tax forum in October 2011. However, this transitory provision was not implemented for reasons including the following:

- Business thought it was unlikely that the government would honour the framework of providing continuing deductions for equity where profits are consistently low;
- On the flip side, as ACE was to shelter "normal profits" there were concerns that the rate on super profits would be set too high; and
- Business was not ready to enter a complex transition into a new regime tested only in very few jurisdictions including Belgium and Italy.

4.6.1.2 Design of the specific CFT discussed

4.6.1.2.1 General

In 2009, the Henry report[145], a report compiled on behalf of the legislator, discussed CFT as an option for a broad based indirect tax, side stepping the need to recommend changes to the Goods and Services Tax (GST) base or rate. Henry Report's recommendation fifty-five stated that "*over time, a broad-based CFT — applied on a destination basis — could be used to finance the abolition of other taxes, including payroll tax and inefficient State consumption taxes, such as insurance taxes. Such a tax would also provide a sustainable revenue base to finance future spending needs.*"

An R+F-base tax was initially considered as it would effectively tax the value generated in all sectors of the economy, including businesses generating most of their revenue by charging interest rather than selling tangible goods or services. An R+F-base tax was considered to provide a more neutral form of consumption taxation whereby products that rely more on the value add from financial services would not enjoy a relative price advantage to other products. Although theoretically attractive, an R+F-base tax would affect assets that have already been financed by debt. From the perspective of a lender, interest payments and repayment of principal would become taxable in the hands of the lender after the introduction of the tax but no deduction would have been provided for the original loan.

The report recognised that complex transitional arrangements would be necessary and these would severely undermine the simplicity of a CFT. This problem would be widespread as nearly all entities engage in at least some purely financial transactions during their business lifecycle. However, as most value in the economy is generated

[145] The Australia's Future Tax System Review, informally known as the Henry Tax Review was commissioned by the Rudd Government in 2008 and published in 2010. The review was intended to guide tax system reforms over the following 10 to 20 years.

from the production of non-financial goods and services, this problem can be avoided without significantly undermining the tax base.

The solution suggested by the report is an R-base CFT. While an R-base would not considered to be as comprehensive as an R+F-base, and required a distinction to be drawn between (untaxed) financial and (taxed) non-financial cash-flows, it was nevertheless considered as an appropriate base with which to tax the non-financial sector, particularly as most of the value add in an economy could be effectively taxed by restricting the CFT to non-financial cash-flows. To ensure a broad and neutral consumption tax base, the report suggests that the value add of those sectors of the economy that could not be captured using an R-base CFT should instead be taxed using an equivalent tax specific to financial services. The equivalent tax specific methods suggested were the addition method, the tax calculation account method and the reverse charging method. However, taxing financial transactions using a specific tax was seen as politically difficult.

4.6.1.2.2 Tax Calculation

The method of calculation discussed by the report was direct subtraction. This was considered the simplest and likely to be the most consistent with the needs of a modern economy, as it can run off standard business cash-flow management practices.

Under this method taxable cash inflows would include inflows such as sales but not revenue from exports, as goods and services consumed outside Australia should not be taxed under an Australian consumption tax. Likewise, imports of goods would be taxed at the border. Deductible cash outflows would make no distinction between capital and non-capital expenses, but would exclude cash payments related to labour remuneration (as the value of labour, unlike the value of most other inputs, would not have been subject to the tax, ensuring that there would be no bias between in-sourcing and out-sourcing labour)."

4.6.1.2.3 Rate

The Henry report uses a rate of 10% for illustration purposes but does not specify which rate should be applied if this system would have been implemented.

4.6.1.2.4 Net-refund position

The report suggests that if an entity's cash outlays exceeded its cash receipts, it would be in a negative net cash-flow position, a cash refund should be provided. The effect of providing this immediate refund would be to exempt the normal return to capital from tax, thereby ensuring that the tax only falls on consumption.

4.6.1.2.5 Administrative provisions

Administrative provisions were not considered in much detail in the report, however with respect to small businesses it was suggested that there can be reliance on the natural systems of businesses, such as financial or payroll systems, which can reduce compliance costs. Companies or sole traders with very simple tax affairs might use a bank account to have their CFT liability calculated automatically.

4.6.1.2.6 Discussed motivations for implementing the CFT

The reasons for considering implementation of a CFT include: lower compliance and administrative costs, the system treats debt and equity-financing in a similar way, neutrality with respect to the choice between present and future consumption, does not affect choice of organisational form, promotes investment and it is considered as a sustainable source of tax revenues.

With respect to the ease of administration the Henry report explains that large companies already prepare statement of cash-flows as part of statutory financial reporting. While, smaller companies capture transactions to prepare the "business activity statement" for GST reporting. Meaning that no extra administrative burdens would be faced by the CFT.

4.6.1.3 Reasons for not implementing the CFT discussed

International compatibility was one of the major concerns. If no other country adopted the CFT, Australia would have ended up a "loner" making it tough to update the existing treaty network. In addition, broadening of the indirect tax base was seen as political hard to sell generally and the broadening of GST specifically was not politically supported.

Feasibility of the tax was questioned. If carried forward losses lost value they would need to be compensated for and considering the amount of losses in the system this may have not been feasible. Moreover, a refund mechanism for companies having negative cash-flows was not seen as viable.

The Henry Review was commissioned in March 2008 and the terms of reference declared any changes to the base or rate of the Good and Services Tax (GST) off limits. The Henry Review did not, however, fail to mention Australia's major structural issue around a weak indirect tax base and disproportionate reliance on taxing corporate profits. The CFT was discussed in the final report delivered in December 2009 as an option for a broad based indirect tax, side stepping the need to recommend changes to the GST base or rate. The government decision not to respond to Henry's recommendation on CFT was political relating to the terms of reference and not based on technical arguments.

Neither in the 2012 Final Report of the Business Tax Working Group nor in the "2015 RE: think tax discussion paper" a reference was made to a cash-flow type system as an alternative to the classical corporate tax system.

4.6.2 New Zealand (Tax Review 2001)

4.6.2.1 Design of the specific CFT discussed

4.6.2.1.1 General

A CFT was considered by Tax Review 2001, an independent review of New Zealand's tax system set up by the Government. However, this tax was never implemented.

4.6.2.1.2 Design of the CFT discussed

Tax Review 2001 primarily considered an R-base CFT, but not in detail. Main characteristics included:

- depreciation and other capital allowances being replaced by expensing,
- trading stock rules being replaced by deductibility for acquisitions,
- revenue from all sales, including those from sales of capital assets being included in the tax base,
- deductions for interest and similar financing costs being abolished and interest receipts not being taxed in the hand of the lenders.

At the level of the firm, an R-base CFT would therefore look rather like the GST but with a deduction for wages paid.

4.6.2.1.3 Qualitative and Quantitative benefits and problems

The Tax Review 2001 states arguments in favour and against the introduction of a CFT system. Arguments in favour include a possibility to offer simplification opportunities, tax neutrality, the fostering of investment, the ability to tax income attributable to the existing capital stock while exempting that arising from net additions to the capital stock and strengthening the taxation of labour income by preventing its re-characterisation as (untaxed) income from capital. Arguments against included transitional problems regarding debt-financed investments, impact on asset valuations and ongoing revenue risks as well as the absence of CFTs in practice.

4.6.2.2 Reasons for not implementing the CFT discussed

4.6.2.2.1 General

The CFT was rejected due to transition problems regarding debt-financed investments, impact on asset valuations and ongoing revenue risks. Tax Review 2001 argued that severe transitional problems arise from the large part of the capital stock that is debt-financed. After the introduction of a CFT, holders of debt would be able to avoid paying net CFT when liquidating their assets to finance consumption, while those holding real assets or equity positions in those assets at the time of the transition would not.

In addition, a CFT would create ongoing revenue risks. For example, since the rules would allow full deduction of capital outlays as they occur, the government would, in a practical sense, be providing one-third or more of the equity in ventures with uncertainty over whether taxable cash inflows would materialise in future years. Foreign firms could engage in investments in New Zealand, creating losses through

their initial capital outlays, and structuring their affairs so that future cash inflows were received in another jurisdiction.

4.6.2.2.2 ACE or CBIT considered as alternatives

In 2009 The Victoria University Tax Working Group (chaired by Victoria University but with support from the New Zealand government), considered a combination of a dual income tax applying domestically, with an ACE applying to investments from non-residents. This was based on a proposal from Sorenson/Johnson discussed in Australia's Future Tax Review.

While the TWG thought this approach was innovative and worth considering at some time in the future, it was untested and raised significant transitional and implementation issues.

CBIT was not examined.

4.6.3 New Zealand (Treasury 2002)

4.6.3.1 Design of the specific CFT discussed

4.6.3.1.1 General

The Treasury released a subsequent study of CFT for small businesses in December 2002. However, this tax was never implemented.

4.6.3.1.2 Transition

The Treasury argued that transition with regards to existing assets appears insoluble. Under an income tax, income-earning assets are deductible over their economic life, while under a CFT a firm receives an immediate deduction. On disposal, proceeds from the sale of assets held on capital account are exempt from income tax, while under a CFT all proceeds are taxable.

It considered three options for dealing with existing assets.

- "Free entry", which would allow an immediate deduction for the value of undepreciated assets. In this approach, on the implementation date, all taxpayers get an immediate tax deduction equal to the undepreciated value of their existing capital. This approach will not bankrupt any firms, but it might get close to bankrupting the government, as the fiscal cost would be huge (with an earlier estimate amounting to over half of annual tax revenues). It would incur large deadweight cost wealth transfers, from higher taxes on labour income to plug the fiscal deficit to those with savings who get an unanticipated increase in the after-tax rate of return on their investments.
- "Cold turkey", which would deny any further deductibility for existing assets. This would hit existing firms, especially those that have borrowed to finance the purchase of assets. They would continue to have a commercial liability for the gross amount of any interest payments, but would receive no offsetting tax deductions.
- Continuing to operate an income tax for existing assets, including assets sold to other taxpayers – which would significantly, if not totally, reduce the

administrative and compliance cost savings of transiting to a CFT. Three options discussed with respect to the transition of depreciation allowances:

1. 'Free entry', allowing firms an immediate deduction for the value of undepreciated assets, with huge fiscal cost to government.
2. 'Cold turkey', with no further deductions for existing assets, with risk that existing firms will become insolvent.
3. Continuing to operate an income tax system for existing assets, reducing administrative and compliance savings of CFT.

Transition was also seen as a problem for ongoing treatment of assets with an enduring nature.

4.6.3.1.3 Qualitative and Quantitative benefits and problems

This report mentioned both arguments in favour and against the introduction of a CFT system. Arguments in favour include a possibility to offer simplification opportunities, tax neutrality and the fostering of investment. Arguments against included transitional problems regarding debt-financed investments and the absence of CFTs in practice.

4.6.3.2 Reasons for not implementing the CFT discussed

The CFT was rejected as transition was considered to be insurmountable, including the difficulty of moving from a CFT to an income tax once a business was no longer small.

If small businesses are taxed under a CFT, while large businesses are taxed under an income tax, then there needs to be a set of rules to allow firms to transfer from CFT treatment to income tax treatment.

Complexity surrounds the ongoing treatment of assets of an enduring nature. Treasury explained the position as follows:

Consider a firm that is taxed under a CFT and has an asset that is still economically valuable. The firm ceases to be small and becomes subject to the income tax. A rule would be needed to deem the asset to be fully depreciated. Conceptually, this is not difficult for assets that are simply used in the business and then disposed of when they have zero economic value. Difficulties could arise if an existing asset was improved, since depreciation would, under an income tax, be allowed on the improvements over the remaining life of the asset.

A particularly difficult issue would arise when the asset is sold, since the income tax includes the revenue/capital distinction. Thus, under an income tax, the proceeds from selling an asset that is held on capital account are not assessable, while under a CFT they are. Allowing firms to have cash-flow treatment on acquisition (immediate deductibility) and income tax treatment on disposal (exemption of proceeds for assets on capital account) would leave the government with a potentially large fiscal cost. It would also be inappropriate to allow the purchasing firm (if it were subject to income tax treatment) to depreciate an asset for which deductions had already been taken under the CFT.

As mentioned in Section 5.6.2.2, ACE was considered in 2009 by The Victoria University Tax Working Group.

4.6.4 United States

4.6.4.1 ACE and CBIT considered as alternatives

The 2005 Tax Panel and 2007 Treasury Study were focused on broad reforms of the US federal income tax. The ACE and CBIT approaches were not considered as part of these efforts. In addition to recommending the GIT and analysing the PCC, the 2005 Tax Panel also recommended a Simplified Income Tax, which included a partial shareholder exclusion to address the double tax on corporate profits and its impact on the tax treatment of debt versus equity financing.

4.6.4.2 Discussed motivations for implementing the CFT

4.6.4.2.1 General

The US Department of the Treasury considered the possibility of enactment of a CFT in the United States several times during the past decade. A CFT was analysed by the US Department of the Treasury on behalf of the President's Advisory Panel on Federal Tax Reform in 2005 (the "2005 Tax Panel") and considered as part of the 2007 Treasury Report, Approaches to Improve the Competitiveness of the US Business Tax System for the 21st Century, (the "2007 Treasury Study"). While considered, neither the 2005 Tax Panel nor the 2007 Treasury Study recommended these approaches by themselves. The analyses of these approaches were generally included in the respective reports to facilitate and help generate additional consideration and discussion of design issues and potential impacts.

The 2005 Tax Panel considered several reforms of the US federal income tax. One recommended reform was to replace the current income tax with a Growth and Investment Tax (GIT) that combined a progressive consumption tax (PCC) with a flat rate tax (at 15%) on financial income (i.e., interest, dividends and capital gains). The PCC component of the GIT proposal included a household level tax on compensation plus a CFT on businesses. The business CFT included in the GIT would have been similar to the current US corporate income tax but with an immediate write-off for all investment purchases (equipment, structures, inventories, land) and the general exclusion of interest income/expenses from the tax base (with special treatment of interest received/paid by financial institutions). The 2005 Tax Panel also recommended a Simplified Income Tax (SIT) that focused on making a broad range of simplifying changes to the current income tax, but this plan did not include a CFT.

The 2005 Tax Panel also considered, but did not recommend, several other reforms plans including: 1) a national retail sales tax to replace the current US federal income tax, 2) a partial credit-invoice method VAT to replace a portion of the current US federal income tax, and 3) a progressive consumption tax (an "X-tax"), composed of a household level tax on compensation plus a CFT on businesses, but without the flat rate tax on investment income included in the GIT plan.

It is important to emphasize that the CFTs considered by the 2005 Tax Panel were all part of broader reforms that made fundamental changes to other elements of the US federal income tax to achieve various simplification, distributional and economic efficiency objectives. The GIT, for example, combined a PPC with a flat rate tax on financial income to address concerns over the progressivity of the PCC. The

standalone PPC (i.e., without the flat rate tax on financial income) considered by the 2005 Tax Panel was not recommended because of concerns over its progressivity. The household level component of the PCC was an important design element because it allowed progressivity to be introduced through graduated tax rates and the inclusion of various exclusions, deductions and credits.

It is also important to recognize that the CFTs were included as part of reform plans that had at least some element of shifting the US income tax base towards a tax base more focused on taxing consumption. In the case of the GIT, some income tax features were retained through the flat rate tax on financial income, while the PCC would have involved a total shift to a consumption tax base.

The 2007 Treasury Study, which was part of a nearly one year effort by the Treasury Department to consider approaches to reform the US business tax system with the objective of improving its competitiveness, considered several approaches to reform the US business tax system, one of which included replacing the US federal corporate income tax with a subtraction method VAT, which would operate in a fashion similar to a CFT. In contrast to a CFT, however, the VAT would not have allowed a deduction for employee compensation, and thus, include employee compensation in its tax base.

These approaches were considered because of their potential economic impacts and potential to simplify elements of the tax system (e.g., treatment of financial income), while maintaining the progressivity of the tax system. The CFT element of these plans was important because it was a significant contributor to the impact of the plans on economic growth. The GIT and PCC were estimated by the US Department of the Treasury to increase the level of US national output by as much as 4.8% and 6.0%, in the long-run. The VAT considered in the 2007 Treasury Study was estimated by the US Department of the Treasury to increase the level of US national output by between 2.0 percent and 2.5 percent in the long-run. The potential impact of consumption taxes on the progressivity of the tax system and/or the enactment of a new revenue source (in the case of partial replacement of the income tax) were prominent concerns regarding these approaches.

In January 1992, the US Department of the Treasury issued a report, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once, which described in detail prototypes to integrate the individual and corporate income taxes. The CBIT was included as one of the prototypes. The US Department of the Treasury put forward a specific proposal for a dividend exclusion in December 1992, which became the foundation for the dividend exclusion proposed by the Bush Administration in January 2003. The dividend exclusion proposal then became the basis for the lower dividends and capital gains tax rates enacted in the United States in May 2003.

The CFTs/VATs contemplated and described above would have been applied on a destination basis with border tax adjustments. The expectation was that border adjustments would help ensure that businesses claim deductions that are offset by corresponding inclusions and that this would help prevent tax evasion through cross-border transactions structured to generate tax deductions for payments to foreign parties.

4.6.4.2.2 Tax calculation

The CFTs considered in 2005 and 2007 were R-based with a special regime for financial transactions. Under the GIT and PCC plans considered by the 2005 Tax Panel, the CFT rate was set at the top household tax rate (30% under the GIT, 35% under the PCC). The tax rate was chosen to be revenue neutral relative to the Bush Administration's policy baseline over the 10-year budget period (and assuming repeal of the alternative minimum tax). The US Department of the Treasury estimates that the VAT considered by the 2007 Treasury Study would need to be imposed at a rate of 5 percent to 6 percent to replace corporate income tax revenues over the 10-year budget period relative to the current law baseline.

The tax base under the CFT plans would generally not include financial transactions, such as interest paid and interest received in the tax base. It was acknowledged that excluding financial transactions from the business tax base would create special difficulties for businesses that provide financial services and special rules would be needed.

4.6.4.2.3 Transition

It was recognized that transition from the current to the new tax system could pose significant difficulties for many taxpayers. Various types of transition relief were contemplated. For example, depreciation allowances for assets put in place before the effective date of the new plan would be phased-out over five years with the percentage of allowances falling by 20% per year. The same type of five year phase-out would be applied to business with outstanding debt and their interest deductions. The same phase-out would also apply to interest income. Modifications to existing contracts would be treated as new contracts and terminate transition relief. Sale of tangible property would similar terminate transition of depreciation allowances. Special transition relief would also need to be designed for financial institutions/transactions.

Transition issues arose for other elements of the tax plans outside of the CFT. For example, changes in the home mortgage deduction were accompanied by transition relief for existing mortgages due to concerns that the proposed changes might cause substantial devaluations in home prices.

4.6.4.3 Reasons for not implementing the CFT discussed

The CFT systems, that were proposed in the 2005 and 2007 discussions, were not implemented due to the political situation in the US at the time. All kinds of proposals for fundamental reforms of the tax system have consistently been rejected prior to the formalization into legislative proposals. From our research we could not identify any other specific reasons for not implementing these tax systems.

4.7 Countries having considered but not implemented a CFT

4.7.1 General

This report considered the following countries to be outside the scope of this study. The three main reasons for excluding these countries from further analysis were as follows:

1. the tax considered or implemented had only non-essential elements of CFT,
2. the tax was considered before the year 2000, or

3. the discussion around CFT was not in enough depth for it to be beneficial for the purposes of this study.

In the following subsections a brief description of the findings gathered on these countries is presented.

4.7.2 Denmark

In the committee[146] discussions in the early 2000's for a proposed reform of taxation in the petroleum sectors in both Norway and Denmark, we established that the elements of the proposed reforms have non-essential elements of a CFT for Denmark. Therefore, the tax is not a CFT in nature and falls outside the scope of this report. FAT on wages in Denmark does not fall within the scope of this study on CFTs.

4.7.3 Bolivia

Bolivia attempted to implement a CFT in 1994, in order to establish an income tax system, which was inexistent at this time. This attempt was also motivated by the need for taxing its mining sector. However, the United States Internal Revenue Service (IRS) was not confident that a Bolivian CFT was eligible for foreign tax credits. This threatened United States investments in Bolivia and resulted in the rejection of the CFT system altogether.

In Bolivia, a hybrid CFT system was envisaged. It was supposed to be R-based for individual companies, and R+F-based for other companies or individual companies with significant financial transactions.

Notwithstanding, since the system was considered more than 20 years ago, the reasons supporting consideration at the time may not be relevant anymore to the current market circumstances.

4.7.4 Colombia

Colombia envisaged a CFT system implementation in 1986, mostly motivated by inflation adjustment issues. However for several reasons, the implementation did not take place. The CFT system considered was supposed to be R-based for individual companies, and R+F-based for other companies or individual companies with significant financial transactions. Considering that the system was not implemented, an indexing system to adjust for inflation, similar to that applies in Chile, was preferred at the time.

Creditability of the tax in the US was a major issues encountered when considering the implementation. In addition the following issues were considered as problematic: R-base CFT exempts capital income from tax, expensing of capital may lead to negative cash-flow positions and companies may use avoidance schemes (buying more expensive asset) to benefit from direct expensing.

[146] Danish government tax reform committee for 2000.

Notwithstanding, since this system was considered 30 years ago, the motivation and context for consideration will not be of much relevance nowadays. In addition, currently Colombia has no CFT in place and it is not considering imposition in the near future.

Financial transaction tax/debit tax is applied and could have certain characteristics of a CFT system, however these do not show enough elements of a cash-flow system to fall within the scope of the report.

4.7.5 France

The auto-entrepreneurs regime in France concerns self-employed people with limited turnovers. Therefore, we consider this system as a personal income tax scheme, and hence not relevant for the scope of this report.

4.7.6 Ireland

The Department of Finance issued a consultation paper in December 2012 entitled 'Taxation of Micro Enterprises: Reduction in Compliance Costs' on the basis of which submissions have been received. The consultation paper sought submissions on a move away from an 'earnings' basis to a simplified cash accounting and receipts basis. However, on the basis of the views contained in the (7) responses received, it was decided not to proceed with the proposed simplified accounting and expense deduction regime for micro-enterprises.

The consultation paper did not result in any legislative proposal. In addition, simplified cash accounting systems are outside scope of the report.

4.7.7 Italy

The Italian tax system for small businesses, called "Regime dei minimi" has been indicated as being a CFT. The regime dei minimi, concerns self-employed people with limited turnovers. Therefore we consider these systems as a personal income tax scheme, and hence out of scope.

In addition, Regional tax on productive activities (IRAP) cannot be qualified as a CFT as the taxable basis is equal to the so called "net value of production", which is calculated by subtracting the cost of production from the value of production as resulting from the Profit and Loss of the Italian Financial Statements. As a consequence, it can be stated that IRAP does not depend on the cash-flows of the company but rather on costs and revenues accounted in the Financial Statements according to the "accrual basis" accounting principle (as provided by the Italian Civil Code) regardless of when the payment of such costs and revenues has been, respectively, received or performed.

IRAP Taxable basis

The main accounting lines (revenues and costs) relevant for IRAP purposes are the following.

Revenues

1) Revenues strictly connected to the main business activities of the company, including but not limited to:
   - sales of products produced by the enterprise
   - sales of products not produced by the company and resold without transformation that is manufacturing activities on behalf of and concerning raw materials/semi-finished products owned by third parties
   - manufacturing and industrial services upon third parties request
   - Other services
2) Positive changes in stocks:
   - of finished products
   - of work in progress and semi-finished products
3) Revenues arising from works in progress on long-term contracts
4) Internally generated fixed assets
5) Other revenues and income (e.g. income statement contributions supplied by the State and other public entities, earnings from royalties, capital gains and prior year income accounted in the present year, capital contribution (and other interest) rendered by the State and other public entities, other not financial revenues)

Costs

1) Purchases of:
   - raw materials
   - products not produced by the enterprise and resold without transformation
2) Services:
   - manufacturing activities carried out by third parties
   - transportation expenses
   - commissions and expenses reimbursements for agents and sales representatives
   - advertising and promotion
   - studies and researches
   - technical, legal, fiscal, administrative and commercial assistance services and expenses for auditors
   - reimbursements for administrators, mayors and external editors
   - services concerning information technology
   - damages insurance premium
   - royalties (e.g. for know-how)
   - other services

3) Rental and leasing costs (operative and financial, without considering the included interests if any)
4) Labour cost for permanent employees (for temporary employees is allowed only the social contribution deduction in application of the so called Cuneo Fiscale
5) Amortization, depreciation and write-downs
6) Negative changes in stocks:
   - of raw materials
   - of goods not produced by the company and resold without transformation
7) Different operating expenses (including capital losses and prior year income accounted in present year).

As results from the above, certain costs deductions are not allowed for IRAP purposes, such as the following:

- Certain extraordinary costs (conversely, extraordinary income is not taxable)
- Bad debt losses
- Labour costs for temporary employees (excluding certain social contributions in application of the so-called Cuneo Fiscale)
- Interest expenses (conversely interest income is not taxable).

IRAP tax rate

IRAP is levied at a "basic" rate of 3.9% on the "net value of production" computed as above explained. Each Italian region may increase or decrease the rate of IRAP by a maximum of 0.92%, and companies generating income in more than one region are required to allocate their tax base for IRAP purposes among the various regions in the IRAP tax return. Different rates apply to the following:

- Corporations and entities granting concession rights other than those running highways and tunnels: 4.2%
- Banks and other financial entities: 4.65%
- Insurance companies: 5.9%
- Public entities performing commercial activities: 8.5%.

Special rules

Special rules for the calculation of the IRAP taxable basis apply to banking institutions, insurance companies, public entities and non-commercial entities. For example, with reference to the taxable basis for banks, insurance companies and financial holding companies, Italian tax laws provide for a deduction of the 96% of interest expenses and, conversely, the 100% of interest income is taxed.

4.7.8 Netherlands

Dutch CIT is accrual based. Only as an exception to this rule, some small enterprises may, for the sake of simplicity, calculate their profits on a cash-flow basis (Dutch Supreme Court 20 April 1955, No. 12 251, BNB 1955/204).

Furthermore, under limited circumstances, Dutch investment funds are allowed to report investment income on a cash-flow basis (Dutch Supreme Court 3 November 1971, No. 16 605, BNB 1972/24). In all cases, the calculation on a cash-flow basis is based on Dutch tax accounting principles (i.e. simplicity and reality principle).The rationale is therefore different compared to more genuine CFT systems. In addition, CFT is based on case law of the Dutch Court and therefore there are no clear policy considerations behind the system, other than those just mentioned.

As most close to a CFT system, the introduction of an ACE system had been briefly considered by the Dutch government in 2013. It was decided, however, not to explore the possibility of the introduction of an ACE system in more detail, because of the adverse budgetary consequences such a system would have. On top of this, the Netherlands had considered to introduce an optional CBIT system for interest payments made within a group of companies as per 2007 (“group interest box regime”). However, the European Commission subsequently decided that the system had to mandatory in order to be compatible with the EU state aid rules. Eventually, the Netherlands refrained from introducing the group interest box regime.

Finally, a special tax regime for mining activities applies in the Netherlands. The profit calculation under this regime, however, is still CIT-based instead of CFT-based.

Despite the above, taxation on accrual basis is the main rule under the Dutch CIT system and taxation on cash-flow basis is the exception. No fundamental change of the current CIT system in this regard is currently being considered in the Netherlands. Neither has Cash-flow taxation considered in the past as a possible alternative for the current system in the past.

Hence, the Netherlands did not consider or implement a CFT system within the scope of this report.

4.7.9 Sweden

In an official Commission’s report for 2002 (SOU 2002:47) there is a section about alternative taxation measures which discusses a CFT system. Immediate deductions are referred to as a particularly desirable aspect. Even though a CFT is theoretically ‘interesting and educative’, the CFT is eventually discarded in the report on the basis that it was not viewed as practically possible to implement at the time, particularly as it was unclear how a CFT would work in relation to double tax treaties.

4.7.10 Switzerland

CFTs have been considered in a green paper ("Moderne Steuersysteme - Grundfragen und Reformvorschläge") of the Swiss Finance Ministry of 10 September 2004. In this paper, the tax department set out the features of various tax systems discussed in the academic world in order to foster a general discussion on overhauling the Swiss tax system. According to oral information given by a Member of the Swiss Ministry of Finance, CFTs have never been considered at political level as a serious alternative to the existing accounting based corporate income tax system since the paper indicated that CFTs are not creditable in the United States. Therefore, a (political) evaluation of the advantages and disadvantages of such a tax has not taken place.

4.8 Countries that did not discuss or implement a CFT

In the initial stage of this report we approached 47 different countries with a questionnaire. Following this initial data collection process, twenty-five of those countries confirmed that they did not consider or implement a CFT system and therefore could not contribute to the furtherance of this report.

The countries that did not discuss or implement a CFT are the following:

Table 11: Countries that did not discuss or implement a CFT

Argentina	Czech Republic	Latvia	Slovak Republic
Austria	Finland	Lithuania	Slovenia
Belgium	Germany	Luxembourg	South Korea
Bulgaria	Greece	Malta	Spain
Chile	Iceland	Portugal	Turkey
Croatia	Israel	Romania	
Cyprus	Japan	Russia	

5 Discussion of policy options: optimal design of a CFT

5.1 Typology

5.1.1 Introduction

A number of taxes are using the cash-flow, in one sense or the other, to determine the tax base, either directly or indirectly. Chapter 4 contains a detailed account of the scope, application and issues arising in applying these systems as well as arguments applied in practice for introducing, maintaining and abolishing such systems.

The purpose of this Chapter is to benchmark a CFT system against a CIT and the prospects of replacing a CIT, rather than to extract all important aspects as regards all types of CFTs in the broad sense of the term. It focusses on the tax systems that most closely resemble the benchmark CFT systems of this report and refers to chapter 4 for a full account of details of the various cash-flow varieties of taxes studied.

5.1.2 General remarks on typology

It is clear from both the discussion of theoretical and practical features of CFT systems in chapter 3 and from the description and assessment of real-world CFT systems and systems with CFT features in chapter 4 that there is not a unique, optimal CFT system. Instead, various types of CFT systems and tax systems with CFT features have been identified with different features and which are serving, to some extent, different purposes. In total, five types of CFTs have been found. Of these, two will not be dealt with than in this section.

1. Small enterprises

   Firstly, tax systems for small enterprises have been designed based on cash-flow. How the small enterprise is defined is determined by the turnover or in combination with the number of employees.

   We note that such taxes seem to be frequently present. They may very well be a viable choice for countries when designing their tax systems for small enterprises. We found that a CFT system has been applied o that it replaces, not only the CIT, but also the payment of social security contributions and similar levies (as in Brazil and Hungary). The systems look very different, from being gross receipts taxes (taxing the net cash inflow, see also below) to production type value added taxes calculated on the cash-flows on a yearly basis, with addition of wages (Hungary). Nonetheless, they seem to achieve their main purpose that is providing for administrative simplicity. That is in itself noticeable – there is evidence that a CFT is a viable option for the taxation of the income (and for other taxes) as regards SMEs.

   As these systems are not applied to bigger companies and apply primarily in a domestic - as opposed to international - setting, they are of less interest in the perspective of this report.

2. Gross Receipts

   Secondly, we have found that some states, notably in the US and Brazil, use a gross receipts tax as an alternative to a CIT. The method of calculating these taxes may resemble partly a cash-in cash-out system since the starting point is the gross receipts; however these taxes show only few of the elements of a cash flow tax and cannot be deemed as such.

3. Production-type VAT systems

   Likewise and thirdly, some countries also use production-type VAT systems. These types of taxes could be classified as CFTs. Yet, they lack the essential features of a CFT outlined in chapter 3: they do not provide an incentive for investment (as regards gross receipts taxes); and they are accounts-based rather than cash-flow based (as regards most production type VATs). These types of taxes are thus so different from the CFT features that they are not part of the optimum design alternatives discussed further in this report and therefore they are not analysed further.[147]

4. Manifestations of theoretical forms of CFT

   Fourthly, we have found types of CFTs that we considered for the optimal design. These types included manifestations of the theoretical forms of CFT and a commonly applied variation of an R-based CFT to a particular industry.

   We found one example of R-based and R+F-based CFT, applied in Mexico. This is discussed in detail below. We also found two countries which are applying, or have been applying, a form of S-based CFT, namely Estonia and Macedonia. This is also discussed in detail below. Since the S-based CFT is different from the R-based and R+F-based CFTs, it is assessed separately.

5. Sector specific

   Fifthly and lastly, we also found that CFT systems are applied in a specific sector, taxing extraordinary economic rent. These serve similar purposes and are designed similarly and we have assessed them jointly as well. These CFT systems are applied in a sector of the economy where investments are onerous but profits also potentially very high. Examples are mining and oil and gas. The CFT system then applies and includes an additional tax burden (in addition to the CIT), in order to tax extraordinary, economic rents. The reasons to introduce such a system seem, mainly and generally, to be two-fold; taxing extraordinary economic rents and creating an investment incentive. A detailed review is done below.

[147] In addition, the drawbacks of the cumulative turnover tax system are well understood in literature and in practice in the pre-VAT situation in Europe in countries such as Germany and the Netherlands.

Table 12: Elements of CFT identified in the CFT systems discussed in this report

	MX IETU	EE CT	MK CT	BR LP	BR SN	HU KIVA	AU PRRT	AU MRRT	CA BCMT	PO STH	NO PT	UK PRT	UK RFCT	BR PP/C
Immediate expensing	✓	✓	✗	✗	✗	✓	✓	✓	✓	✓	✗	✓	✓	✗
Ease of administration	✗	✓	✓	✓	✓	✓	✗	-	✓	✓*	✓	✗	✓	✓
Neutrality between debt and equity-financing	✓	✗	✗	✓	✓	✗	✓	✓	✓	✓	✗	✓	✗	✗
Promotes investment	✓	✓	✓	✓	✓	✓	✗	✗	✓	✓	✓	✗	✓	✗
Neutrality between present and future consumption	✓	-	✗	✓	✓	-	✓	✓	✓	✓	✗	✓	✓	✓

*In the first years cost of compliance will be high as it is a new system with new rules

In Table 12, five features of CFT have been assessed for each system analysed in this report. The immediate expensing element was not applied in any of the Brazilian systems for SME with elements of CFT (Lucro Presumido, Simples Nacional and Pis-Pasep and Cofins), in the Macedonian corporate tax system and in the PT system. Lucro presumido is based on presumptive profits (see 4.3.1.4.3), Pis-Pasep and Cofins is a gross receipts tax with special deductions (see section 4.3.3.4.3), Macedonia uses IFRS for determining company profits (see section 4.2.3.4.3), while Simples Nacional and PT have special rules (see sections 4.3.2.4.3 and 4.5.5.4.3 respectively).

Ease of administration was not in the IETU, PRRT and PRT systems. The Mexican system suffered mainly due to the fact that it was applied in parallel to the CIT system, meaning that the IETU did not reduce traditional compliance requirements but only caused additional compliance burdens (see section 4.2.1.6). In Australia, following the introduction of the PRRT there was an increase in compliance costs for both the authorities and the taxpayers. In response to this various policy changes were introduced to mitigate this issue (see 4.5.2.6.2). UK's PRT was criticised as being a complex tax due to the large number of reliefs and deductions available. It is also administratively time consuming due to twice annual returns (4.5.6.6).

Neutrality between debt and equity is not a feature of the S-based systems applicable in Estonia and Macedonia. In these countries paying dividends to foreign shareholders triggers corporate income taxation while repatriating cash through interest does not. In Hungary, since KIVA aims at small enterprises, neutrality between debt and equity financing was not given much importance, as tax planning is not common for such small companies (see section 4.4.1.2). The PT system provides for a combination of deduction for actual interest payments on debt and an uplift deduction for the whole amount of invested capital (equity plus debt). This means that there is a double deduction on the debt financing (see section 4.5.5.4.10). In Pis-Pasep and Cofins,

there is a bias as the dividends are excluded from the tax base while interest are included (see section 4.3.3.6). Similarly in PRT, interest is taxable/deductible on an accounting accruals basis while dividends are non-deductible (see section 4.5.7.4.3).

Promotion of investment seems to be predominant in most of the systems. However, the Australian PRRT and MRRT have been criticised for being an additional tax that may act as an investment deterrent (see sections 4.5.2.6.1 and 4.5.1.6 respectively). Similarly, the PRT was criticised for being an additional tax and diverting investment to fields not subject to the PRT (see section 4.5.6.5.1). Pis-pasep and Cofins' complexity in calculating the tax due is considered to discourage investment rather than promote it (see section 4.3.3.6).

Neutrality between present and future consumption is achieved in almost all the systems except for the Macedonian corporate tax and the Norwegian PT. The Macedonian corporate tax was targeted to promote profit retention and therefore encourage present investment in the company. This was a way to boost the Macedonian economy in a time of economic downturn (see section 4.2.3.4.10). Similarly in Norway it was noted that there is a bias towards encouraging investments and exploration (see section 4.5.5.3).

5.1.3 Desirable features as suggested by academic literature

The academic literature[148] suggests that a taxation system that would significantly improve the CIT system would have the following desirable features:

- Destination-based[149]. This would limit aggressive tax optimization behaviour and transfer pricing.
- Neutrality between debt and equity financing, to limit thin capitalization issues.
- Not distortive for investment choices. It does not affect investment by allowing immediate deduction of all expenditure relating to investments and inventory.
- Administrative simplicity, with low costs of compliance and collection.
- A low tax rate and a broad tax base that would ensure adequate revenues for government.

The table below compares the different types of CFTs with respect to the previous features.

[148] See Annex 2

[149] Under such a system, the profit made by an enterprise is taxable in the country where the customer buying the goods or services is located. In other words, the country of the market shall have the right to tax the profit generated by an enterprise.

Table 13: Features of a CFT

Features	R-base CFT	R+F-base CFT	S-base CFT
Neutrality between debt and equity financing	By essence this is achieved since the tax base for both equity and debt financing is the same. So as long as the tax rate is independent of the financing mode both provide the same after tax return for investors.	By essence this is achieved since the tax base for both equity and debt financing is the same. So as long as the tax rate is independent of the financing mode both provide the same after tax return for investors.	By essence this is achieved since the tax base for both equity and debt financing is the same. So as long as the tax rate is independent of the financing mode both provide the same after tax return for investors.
Not investment distortive	Achieved since only above-normal profits are taxed. The uncertainties around the taxation of the financial sector still remain.		
Administrative simplicity	No adjustment for inflation, nor indexation for provision depreciation. Financial transactions are not considered.	No adjustment for inflation, nor indexation for provision depreciation.	No adjustment for inflation, nor indexation for provision depreciation.
Government revenue*	There may be a reduction of the tax base; government revenue needs to recover initial investment in the system and make up for the financial sector not being taxed.	There may be a reduction of the tax base; government revenue needs to recover initial investment in the system.	Reduction of the tax base due to the ability of taxpayers to defer payment of tax by deferring distribution, government revenue needs to recover initial investment in the system.

*The amount of revenue collected depends upon which kind, and how broadly based, the CIT system in place is. It is assumed that a broad-based CIT system is in place and the CFT system is introduced to replace such a system.

According to the above table the main weaknesses of CFT refer to the government revenues. First, tax revenues will be lower than under CIT. To avoid lower government revenues, there could be a cap on the amount of immediate expensing so that the amount of tax collected is never negative. Second, government revenues under a CFT tend to be more volatile. The volatility also creates uncertainties on the amount of tax to be collected. This could have negative effects such as an increase of the tax burden on companies in time of general economic downturn due to the fact that they are not in an investment phase and consequently have lower deductions.

5.1.4 Discussion of findings against the desirable features

5.1.4.1 Difficulties in implementing a destination-based CFT

The change to destination-based CFT would thus, if implemented so that also the destination country receives the proceeds from the tax, completely change one

fundamental aspect of the tax – that it should in principle be raised in the jurisdiction where the value is created.

The implementation of a destination-based CFT system requires some degree of tax coordination. Foreign countries that operate a residence-based taxation system would not regard the destination-based CFT as a creditable tax. Foreign cash-flows could be subjected to double taxation in the country applying the destination-based tax, which may deter foreign investment.

In addition, there is significant lack of clarity as regards the design of a destination-based system and there are only a few academic contributions that specifically address the issue. It seems that the destination of goods and services sold is the "destination" referred to, rather than the destination of the payments made. That would require an additional set of rules to determine to which jurisdiction a good or service is destined.

Furthermore, not all countries will benefit from moving to a destination-based system. The destination-based CFT imposes a tax burden only on the location specific rents that accrue to domestic consumption. On the contrary no burden is imposed on consumption abroad and on firms that benefit from local rents. As a consequence, a country with considerable location specific rents might lose revenue when shifting to a destination-based system. This loss might be offset (in part or in whole) by the benefits brought by reduced erosion of the tax base achievable with a destination-based CFT.

We note thus that uncertainties exist alongside this desirable feature. Exactly how it should be implemented and how it should be construed in comparison to the VAT etc. are uncertain. The revenues and reallocation of revenues are also uncertain but seem to be an issue. The international tax issues would have to be addressed and existing double tax treaties re-negotiated.

Lastly, we also note that no country falling within the scope of this study had implemented a destination-based CFT or features of a CFT implemented in a CIT which was destination based. There is thus no practical experience concerning how to deal with the uncertainties discussed above.

Considering all these facts, we conclude that at this stage, even if a desirable feature in isolation, we cannot propose as current best practice to introduce a destination-based CFT.

5.1.4.2 International tax issues

One of the key issues when discussing CFTs in the theoretical assessment was that the international tax aspects were unexplored. In countries operating taxes with essential elements of a CFT system applied to SMEs, such as the Brazilian taxes (Lucro Presumido, Simples Nacional and Pis-Pasep), the international tax issues seem to be disregarded. Considering that these micro and small companies presumably have very limited international trade, the effect of the issues, outlined below, relating to international tax law are minimal. These systems are also reported to function well domestically.

We note that the potential difficulties with regard to the international tax treatment of CFTs were an important issue when the decision was taken not to further explore the

introduction of a CFT in a country (see Section 5.2). It is therefore noticeable that Mexico managed to receive recognition of the cash outflows as costs under existing tax treaties. The only practical experience with a CFT thus indicates that it would be possible to solve the international tax issue through bilateral negotiations.

Countries with a CIT have reportedly had difficulties in recognising the future tax debt in an S-based CFT. A PE in Estonia would therefore be taxed on an annual basis on its profits under a CIT in its domicile, and credit or exemption for the profit arising would not be considered when the PE is distributing profits and Estonian tax should be charged. In practice, the profit is taken out and attributed to the entity again to deal with this mismatch. It seems that there is a need to deem profit arising taxed in another jurisdiction to have been taken out and contributed again in the legislation of an S-based CFT (and thereby the S-based CFT future tax liability recognised).

Another aspect that should be highlighted in this context (notwithstanding the previous comment) is the consequences of a CFT-system in relation with existing double tax treaties network. The question is whether a CFT would qualify as an "income tax" in the meaning of tax treaties. This is a vital question as if this were not the case a CFT-system would trigger issues of double taxation, which would go fundamentally against one of the objectives of a CFT, namely tax neutrality. It is not disputed that indirect taxes are not covered by double tax conventions. Still, an S-based CFT could be seen as a hybrid form that has aspects of a direct and indirect tax. An interesting case in this regard is the tax on regional productive activities introduced by Italy in 1998 ("IRAP "). It replaced several taxes including the Italian local income tax that was listed in Italian tax treaties. One of the features of the IRAP is that it is not based on a traditionally determined taxable profit, but is more akin to a turnover tax in the meaning that it is levied on each stage of production. The IRAP was accepted as a creditable tax under most tax treaties (for instance, the current Italy/US tax treaty, however, explicitly mentions the IRAP as a covered tax). In an EU-context, the ECJ decided that the IRAP did not contravene the VAT Directives[150]. To conclude, in order to avoid disputes and the risk of double taxation, states should preferably agree on the qualification as an income tax for DTC purposes before introducing a CFT.

Specific issues may occur where a destination-based cash-flow tax is implemented. While under standard double tax treaties the right to tax specific income is allocated to the contracting states under the source-/residence-principles (which most national tax laws of many states follow), a destination-based system would not allocate the taxing rights relying on categories such as the permanent establishments. Rather, with such a tax system, a country (State A) would claim the right to tax profits allocated to its own market without looking for a permanent establishment in its territory. At the same time, that country (State A) would not claim a taxing right for income which is generated from sales to customers in another country (State B) (unless that country (State B) does not only apply the tax rates of the destination-country (State A) to the foreign profit; see in this respect section 3.1.5.4). The other contracting country (State B) (applying a source-/residence based CIT) most likely would credit foreign

[150] Brandstetter P., (2011).

taxes only if a permanent establishment is located in the other contracting state (State A). Furthermore, this country (State A) will claim a taxing right only if a permanent establishment exists in his territory (leaving aside potential withholding taxes). Existing double tax treaties will likely not provide for a satisfying solution to a destination based system as the taxing rights and the obligation to avoid double taxation are based on the source/residence approach.

5.1.4.3 An investment incentive

We have found clear evidence that the investment incentive inherent in a CFT is considered to hold in practice. In the extraction sectors, this feature is reported as very important for the efficient exploitation of the natural resources.

In Estonia, criticism has been raised that while the S-based CFT promotes investments in financial and real assets, it does not promote job creation. We fail to see the correctness of the criticism as labour costs are deductible from profits under the Estonian system.

It should be noted, however, that a CFT which does not allow for the deduction of wages is a tax not only on profits but also on labour. Thus, a CFT does not constitute an incentive to employ personnel unless deduction of wages is allowed.

The sector-specific CFTs described in section 4.4 are sometimes imposed in addition to CIT to tax extraordinary rents in a specific sector, such as mining and the oil industry. Of course, these additional taxes do not act as an investment incentive, as the profit is still subject to CIT and the CFT imposes an additional burden. Sometimes, to promote investment there is an additional uplift provided in terms of an extra investment incentive, so that the value of investment expenditure is deductible to a greater extent than the value of the investment. The tax regimes applicable in the petroleum sector in the UK illustrates how such uplifts could be done and also how to treat past investments when the system is introduced (see further section 5.3.5).

In one system, in Norway, in the investment phase, the tax share of investments was paid back to taxpayers. Essentially the government then funds, partly, the investments. In the other systems assessed, no refund was allowed, but the investment may be deducted in coming years, i.e. a carry-forward of the deductible expense or loss. In these systems, an uplift is allowed to compensate for the present value of the investment. The loss is then uplifted each year if not used.

We conclude that the CFT in itself is an investment incentive and that that characteristic is present in enacted CFT systems.

5.1.4.4 Administrative simplicity

The CFT system is considered simpler to administer in many countries, such as in Estonia. It is often claimed that CFTs would also reduce the hidden economy as they do not entail large compliance costs.[151] Even taxes based on cash-flows that are not considered CFTs for the purposes of this Study - such as gross receipts taxes - are motivated foremost with administrative simplicity.

[151] The gross turnover tax also compensates for social security contributions (see for example Brazil)

However, the review showed two situations where the administrative simplicity was arguably not present in countries with fully fledged CFTs for the following reasons.

Firstly, a CFT can add additional administrative burden for the tax payers when it is applied in parallel with CIT systems, like for example in Macedonia and Mexico. The tax then requires additional tax calculations and will not result in ease of administration, neither for tax payers nor for tax administrations.

Secondly, a CFT system applied to a specific sector seems more complex to administer. Often, the specific deductible expenditure and taxable cash inflows are determined in detail, so as to ring-fence the system to the specific sector or activity. That results in complex regulations and a higher administrative burden. In addition, these systems are also applied alongside CIT in many situations; presumably resulting in a higher administrative burden than if only a CIT would be applicable.

We conclude from this that a CFT in itself has proved simple to administer, but that it is a different form of tax than the CIT and it requires separate forms of calculation etc. The administrative simplicity inherent in the tax could be lost if the system is applied alongside other tax systems.

5.1.4.5 Government revenue

A CFT carries with it a risk for government since it invests in companies by providing for immediate tax refund for the cost of the investments (see section3.1.8.5). This section discusses the “silent partner” effect and whether it has been identified in the countries’ experiences. In addition, it discusses the anticipated volatility of the revenue (see section 3.1.8.5).

Silent partner

Government is a silent partner in the company, since immediate deduction is allowed of all acquisitions. Above all, the silent partnership means tax is paid only when cash inflow exceeds outflows, which results in that revenue is received only when investments have been paid off. We received no reports, (notably not in Mexico[152]) however, that this was an issue when implementing or operating a CFT.

The silent partner argument has been used as an argument against implementing the tax (see also section 5.2).

Revenues

Two different effects on tax revenues are expected following the replacement of a traditional CIT system with a CFT. First, in principle revenue will decrease since the normal return to capital is exempt under a CFT; second, there will be a change in the pattern of tax revenues that will likely become more volatile. (see also section 3.1.7.3).

In accordance to with the above, Estonia experienced a decrease in revenues the initial years when introducing an S-based CFT, although revenue later picked up. Macedonia collected significantly less revenue than under their CIT which their

[152] Mexico is the the only country applying a fully fledged R- and R+F based CFT

variation of an S-based CFT replaced. The Australian mining tax also yielded initially low revenues, but that could

However, the Mexican experience is positive as regards the effects of the CFT. The Mexican CFT operated alongside the CIT and has been reported to have a positive effect on CIT collected, reducing loopholes and planning opportunities. It was estimated that an additional 78 per cent increase in revenue from the classical CIT was generated by the co-existence of the CFT.

The above could be seen as evidence that the CFT system is more difficult to avoid than a CIT, despite the fact that some CFT "abusive tax planning" was reported to be widely present in Mexico. That tax planning allegedly increased the deductible cash outflows and potentially reduced revenues, especially during the first years of introduction of the CFT.

Overall, the evidence of the revenue patterns is that it follows theoretical believe (Estonia and Macedonia), unless the system is applied in parallel with a CIT (Mexico). There is some evidence consistent with the broad-based nature of the tax (that it is difficult to avoid) and also proof that it could raise considerable revenue (Estonia).

We conclude that the revenue patterns are an issue when a CFT is implemented. This problem may be just temporary since (see further section 5.3.5) revenue appears more stable after a few years.

5.2 Motives to have (introduce, continue to apply v. abandon) a CFT: theory and practice

The theoretical motives for introducing a CFT were presented in section 3.1. This section discusses these motives in relation to the real-world experiences with CFT described in Section 4.

The most common motive from the countries assessed not to introduce a full-fledged CFT system as a replacement for the CIT was uncertainty, mainly in two regards. First, from an international tax perspective, i.e. that the present system for handling cross-border trade relies on countries having a CIT and, if a CFT were to be introduced, there would be an uncertainty to what extent the system would be recognised under current double tax treaties. Second, there was uncertainty as regards tax revenues and effects on a domestic level. Furthermore, the fact that any country would be "a first mover" and thus suffer from the absence of practical experience, acted as deterrence.

An additional uncertainty stated relates to the transition to the CFT system from the CIT system. The problems were considered so great that implementation would not be possible. Other motives include the "silent partner" effect, discussed in section 5.1.4.5 and uncertainties as regards revenue.

It is also noticeable that, other than for SMEs, only Mexico has introduced a fully-fledged R-based and R+F-based CFT system.

Interestingly, the primary motive for Estonia's introduction of the S-based CFT seems not to have been to boost investments, but to discourage the use of tax havens. In an S-based CFT, no tax is levied as long as profits stay within the company. The

administrative simplicity and immunity to inflation were also reasons provided, as well as neutrality towards organisational form and location.

The motive in Macedonia was an outside pressure as neighbouring countries were lowering their tax rate, together with the boosting of investment, especially to attract new foreign investments during the financial crisis in 2008. It was abandoned largely because of lack of revenue for government in total, i.e. the combined effect with other tax incentives created too much revenue leakage.

In Mexico the main motivations were to simplify compliance and administration, create new jobs, reduce poverty through new investments, and increase tax collection. However, the Mexican CFT regime did not decrease the cost of compliance or the cost of administration; to the contrary, it increased such costs. On the other hand, considering this was an additional tax it increased substantially government's tax revenues. The present study also shows that the CFT achieved its objective to increase tax revenues (also for the CIT).

In the CFT systems for SMEs, administrative simplicity seems generally to be the most important objective (see, for example, the Brazilian SME systems) yet not always the most important one (compare the Hungarian KIVA).

With regard to CFT elements implemented in a sector, the main reasons provided were that there should be an incentive to invest in the sector, through direct deduction, and (most often also) that the value of natural resources, and extraordinary economic rents, should go to society and not to the business. These reasons were provided in Norway and the United Kingdom. The fact that other jurisdictions have these kinds of taxes has also been a motivating factor in choosing to introduce them (as in Poland).

The Australian mining tax was abandoned after political turmoil. Reasons were that the taxes raised less revenue than expected, caused an administrative burden and hampered investment in the sector. It seems that the tax was introduced at a time when world market prices for minerals were falling and the extra tax was an additional burden in a particularly difficult time. In contrast hereto, other mining taxes (such as those in Canada) and extraction taxes have stood the test of both time and political pressure and continue to apply.

We conclude that the motives found in theory also apply in practice. Above all, the investment incentive and administrative simplicity are two features that have motivated the introduction of the tax (Hungary being a good example hereof). There are no proofs of the CFT in itself being administrative burdensome yet, as noted in section 5.1.4.3, in combination with other taxes it may constitute an extra burden and thus be perceived to add complexity rather than simplify administration.

One argument quoted in practice was attracting investments from abroad in a global (and sometimes regional) competitive environment has been an argument. There is also an argument not to be the last mover (when there is a CFT system in many other jurisdictions, namely in the extraction sector), just as there is a resistance to be the

first mover (when there is virtually no international benchmark, as has been, and still to a certain extent is, the case with the more fully-fledged CFT[153]).

5.3 Optimal design

5.3.1 Introduction

Our research has shown only a few examples where countries introduced a pure CFT- or at least essential elements of it. Indeed, based on the various comments and experiences received from government officials, the tax systems explored under chapter 4 follow very different objectives and do not apply the theoretical works on CFT as a model but build a country specific version around it. Therefore, the optimal design which we discuss in the following elaborates on the fundament of the key findings (Mexico, Estonia and Macedonia as well as the extraction sector) in order to establish some specific features of an optimal CFT in respect of R/R+F type and S-based CFTs.

5.3.2 R-based and R+F-based CFT systems and the Mexican experience

The desirable objectives of a CFT are that it is neutral as regards debt and equity financing, it is neutral with respect to the choice of the scale of the investment by allowing immediate deduction of all expenditure and it is administratively simple. The related positive aspect to strengthen the equity financing of companies (in comparison to under a CIT, which favours debt financing) and hence making the CFT more robust against indebtedness, could neither be verified in practice nor had there been any discussions relating to this aspect. In addition, a low tax rate should be applied to a broad tax base. As discussed above, these objectives could be achieved by an R-based and R+F-based CFT system.

Mexico applied a CFT, which complied with the benchmark for an R-based CFT. Notably, it allowed immediate deduction and denied the right to deduct interest and thus was neutral towards debt and equity financing. This precise feature was unpopular among businesses. However, it complies with the features of a CFT

Distinguishing an R and R+F-based CFT seems desirable. In the general business sector, only an R-based CFT needs to be applied, while in the financial sector an R+F-based CFT must be applied which taxes the intermediation services provided by the financial sector. The financial sector needs special regulations.

The dual system brings about a necessity to distinguish between sectors. That could be solved by listing entities subject to the tax (as in the Mexican system where banks, financial leasing companies, special-purpose financial institutions, multipurpose financial institutions (SOFOMs), warehouses, insurance companies, brokerage firms were listed as subject to the R+F-based CFT). The weakness inherent in this approach is that it is, in principle, less sustainable in time to changes in the economy and

[153] A CFT with all the elements (as developed by the economists.)

potentially could also entail a possibility to avoid paying the tax by being able to be classified as a not covered entity.

An R-based CFT should, based on the Mexican experience, have the following features. The following cash inflows included in the tax base, namely cash inflows from (i) transfer of goods; (ii) rendering of services and; (iii) granting of temporary use or enjoyment of goods.

Cash-flows between related parties need special regulation. For example, related parties could sell on deferred terms and thereby avoid charging the tax. With regard to transactions between related parties, the issue needs to be handled with special rules as regards such transactions. For example, tax could be chargeable if no payment is made within 90 days of the supply taking place. Transactions relating to certain kinds of supplies, like royalty payments, may also receive special treatment when performed between related parties.

Sales with deferred payment terms however also need to be handled in other situations in an R-based CFT, to deal with situations of unwanted tax planning. The Mexican CFT contained a special provision which resulted in credit being treated as cash-inflows. The provision was aimed at avoiding a reduction of the tax basis through the deferral of cash-inflows.

The Mexican CFT excluded from the deductions wages and fringe benefits paid to employees. However, there was a tax credit calculated upon a certain percentage of wages. Consequently, a part of the cash-flow from wages was deductible. Considering the room to manipulate the deductible cash-flows, a similar anti-avoidance rule is recommendable in the design of a CFT.

Exemptions and exclusions from the scope of the tax

The Mexican system excluded a number of entities from the scope of the tax for equity, convenience, and/or economic or political reasons. Considering the list of excluded entities, the following could be noted:

- The public sector could be excluded for practical reasons.
- Entities excluded for social and other reasons from the CIT could be excluded from the CFT (charities, cooperatives, political parties and labour unions are examples of entities excluded from the Mexican CFT).
- Legal entities whose shareholders are retired and retirement funds resident abroad were also excluded in Mexico presumably for tax avoidance purposes.

The experience of Mexico also shows that it is possible to exclude also certain activities, and the related cash-inflows and outflows, from the scope of the tax. A number of adjustments seem necessary to distinguish real from financial flows. The Mexican tax excluded such elements, namely:

- Financial derivative transactions when the sale or disposal of the underlying was not subject to the IETU Law
- Sale of shares
- Dividends

Treatment of losses

Under a pure CFT system, losses, i.e. negative cash-flow, should entail a reimbursement of taxes or at least a carry forward with interest. It is difficult to draw conclusions from the Mexican system in this regard, as the system was operated alongside the CIT. The excess of deductions over income in a tax year gave rise to a credit which could be carried over for 10 succeeding tax years and could be credited against the CIT. We consider that there should be at least a carry forward system with a lift up for losses incurred.

5.3.3 S-based CFT in Estonia and Macedonia

According to the academic benchmark, the S-based CFT system taxes the net distribution of a corporation to its shareholder. An open distribution to shareholders increases the tax base, repurchases of shares increase the tax base and revenues from issuing own shares reduce the tax base. In addition, profit calculation for tax reasons at the level of the corporation is not necessary.

The desirable characteristics of a CFT are that it is neutral as regards debt and equity financing, it allows immediate deduction of all expenditure (yet in an S-based system that is inherent in the taxation of distributed profit) and it is administratively simple. In addition, a low tax rate should be applied to a broad tax base. As discussed above, not all of these objectives could be achieved by the Estonian and the Macedonian system. As the Estonian system does not allow a deduction for the revenues of share issues, it is not neutral vis-à-vis debt and equity investments. However, at shareholder level neutrality is restored by exempting received dividends from the personal income tax.

As is clear from the description in section 4.2.2, Estonia applies elements from an S-based CFT system. In principle it taxes profit distributions to the shareholders. However, in order to capture all distribution of profit it entails a number of adjustments with regard to inter alia hidden profit distribution, described in detail in section 4.2. In addition, it has one feature that is not consistent with the theoretical benchmark. There is no credit allowed for the issue of shares and capital contributions from shareholders.

In Macedonia, the CIT-system was replaced in 2009 with system containing elements from an S-based CFT system. This system was different from the typological benchmark used in this report (and from the Estonian system) in that it had as a starting point the figures in the financial statements that are based on the accounting accrual concept. Tax was charged on the distribution of profits, and any retained profits were not taxed. However, the different starting point meant that the adjustments made (see below) were of a different kind.

In the following we discuss some key findings relating to the S-based CFT with the experiences of Estonia, and to some extent Macedonia, taken into account.

First, the distribution of profits must include also cash out-flows which are not strictly dividends but which entail a distribution of profit in another form. Consequently, in Estonia, any kind of profit adjustments, in a substance-over-form analysis, increases

the tax base, including certain disbursements, such as transfer pricing adjustments, liquidation proceeds and capital reductions. .

We note that, under an S-based CFT, there is a need to distinguish between equity and debt flows of funds as debt flows should not impact the tax base but equity flows should. Estonian companies have been claimed to be used as banks for profits, meaning that the companies have been used to hold profits tax free until distribution through loans. It is therefore interesting to note that there is no specific rule that addresses the issue of how to treat inter-company loans as distinct from equity transfers. Despite the presence of the "profit adjustment" rule, which is seemingly a very broad anti-avoidance rule, reportedly profits are shifted from Estonia through inter-company loans. In contrast hereto, the Macedonian system had special rules to deal with such transfers, essentially treating non-deductible interest expenses subject to thin capitalization restrictions as taxable cash inflow when originating with a shareholder. Expenditure relating to related parties' transactions were increasingly disallowed and increases in the value of assets following a restructuring was deemed to be profit distribution. Any hidden profit distribution was taxed, but also such costs as inventory shortages. The Macedonian regime seems to have been increasingly unpopular over time and more costs were deemed to be distribution. Outstanding collectible receivables not paid for by the end of the year were treated as distribution of profit, unless paid for.

Second, distributions of the profit in the form of fringe benefits, representation expenses and similar consumption expenditure are included in the tax base. Similarly to a CIT where certain non-business expenses, relating to private consumption rather than the operation of the business, are not considered as deductible costs, the S-based CFT system in question treats such expenditures as cash outflows to shareholders. In the Macedonian system, with its starting point in accounting, the various costs deemed to be profit distribution were listed and increased over time (see above). The effect was that also when the company made a loss, tax was charged on the business because of the costs deemed to be profit distribution.

Third, certain donations are excluded when provided to certain non-profit making entities. Although one might view this as contrary to the principles of a CFT, it should be noted that payments to certain non-profit organization are also deductible from the tax base under classical CIT systems. Hence, the rule is a feature which is not uncommon to corporate taxation.

In our view, the issue of how to treat such losses depends on avoidance concerns and the stake (silent partnership) a government is prepared to take in the business. Such losses should, provided they are real expenditure for the business, be able to be carried forward to off-set towards future cash-inflows and the value uplifted. In so far as the expenditure does not constitute real expenditure for the business, taxation of such profits relating to expenses for private consumption should be taxed as a distribution to shareholders (and to tackle avoidance).

Fourth, there are limitations of the tax to distributions to certain shareholders in Macedonia. Only distribution to non-resident or individual shareholders formed part of

the tax base, contrary to the situation in Estonia where all distributions are taxable[154]. Effectively there was thus an exemption for domestic, related, companies from the scope of the tax. We consider that ideally the S-based CFT should apply to all entities established within the country, with possible relief for transactions within a group of companies.

5.3.4 Best practice of a CFT in an investment intense industry with high economic rents

As can be seen from section 4.4, a number of countries apply a CFT in a specific sector or sectors.

The purpose of these taxes is primarily to reserve for the community a share in returns from non-renewable resources. At the same time, the purpose is to have a tax system which promotes investment and production in these sectors. This is achieved by a resource rents tax system or, formulated differently, a system that taxes extraordinary profits.

Other features of a CFT, such as neutrality between debt and equity-financing, neutrality over choice of organisational form and immunity to inflation, are often featured as additional reasons behind a move to a sector specific CFT.

We note that it is turning into an international common practice to have a CFT for the extraction sector (see the discussion on Poland).

Based on the experiences in the countries assessed, the following considerations can be seen:

- Since the CFT should apply only to a specific sector or activity, it is necessary to ring-fence that activity. Ring-fencing the cash-inflows relating to the project may entail difficulties, which, for example, the Australian gas and oil tax shows.[155] Internal flows between related companies pose specific problems. In fact, all income that does not constitute the direct remuneration for a sale of products emanating from the activity in question must be considered, and whether they pertain to the activity or not.
- Similarly, ring-fencing the cash-outflows, i.e. deductible expenditure, is also not straight forward. Often the legislator resorts to detailed lists (the British Columbia/Canada resource tax system being one example, see section 4.5.3) which then run the risk of being outdated (if business models change) etc. Again, this is a consequence of the fact that a specific sector or type of activity receives a special tax treatment and the problems are similar as regards taxes in general when an activity or sector is to be treated in a particular way for tax purposes.
- The tax base comprises the net income of the sector.

[154] With respect tot he compatibility of such a tax upon distributions with Art. 5 of the EU Parent-Subsidiary Directive see section **Error! Reference source not found.** of this report.
[155] See section 4.4.2.

- Allowances to use resources charged by the state are sometimes deductible to avoid double taxation (see Australian mining tax), or their resale excluded from the scope (as in the UK).
- All expenditure is immediately deductible. We note that the Norwegian system is integrated with the CIT. Only exploration costs are immediately deductible and refunded if the net income is negative.
- If the net position is negative and there is a loss in one year, an uplift could be allowed and the possibility to credit the negative result from future profits. Or, a refund could be provided directly of the tax value of the investment. Both systems are applied. Notably, to provide for a refund increases neutrality vis-à-vis new entrants to the market, which was the reason why that system was chosen for exploration costs in Norway. (And it seems to work.) A third possibility is to carry-back the loss and off-set it against profits in previous years which obviously only works with established businesses. For any newly established business, a carry forward or a refund are the only options.
- These types of taxes are levied alongside CIT and how they are integrated and treated within the CIT system varies. In principle a choice must be made between levying the CFT in addition to CIT and allowing a deduction of the CFT from the CIT burden. All varieties exist, including treating some expenditure under a CFT system (allowing immediate deduction) and some on an accrual basis under the CIT system, see the Norwegian system, section 4.5.5.2.

5.3.5 Transitional issues

Considering the literature, we would expect special rules to deal with the transition. If no such rules were enacted, we expected to find a lack of investments in the phase leading to the introduction of the CFT. In both situations, we would expect some difficulties, as this is clearly seen, theoretically, as a difficult issue.

The Mexican introductory rules provided for a stand-still of cash-flows at the introduction based on activities performed (before or after the introduction) and accrued expenses (where any deduction was denied, even if cash-outflow occurred after the introduction of the CFT). Effectively, accrued accounting rules determined the breaking point when the system was introduced. Past investments were treated based on a system of uplift.

The Mexican system proved easy to circumvent (see section 4.2.1.2 above). It seems not to be suitable as a benchmark for best practice but illustrates the problems that could arise.

We note also that the potential problems and difficulties associated with the transition from a CIT to a CFT have acted as a deterrent against implementing the CFT (see section 5.2).

In the resource rent tax systems (tax systems for a specific sector), the main problem faced at the transition is that past investments needs to be placed on the same footing as new investments. That is often done by providing for an uplift of investments made.

An alternative model would be to, as in the case of Poland's extraction tax (see section 4.5.4), introduce the reporting obligations and calculation obligations years before the tax becomes chargeable (the tax comes into force in 2016 but is chargeable first in 2020). Presumably such a model will alleviate the introduction of the problems experienced in other countries to some extent. It is noticeable that, under the Polish system, expenses incurred from 2012 will be taken into account.

We note that in the transition from a CIT to a fully-fledged R-based or R+F-based, CFT, a number of difficult issues arise and no clear best-practice has emerged in the only practical example there is (Mexico). The transition remains a difficult issue.

In the transition to an S-based CFT, there seem to be less transitional issues. In Macedonia no transitional rules were enacted at all. But, importantly, the system was abolished without prior notice. Anyway, we also have indications of problems in Macedonia in connection with the introduction of the system.

In Estonia there seems to have been no specific transitional rules. It seems thus easier to move to an S-based CFT than an R-based (or R+F-based CFT).

We note that the S-based CFT seems simpler to implement than the R-based, or R+F-based CFTs. There are less risks and leeway for planning ahead when it comes to profit distribution than investment decisions. The difference thus seems understandable.

6 Conclusion

CFTs occur in several forms which are commonly divided into **three main classes**:

- Cash-flow tax on "real" business activity: the **R-based CFT**. Its tax base is set on sales, minus wage costs and purchases of material, good and services, and fixed assets.
- A cash-flow tax on real and financial transactions: the **R+F-based CFT** tax combines taxation on real transactions and on financial transactions. Its tax base is the same as for R-base CFT, plus it adds received borrowing and interest minus repayment in borrowing and interest paid. Contrary to R-based, the R+F-based CFT can be applied to financial sector.
- A cash-flow tax on distribution of dividends ("stock"): the **S-based CFT**. Its tax base comprises distributions of a corporation to its shareholders. Cash inflows resulting from the issuance of new shares decrease the tax base, while a repurchase of shares increases its tax base. Cash inflows or outflows from or to the corporations from third-party transactions are not taxable.

From our country research, we have defined a pure cash flow tax system as a system comprising the following essential elements: a tax which can be classified as a R, R+F or S-based system with immediate expensing[156], equal treatment of debt and equity, based on cash in-cash out without accrual accounting surrogating the corporate tax and striving for administrative simplicity. In addition we have examined those countries which implemented a tax which shows essential elements of a cash flow tax system surrogating the corporate tax.

Therefore, we did not cover ACE systems which form part of the normal corporate tax system or tax systems mainly covering individuals. We have included one FAT system applied to SME as an example (see Hungarian KIVA) which showed essential elements of a CFT.

Sector specific taxes which aim at taxing the economic rent of exploitation of natural resources (extraction industry) and corporate taxpayer specific systems which strive for administrative simplicity and which reflect also other CFT elements (taxation of SMEs) are dealt with separately.

This report (based on the questionnaire in Annex 1 which was sent to the relevant countries, additional interviews with officials from tax administrations and publicly available reports and legislation) identifies **three jurisdictions where a (close to) full-fledged CFT was implemented, namely Mexico, Estonia and Macedonia**.

With the exception of Mexico, there is no clear evidence that the CFT-systems were derived from academic models as discussed in the literature.

- Mexico's CFT system operated in parallel with a CIT system and generally applied an R-based, while it applied an R+F-based CFT to financial institutions. This system

[156] With regards to an S-based system immediate expensing is not relevant

was abandoned in 2014 mainly due to the administrative burden that an additional tax put on the Mexican businesses.

- Macedonia and Estonia both applied elements of an S-base CFT, only taxing distributed profits and leaving retained profits untaxed.[157] Macedonia abandoned this system in 2014, as the regime was a temporary measure introduced to counteract the financial downturn of the Macedonian economy at the time of its introduction. The Estonian S-base CFT is still in place. The Estonian tax system is considered by some to be the most competitive tax system in the OECD.[158] In general the Estonian CFT system is considered to be efficient and has been well received by Estonian businesses.
- Australia, New Zealand and the United States had in-depth discussions with regard to reforming the CIT system and introducing a CFT. However these discussions did not evolve into legislative proposals due to various criticisms. Feasibility of the tax, international recognition and lack of political support were some of reasons identified for the non-implementation of these proposed systems.

The other identified CFTs relate to three broad categories: small and medium enterprises, sector specific taxes and gross receipt taxes.

There is a predominant presence of CFT elements in the **extraction industry**. CFT elements were present in the extraction industries of Australia, Canada, Norway, Poland and the UK. The leading motivation for applying a CFT in this sector was for governments to be able to tax the economic profits (supernormal profits or super-rents) of the industry.

Brazil and Hungary applied elements of a CFT system to their **SMEs**. The main motivation was to reduce the complexity of the tax compliance requirements and to allow for a less complex way of complying with the administrative requirements for SMEs that have fewer resources to keep up with such high burdens.

CFT elements were identified in gross receipts tax in Brazil and in individual US States (see Annex 5). Under a gross receipts regime, tax is charged on gross receipts, but a credit is granted for certain expenses incurred by the business. The method of calculation is hence based mainly on cash inflows subject to certain exemptions and accounts for cash outflows in the form of a credit.

Given the real-world experiences with cash-flow taxation, and the theoretical understanding thereof, it is possible to claim that there is no one, single best practice for an R-/R+F-based CFT system. Rather, we have seen jurisdictions using cash-flows to determine the tax base in a number of quite different tax systems. Macedonia and Estonia apply an almost fully-fledged S-type system with the single difference that these countries do not allow a deduction for the issuance of new shares or capital contributions by shareholders.

There are systems to measure the profit of companies that have (some of) the following characteristics of a CFT: can be classified as an R-, R+F- or S-based system

[157] It is interesting highlighting that both Estonia and Macedonia do or did not recognise its corporate tax system as an S-based CFT.
[158] Tax Foundation's International Tax Competitiveness Index

with immediate expensing; achieve an equal treatment of debt and equity; are based on cash in-cash out without accrual accounting surrogating the corporate tax; and strive for administrative simplicity. The overall purpose of a CFT (as defined in the context of this report) is as an alternative for applying the CIT and as a way to improve the CIT system. Given that starting point, we have assessed the alternatives.

Of the three types of CFTs theoretically most often discussed (being the R-based CFT, the R+F-based CFT and the S-based CFT), **the R-based CFT is particularly attractive for small businesses** (with primarily domestic transactions and with a limited turnover and/or number of employees) whose activity is based on "real business" activity, and not on financial transactions (and hence the distinction of financial transactions is less important and presumably less difficult compared to if it has to be made vis-a-vis larger businesses). R-base CFT would ensure administrative simplicity since only information on cash inflow and outflow should be provided to tax administrations. In practice such systems are applied to corporations rarely. Our research only detected the Brazilian systems (Simples Nacional, Lucro Presumido and Pis-Pasep and Cofins) and the Hungarian system (KIVA) as experiences showing this administrative advantage for SMEs.

With respect to the international dimension of CFTs, **a destination based CFT is attractive from a theoretical perspective**. It could alleviate problems with the current CIT regimes in a cross-border context. However, despite its attractiveness, we have not seen examples in practice where a destination based CFT is applied. At the present stage of both practical and theoretical knowledge of exactly how it could be designed, and the effects it would have on the allocation of the tax base between jurisdictions, we have stopped short of suggesting it as a best-practice. We acknowledge that once a destination based CFT is better understood, both in theory and in practice, it might become a preferred alternative. However, for now**, an origin-based CFT is the only option that has been tested in practice**.

The administrative simplicity inherent in the theoretical understanding of the CFT was not always clearly visible in practice. However, that seems to be contingent not upon the CFT system itself but how it has been implemented. When a CFT system has been implemented to replace a CIT (and, in some instances with regard to CFTs for SMEs, social security contributions and other taxes) there is evidence of CFTs alleviating the administrative burden both for administrations and the taxpayers. Macedonian and Estonian regimes are an example of this. But when a CFT is applied alongside a CIT, it creates additional administrative burdens and is then not perceived as a simplification. This could be seen in the Mexican IETU system. We conclude that, in itself, the **CFT has proved to lead to more administrative simplification over CIT.** However, it is the tax mix and total administrative burden that in the end determines how it has been perceived.

The CFT system acts as an investment incentive. We found evidence of this in the extraction tax CFT regimes. More generally, whether a CFT regime attracts foreign investment is difficult to assess. There are indications that the tax regime is only one aspect of importance, and enacting a CFT regime is not a miracle measure to attract foreign capital.

With regard to the revenue collected under a CFT, evidence is mixed and conclusions are to a certain degree uncertain. There are some indications that it is more **difficult**

to avoid a CFT than a CIT (Mexico). It has also been reported that revenues initially decrease, though that could be due to the fact that transitional rules and past investment reduced the profit calculated in the very first years (Macedonia, Estonia). Lastly, it has also been reported that a **CFT could raise revenue effectively (Estonia).**

Critique of the CFTs and complexities of the system concern the sector-specific taxes and CFT regimes that are present alongside a CIT. The fact that a CFT is operated alongside a CIT system creates particular difficulties.

The fear of the unknown seems to be among the important reasons for not implementing a CFT. The uncertainties surrounding the CFT, especially as regards the international recognition and the fact that it departs substantially from the current system, are the most important reasons not to go further and propose the introduction of a CFT. Interestingly, **we found evidence that a CFT could be recognised in international tax law (Mexico)**. The resistance to adopt a CFT for international tax law reasons could hence not be confirmed. At least for Mexico, Estonia and Macedonia this reason could not be confirmed in practice.

Transition issues may pose considerable problems in practice as regards R-based and R+F-based CFT systems. Under a CFT the issue of how to treat "old" investment that used to benefit from standard depreciation allowances is a difficult one. An initial revenue decrease and some avoidance patterns seen in practice are typically due to problems inherent in the transition phase.

With regard to concrete examples in practice, an R- and an R+F-based CFT system had been operating in Mexico. We note that these CFTs operated alongside a CIT and the system was not perceived to be simple to administer. Despite its unpopularity in Mexico, it is an important **example and proof that a CFT system can be introduced and recognised internationally.** However, we also note that the transitional issues were considerable.

With regard to S-based CFT, there are less transitional issues and generally this system seems to be simpler to be introduced. In the single country where the S-based CFT completely replaced the CIT, and where it is still in force, in Estonia, no specific transitional issues were identified. The **S-based system, though, seems the most simple**. **Avoidance issues arise, primarily through shifting profit distribution to fringe benefits, loans to related parties etc. These seem to be manageable by introducing anti-avoidance rules.**

Lastly, the choice of a tax cannot be determined outside the context of the specific jurisdiction. This report contains numerous examples as to how the total tax situation impacts greatly the success of a CFT system. The benefits of the CFT system will clearly be less visible, if the CIT system is not abolished and both systems work in parallel.

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9 List of cases

Case C-475/03	Banca popolare di Cremona EU:C:2006:629
Case C-284/06	Burda GmbH EU:C:2008:365

Annex 1 - Questionnaire

What is the design of the cash-flow tax?

1. General Remarks
2. When was the tax implemented?
3. Is the it Source or Destination based?
4. How the base is calculated (in detail)?
5. How is income defined?
    a. What is included of the following items:
        - Sale of capital goods (such as real estate)
        - Sale of intangible assets
        - Sale of goods
        - Sale of services
        - Contribution form the government (subsidy)
        - Interest received on bank surplus
        - Income received from financial placements in shares and bonds and the like
        - Income received from the sale of shares in subsidiaries
        - Other? (Please specify)
6. Which of the following Costs/acquisitions are immediately deductible:
    - Wages
    - Purchase of goods sold and other direct costs
    - Investment in capital goods
        - Real estate
        - Machinery and the like
        - Research and development costs and the like
    - License fees
    - Interest paid on a loan to expand the business
    - Other financial charges on ….
    - Dividends paid to shareholders
    - Other? (Please specify)
7. How is a net-refund situation dealt with?
8. What is the rate
9. What is the scope of the tax - (organisational forms of companies, size, etc.),
10. Were ACE or CBIT considered

Explanation:

An ACE-System allows an entity to deduct a fictitious interest on its equity ("notional interest deduction".

A CBIT disallows the deduction of interest expenses.

Bothe the CBIT and the ACE aim to avoid the "debt/equity bias" by treating both forms of financing in the same way.

11. What are possible exemptions? What entities are covered/exempted? Why? Is this linked to problems with international tax issues or other aspects identified?
12. General revenue implications
13. What are the revenues of this tax (please provide figures)
14. Revenue figures under previous system (please provide figures)
15. What are specific administrative provisions of the tax
16. Which qualitative and quantitative (administrative or economic) benefits or problems it brought
    a. Ease of administration
    b. Treats debt and equity-financing in a similar way
    c. Neutral with respect to the choice between present and future consumption
    d. Immune to inflation
    e. Does not affect choice of organisational form
    f. Promotes investment
    g. Does not affect location choices
    h. Other benefits
    i. Transition

       What were the exact rules enacted to deal with the transition to the CFT?

       - Treatment of past investments – phasing out period?
       - Treatment of future investment – phasing in period?

    j. Financial sector taxation
    k. Territorial scope
    l. International recognition
    m. Avoidance schemes
    n. Distinction between corporate and personal expenditures
    o. Carry forward of losses
    p. Other problems
17. How the potential problems identified were addressed:
    a. Domestic

b. International

18. If it was abandoned, in which year and why was it abandoned?
19. On the pro-cyclical revenue patterns: How is the issue dealt with? Will surpluses be refunded? Treatment in start-up and winding-up phase of a business and the CFT – are there any protective measures for government if a start-up does not result in any income in the future? Or is the Government's "share" in the business lost then?
20. Is immediate expensing considered a deductible cost under double tax treaties? Exactly how is it handle in practice? (Concrete example of problems/court cases/disputes or discussions with other states.)
21. Treatment of financial expenditure in R-based (and vise-versa)
    In an R-based CFT there is a potential risk of shifting real income to financial income. Are there measures to deal with this? How is the R-base defined when there is a risk of shifting?

Motivation(s) for implementation? (in detail)

Effects of the tax? (in detail)

Were the effects what could be expected?

Year in which the tax was abandoned, if applicable?

Reasons for maintaining the tax?/ Reasons for abondoning the tax? (in detail)

Criticised aspects ? (In detail)

The following are features resulting from the theoretical base of a CFT:

1. No distinction between debt/equity, as all Financial flows (i.e. rent payments, equity distribution and equity contributions) are included or excluded
2. Immediate expensing of all investments/acquisitions

In addition, as a result of the CFT system (i.e. levying on net cash-flow rather than income):

3. the tax point in a CFT results in neutrality between present and deferred consumption (and the fact that a CFT is inflation proof is a consequence of the tax point as well)

4. administrative simplicity arises (as there is no need to calculate depreciation/trading stock and so on).

To what extent 1 and 2 were the main reasons behind a reform in your country, and what role did 3 and 4 play?

How did the systems actually work in relation to 1 to 4?
Did really 3 and 4 follow from the implementation of a CFT?
Other comments ?

Was the tax system discussed/ implemented in your country based on the academic model of such a tax or was it developed around an existing issue as a solution?

Annex 2 - Individual papers[159]

In the following we have analysed for the purpose of the study whether the reports address and discuss essential features of a CFT under the varicose types. The analyses is by no means exhaustive and should serve as a high level orientation only.

A.2.1 The Institute for Fiscal Studies, The Structure and Reform of Direct Taxation, Meade Report, 1978

Summary

This UK paper discusses possible bases for the taxation of corporations, including such bases as turnover, the value of total assets, etc.

Objectives

Discusses 3 types of "flow-of-funds base" (R-base, R+F-bases and S-base) as an alternative to corporate income tax. Identifies various merits (simplicity, familiarity and flexibility) and problems (avoidance and transition). Special attention for financial institutions.

Indicates that R+F-base system may have the merit from a transition and familiarity point of view (although administrative simplicity is lower).

According to the report, it seems likely that both the R-and S-bases would raise no less and perhaps more revenue than the corporate tax systems available in the past.

Best policy approach would perhaps be to approach the S-base gradually by the indirect way of a tax-inclusive rate on [(R-R)] + [F-F)]. On completion of that indirect route, the system might thereafter for administrative simplicity be operated without any upheaval as a tax-exclusive rate on (S-S), provided that some means could then be found for continuing the solution of the problem of double tax relief.

Motivations

Motivations	R-base	R+F-base	S-base
Foster investment	✔	✔	✔
Neutrality between debt and equity	✔	✔	✔
Tax base and tax revenue	✔	✔	✔
Limit tax optimization and transfer pricing (destination based)			
Compliance and administrative simplicity	✔		✔

[159] This list is not exhaustive - work is still in progress.

Neutrality between present and future investment	✔	✔	✔

Limits

	R-base	R+F-base	S-base
Tax creditability			
Transitional arrangements	✔	✔	✔
Problems of avoidance	✔	✔	✔
Anticipation effects			
Silent partner	✔		✔
Tax exhaustion			

A.2.2 The Cash Flow Corporate Income Tax, King, 1987

Summary
Discusses the economic rationales of the advantages of cash-flow tax over CIT

Objectives
Discusses cash-flow tax as an alternative to corporate income tax that has the following drawbacks

- distortion to investment
- instituting bias in financial policy in favour of debt financing
- leaking of revenue from financial sector tax liability, whom profit are harder to collect

Motivations

Motivations	R-base	R+F-base	S-base
Foster investment	✔	✔	✔
Neutrality between debt and equity	✔	✔	✔
Tax base and tax revenue	✔	✔	✔
Limit tax optimization and transfer pricing	✔	✔	✔
Compliance and administrative simplicity	✔	✔	✔

Neutrality between present and future investment	✔	✔	✔

Limits

Limits	R-base	R+F-base	S-base
Tax creditability			
Transitional arrangements	✔	✔	✔
Anticipation effects	✔	✔	✔
Silent partner	✔	✔	✔
Tax exhaustion	✔	✔	✔

A.2.3 Cash-flow or Income? The Choice of Base for Company Taxation, Mintz & Seade, 1989

Summary

Focuses on the difficulties concerning administrative complexities, coordination with international taxes and transition problems that arise when implementing a cash-flow tax.

Objectives

Focuses on the issues which arise in implementation of cash-flow tax, in particular their practical problems comparing to CIT

- Administrative issues
- International issue
- Transition issue

Motivations

Motivations	R-base	R+F-base	S-base
Foster investment	✔	✔	✔
Neutrality between debt and equity	✔	✔	✔
Tax base and tax revenue			
Limit tax optimization and transfer pricing	✔	✔	✔
Compliance and administrative simplicity	✔	✔	✔
Neutrality between present and future investment			

Limits

Limits	R-base	R+F-base	S-base
Tax creditability	✔	✔	✔
Transitional arrangements	✔	✔	✔
Anticipation effects			
Silent partner			
Tax exhaustion	✔	✔	✔

Points of attention on issues:

R, R+F, S-base cash-flow tax

Lack of precedent and experiences.

Immediate expensing: gives rise to evasion opportunity.

Not compatible with personal tax: a tax on consumption requires that tax bases at the personal and company levels are analogous from the outset. Need for appropriate credit arrangement.

New form of transfer-pricing: for example:

- A firm with no taxes after a large investment and another one can engage in transfer pricing to boost the non-taxable revenue of the former.
- A firm can invest today and enjoy a tax-free status for a while, and then dissolve and sell to a tax exempt firm

International coordination: creditability of foreign investment

A.2.4 Cash-Flow Taxation of Financial Services, Merrill and Edwards, 1996

Summary
Describes the way cash-flow tax can be used to tax financial services, and their specific issue.

Objectives
Analyses how cash-flow tax can be apply to financial sector specifically.

Projections of simulation of cash-flow tax for liability of banks, insurance and securities companies, show that they would enjoy a substantial tax cut.

Motivations

Motivations	R+F-base
Foster investment	✔
Neutrality between debt and equity	✔

Tax base and tax revenue	✔
Limit tax optimization and transfer pricing (destination based)	
Compliance and administrative simplicity	
Neutrality between present and future investment	

Points of attention on advantages:

R+F-base cash-flow tax
Allows the taxation of financial sector, which would collect substantial revenue for governments.
Projections of R+F –cash-flow tax applied to business sector in United States between 1992-94 show that it would approximately generate the same amount of revenue as with the income tax.
Develops alternatives of R+F CFT: truncated CFT, “alternative” Cash-flow method.

Limits

Limits	R+F-base
Tax creditability	
Transitional arrangements	✔
Anticipation effects	
Silent partner	
Tax exhaustion	

Points of attention on issues:

R+F-base cash-flow tax
Strain on liquidity due to the imposition of borrowed funds.

Tax Deferral Opportunity: by issuing debt and purchasing financial assets companies can indefinitely defer payment of tax.

Mutual companies (mutual funds, credit unions, mutual savings and loan) have often the specificity that their customers are also shareholders. Cash-flow tax has to differentiate payments between organizations and its owners that are customer transactions from those which are shareholder transactions. This need to differentiate administrative complexities and opportunities for information manipulations.

A.2.5 Taxation of Financial Services under a Value-Added Tax: applying the Cash-Flow Approach, Poddar & English, 1997

Summary
Describes how to apply a cash-flow VAT to financial services and its main difficulties.

Objectives
VAT is not fitted to taxation of financial services, a solution is to use VAT and to apply a cash-flow tax method to financial transactions.

Motivations

Motivations	R+F-base + VAT
Foster investment	✔
Neutrality between debt and equity	✔
Tax base and tax revenue	
Limit tax optimization and transfer pricing (destination based)	✔
Compliance and administrative simplicity	
Neutrality between present and future investment	✔

Limits
Transition effects : would value-added earned prior to change are taxed at old rate, and after at a new rate?
After the tax change, a borrower could receive credit for repayment of a loan, without having paid tax on the cash inflows.

A.2.6 The Economic Case for Foreign Tax Credits for Cash-Flow Taxes, McLure and Zodrow, 1998

Summary
Presents the economic case for granting creditability for cash-flow taxes in international context.

Objectives
Presents the effects of consumption-based direct taxes that are considered as better as CIT:

- "Consumed income" -cash-flow tax: Interest expense are still deductible but purchase of depreciable assets are expensed (rather the depreciated).
- "Yield exemption" cash-flow tax: Debt is neither taxable nor deductible debt transactions have no consequences. Depreciable assets are expensed. Negative cash flow are carried forward with interest.

Presents the risk of tax creditability: no other country may not allow its taxpayer credits against their domestic tax liability for cash-flow tax paid in other country.

Bolivia encounters this issue with United States when it thought of implementing a cash-flow tax: the IRS (internal revenue service) of United States was not convinced that a Bolivian cash-flow tax was eligible for the foreign tax credits.
Motivations

Motivations	"Consumed-income" cash-flow tax	"Yield exemption" cash-flow tax
Foster investment	✔	✔
Neutrality between debt and equity	✔	✔
Tax base and tax revenue		
Limit tax optimization and transfer pricing (destination based)		
Compliance and administrative simplicity		
Neutrality between present and future investment		

Points of attention on advantages:

R, R+F, S-base cash-flow tax

There are numerous reasons why cash-flow tax should be considered as eligible for foreign tax credit (FTC) that were not advocated in 1994 for the Bolivian case

- An income tax that applies to normal and above-normal returns of capital (it is the case for cash-flow tax) can be eligible for FTC.
- FTC is supposed to be only for taxes that have predominant character of an income tax. Some income taxes were declared eligible for FTC and they allow generous deduction and credit allowance. Cash-flow tax may appear to be less generous, and to be more similar to an income tax than those income taxes.
- FTC is allowed for excess profit taxes, cash-flow tax is one of them.

Limits

Limits	R-base	R+F-base	S-base
Tax creditability	✔	✔	✔
Transitional arrangements			
Anticipation effects			
Silent partner			
Tax exhaustion			

Points of attention on issues:

R, R+F, S-base cash-flow tax

US tax law grants a credit only for foreign income taxes. Creditability can also be refused to cash-flow taxes based on the argument that government is a "silent partner".

A.2.7 Generalized Cash-Flow Taxation, Auerbach & Bradford, 2001

Summary
Describes a new form of a tax that combines elements of accrual based capital income tax and of traditional cash-flow tax.

Objectives
Cash-flow tax as a solution to the flexibility of financial transactions that are considered as "capital income" as well as business income that has created tax optimization opportunity.

Another solution is a generalized cash-flow tax: it taxes only cash-flow, but unlike simple cash-flow tax, the tax assessment levied depends on the CF date and the effective capital income tax the government is willing to impose.

Motivations

Motivations	Cash-flow tax	Generalized cash-flow tax
Foster investment	✔	✔
Neutrality between debt and equity	✔	✔
Tax base and tax revenue		
Limit tax optimization and transfer pricing (destination based)	✔	✔
Compliance and administrative simplicity	✔	✔
Neutrality between present and future investment	✔	✔

A.2.8 The X Tax in the World Economy, Bradford, 2003

Summary
Describes the advantages of the X tax for taxing international business income: efficiency, equity and administrative characteristics. Discuss its different design: destination or origin based.

Objectives
The X tax is another alternative to alleviate the complexities and avoidance of CIT: it consists basically on a business tax (as for R-base cash-flow tax) with a deduction of payment to workers and a compensation tax.

It can be set origin or destination based

- Destination based: settles the issue of transfer pricing, but hard to set, need for monitor of the flow of goods or service across borders.
- Origin based: "tourism problem" remains, but avoids transition effects associated with introduction of the tax and tax rate changes.

Suggest rules for cross-border transaction that would eliminate transfer-pricing problem in an origin based system.

Motivations

Motivations	R-base	X Tax
Foster investment	✔	✔
Neutrality between debt and equity	✔	✔
Tax base and tax revenue		
Limit tax optimization and transfer pricing (destination based)	✔	✔
Compliance and administrative simplicity	✔	✔
Neutrality between present and future investment	✔	✔

Limits

Limits	R-base	X Tax
Tax creditability	✔	✔
Transitional arrangements	✔	✔
Anticipation effects		
Silent partner		
Tax exhaustion		

Points of attention on issues:

R-base cash-flow tax
Tourism problem: for consumers, destination based X tax creates an incentive to locate their consumption in the country with the lowest tax rate.

Monitoring in particular shifting to a destination based with border monitoring while treatment if international business is essentially on a origin basis, and treatment of old capital.

X-Tax
Non-neutral to labour supply: positive wedge between social effort of an increment effort and the amount received by the supplier of that effort.

A.2.9 The Corporate Income Tax: International Trends and Options for Fundamental Reform, Devereux and Sorensen, 2006

Summary
Discuss the future of the corporate income tax in an integrating world economy, and alternatives to CIT among which cash-flow tax.

Objectives
Asset the advantages/disadvantages of destination- or source- based taxation over CIT.

Motivations

Motivations	R-base	R+F-base / S-base
Foster investment	✔	✔
Neutrality between debt and equity	✔	✔
Tax base and tax revenue		
Limit tax optimization and transfer pricing (destination based)	✔	✔
Compliance and administrative simplicity		
Neutrality between present and future investment		

Points of attention on advantages:

Limits

Limits	R-base	R+F-base
Tax creditability		
Transitional arrangements		
Anticipation effects		
Silent partner		
Tax exhaustion		

Points of attention on issues:

R-base cash-flow tax
Destination-based:

- Integrated companies with different activities in different locations may have difficulties to allocate the costs and sales. It could leave multinationals with a large scope for base shifting.
- Current international law only allows imposition of local corporation firms with a physical presence in the local jurisdiction, but destination-based cash-flow tax would levy a tax on foreign companies serving the market from abroad.
- A VAT-type destination based cash-flow tax, equal to the current VAT base minus the labour cost, could be more easily implemented because of the current statue of VAT in international tax law.

- Special transition problem: domestic currency price on export will fall, adjustments and frictions to restore price equilibrium in domestic and foreign product market.

A.2.10 A Superior Hybrid Cash-Flow Tax on Corporations, Howell H. Zee, 2006

Summary
Discusses the merits and limitation of R-base cash-flow tax, and R+F/S-base cash-flow tax compared to CIT and then explores the motivation for another option, an hybrid cash-flow tax that taxes only excess corporate profits and treat real and financial transactions neutrally.

Objectives
Cash-flow tax considered: R-base cash-flow tax, S-base cash-flow tax and hybrid cash-flow tax.

Definition of hybrid cash-flow tax: an S-base cash-flow tax modified with:
- replacing of expensing of fixed assets with normal depreciation allowances,
- carrying forward of undepreciated value of fixed assets with interest at opportunity cost of capital.

Motivations

Motivations	R-base	R+F-base	S-base	Hybrid
Foster investment	✔	✔	✔	✔
Neutrality between debt and equity	✔	✔	✔	✔
Tax base and tax revenue				
Limit tax optimization and transfer pricing (destination based)	✔	✔		✔
Compliance and administrative simplicity	✔	✔	✔	✔
Neutrality between present and future investment				

Points of attention:

Hybrid cash-flow tax
Zero marginal effective tax rate is obtained since only returns yield by depreciable fixed assets in excess of the interest rate would results as taxable profits. Tax burden does not affect normal return of equity and does not affect investment at the margins. Limits revenue risk for government: fixed assets are not expensed so no exposure to private sector investment risk. Revenue is less volatile.

Limits the transitional complications of reforming CIT: Interest expenses are still deductible. Tax treatment of fixed asset represents a small difference from CIT.

Limits

Limits	R-base	R+F-base /S-base
Tax creditability		
Transitional arrangements	✔	✔
Anticipation effects		
Silent partner and revenue risk	✔	✔
Tax exhaustion		

Points of attention on issues:

R-base cash-flow tax
Administration must still distinguish real from financial transactions (since it taxes real transactions only) which may inject non-neutrality in the system, and new administrative complexity

New form of tax avoidance may appear: disguise of real transaction (purchases &sales) as financial transactions (interest).

When:
- the tax credit for immediate expensing is granting in the period of investment (instead of carried forward with interest to the period when benefits are raised) and the investor has access to debt financing,
- the rate of return of an investment under cash-flow tax can actually exceed the rate of return of an investment in a no tax environment.

S-base cash-flow tax
Revenue could be limited if profits are retained rather than distributed as dividends.

R, R+F, S-base cash-flow tax
Revenue loss compared with CIT because of narrowing of the tax base when cash-flows are considered instead of corporate income.

A.2.11 Consumption-Based Direct Taxes: A Guided Tour of the Amusement Park, McLure and Zodrow, 2007

Summary
Analyses numerous attempts to implement various forms of consumption –based taxation all over the world.

Objectives
Concentrates on the issues of simplicity in administration and compliance and the international aspects of consumption taxes in implantation of consumption-based direct taxes.

Motivations

Motivations	Consumption-based direct taxes (R, R+F, X-Tax, Flat Tax)
Foster investment	
Neutrality between debt and equity	
Tax base and tax revenue	
Limit tax optimization and transfer pricing (destination based)	✔
Compliance and administrative simplicity	✔
Neutrality between present and future investment	✔

Limits

Limits	Consumption-based direct taxes (R, R+F, X-Tax, Flat Tax)
Tax creditability	✔
Transitional arrangements	✔
Anticipation effects	
Silent partner	
Tax exhaustion	

Points of attention

Describes existing countries experience of implementation of destination-based taxed all over the world.

In 1980, Jamaica halted its tax reform project at a primitive stage.

United States Treasury I in 1983, including consumption tax treatment of many pension plans, in a R+F-based plan: it was not finally proposed for the reform plan because of

- Treasury staff feel that it seems bequest would probably not treated as consumption tax, the outcome will be highly inequitable
- International aspects: adopting a consumption tax while other trading partners continue to tax income will create a variety of opportunities of tax avoidance, evasion, deferral
- Enacting a consumption tax would mean that all foreign tax treaties would have to be renegotiated, and existing provisions for relieving the double taxation of foreign source income would have to be revisited
- Transition effects

Colombia: justifiably halted implementation in 1986: examined R and R+F models, but the project did not examine the issue of creditability. Colombia finally chose a system of inflation adjustment.

Bolivia: halted implementation, but this is less justified than in the case of Colombia. Bolivia was the ideal place to introduce a destination based direct tax:

- No corporate tax so it would have raised more revenue for the State

- Administrative compliance would also then have been simpler
- Their VAT system was one of the most straight forward among the existing VAT systems in developing countries (few exemptions, only one rate)

Suggests a hybrid destination-based tax.

A.2.12 "Cash-Flow Taxation: Pros and Cons", P. Panteghini, 2007

Summary
Theoretical pros and cons of cash-flow tax, analysis of recent examples of tax reform with a US CBIT and Italian IRAP.

Objectives
Pros and cons of cash-flow tax.

Motivations

Motivations	R-base	R+F-base	S-base
Foster investment	✔	✔	✔
Neutrality between debt and equity			
Tax base and tax revenue	✔	✔	✔
Limit tax optimization and transfer pricing (destination based)			
Compliance and administrative simplicity	✔	✔	✔
Neutrality between present and future investment			

Limits

Limits	R-base	R+F-base	S-base
Tax creditability	✔	✔	✔
Transitional arrangements	✔	✔	✔
Anticipation effects			
Silent partner			
Tax exhaustion	✔	✔	✔

Points of attention on issues:

R, R+F, S-base cash-flow tax
Tax coordination: if a cash-flow tax is implemented in a single country, tax avoiding practice could appear; taxpayers could shift income where the taxation is the lowest.

Volatility of revenue. Pro-cyclical: revenue drops while GDP rises, and rises in recession. Under recession it can have very negative consequences.

Revenue loss: U shaped distributional effects of the net gain for taxpayers. The highest and the lowest deciles have the largest gains.

A.2.13 "Taxing Corporate Income", Auerbach, Devereux and Simpson, 2008

Summary

Discusses the different possibilities of design of taxation of corporate income. Discussion of the alternatives R–cash-flow tax , R+F–cash-flow tax, S – cash-flow tax , ACE and CBIT. Focus on their destination basis designs.

Objectives

Discusses the different system of taxation of corporate income, among which R, R+F and S-base cash-flow tax, as well as their optimal properties in closed or open economies.

Describes the corporation tax system in UK and reforms of the structure made since the Meade report.

Discusses the implication of increased capital mobility and asymmetric treatment of debt and equity and how tax system may affect the firm organizational form.

Motivations

Motivations	R-base	R+F-base	S-base
Foster investment	✔	✔	✔
Neutrality between debt and equity	✔	✔	✔
Tax base and tax revenue			
Limit tax optimization and transfer pricing (destination based)	✔	✔	✔
Compliance and administrative simplicity	✔	✔	✔
Neutrality between present and future investment			

Points of attention on advantages:

R+F-base cash-flow tax

Financial returns are taxed, they are more and more important in our economies.

Limits

Limits	R-base	R+F-base	S-base
Tax creditability	✔	✔	✔
Transitional arrangements	✔	✔	✔
Anticipation effects			
Silent partner	✔	✔	✔
Tax exhaustion			

Points of attention on issues:

R-base cash-flow tax
Companies that provide customers with financial and real products have incentive to overstate their profit from financial services and understate their profit from real services.

Return of financial companies is not taxed.

R+F-base cash-flow tax
Financial transactions are not fitted for a destination-based taxation. If most of the resident financial companies realize most of its activities internationally (financial transactions in located in other countries) as it is the case in UK, this tax may have a negative impact on revenue. Indeed R+F cash-flow tax would raise only revenue on lending within the country, which represented a small part of real activity.

R, R+F, S-base cash-flow tax

The direction in which the tax base moves is not clear. Depreciation allowance disappears, and interests are non-deductible, but immediate expensing of investments cost may broaden the tax base. The cost of reforming would then depend on economic conditions: it would generate more revenue if implemented when:

- Investment is low
- Nominal interest rate are high
- The more companies use debt.

A.2.14 Designing and Implementing a Destination-Based Corporate Tax, Devereux and de la Feria, 2014

Summary
Discusses legal and practical issue of implementing a destination-based cash-flow tax.

Objectives
Discusses the implementation issues of a destination-based cash-flow tax, draw on experiences of VAT system.

International coordination is a condition sine qua none for implementation of a destination based cash-flow tax.

Motivations

Motivations	R-base	R+F-base	S-base
Foster investment	✔	✔	✔
Neutrality between debt and equity			
Tax base and tax revenue			
Limit tax optimization and transfer pricing (destination based)	✔	✔	✔
Compliance and administrative simplicity			
Neutrality between present and future investment			

Annex 3 - Brazil

ANNEX I TO *LEI COMPLEMENTAR* N. 123/2006 - Tax rates and Partition of the "Simples Nacional"– Commerce

Gross receipts in 12 months (BRL)	Tax rate	IRPJ	CSLL	COFINS	PIS/PASEP	CPP	ICMS
Up to 180,000.00	4.00%	0.00%	0.00%	0.00%	0.00%	2.75%	1.25%
From 180,000.01 to 360,000.00	5.47%	0.00%	0.00%	0.86%	0.00%	2.75%	1.86%
From 360,000.01 to 540,000.00	6.84%	0.27%	0.31%	0.95%	0.23%	2.75%	2.33%
From 540,000.01 to 720,000.00	7.54%	0.35%	0.35%	1.04%	0.25%	2.99%	2.56%
From 720,000.01 to 900,000.00	7.60%	0.35%	0.35%	1.05%	0.25%	3.02%	2.58%
From 900,000.01 to 1,080,000.00	8.28%	0.38%	0.38%	1.15%	0.27%	3.28%	2.82%
From 1,080,000.01 to 1,260,000.00	8.36%	0.39%	0.39%	1.16%	0.28%	3.30%	2.84%
From 1,260,000.01 to 1,440,000.00	8.45%	0.39%	0.39%	1.17%	0.28%	3.35%	2.87%
From 1,440,000.01 to 1,620,000.00	9.03%	0.42%	0.42%	1.25%	0.30%	3.57%	3.07%
From 1,620,000.01 to 1,800,000.00	9.12%	0.43%	0.43%	1.26%	0.30%	3.60%	3.10%
From 1,800,000.01 to 1,980,000.00	9.95%	0.46%	0.46%	1.38%	0.33%	3.94%	3.38%
From 1,980,000.01 to 2,160,000.00	10.04%	0.46%	0.46%	1.39%	0.33%	3.99%	3.41%
From 2,160,000.01 to 2,340,000.00	10.13%	0.47%	0.47%	1.40%	0.33%	4.01%	3.45%
From 2,340,000.01 to 2,520,000.00	10.23%	0.47%	0.47%	1.42%	0.34%	4.05%	3.48%
From 2,520,000.01 to 2,700,000.00	10.32%	0.48%	0.48%	1.43%	0.34%	4.08%	3.51%
From 2,700,000.01 to 2,880,000.00	11.23%	0.52%	0.52%	1.56%	0.37%	4.44%	3.82%
From 2,880,000.01 to 3,060,000.00	11.32%	0.52%	0.52%	1.57%	0.37%	4.49%	3.85%

From 3,060,000.01 to 3,240,000.00	11.42%	0.53%	0.53%	1.58%	0.38%	4.52%	3.88%
From 3,240,000.01 to 3,420,000.00	11.51%	0.53%	0.53%	1.60%	0.38%	4.56%	3.91%
From 3,420,000.01 to 3,600,000.00	11.61%	0.54%	0.54%	1.60%	0.38%	4.60%	3.95%

ANNEX II TO *LEI COMPLEMENTAR* N. 123/2006 - Tax rates and Partition of the "Simples Nacional"– Industry

Gross receipts in 12 months (BRL)	Tax rate	IRPJ	CSLL	COFINS	PIS/PASEP	CPP	ICMS	IPI
Up to 180,000.00	4.50%	0.00%	0.00%	0.00%	0.00%	2.75%	1.25%	0.50%
From 180,000.01 to 360,000.00	5.97%	0.00%	0.00%	0.86%	0.00%	2.75%	1.86%	0.50%
From 360,000.01 to 540,000.00	7.34%	0.27%	0.31%	0.95%	0.23%	2.75%	2.33%	0.50%
From 540,000.01 to 720,000.00	8.04%	0.35%	0.35%	1.04%	0.25%	2.99%	2.56%	0.50%
From 720,000.01 to 900,000.00	8.10%	0.35%	0.35%	1.05%	0.25%	3.02%	2.58%	0.50%
From 900,000.01 to 1,080,000.00	8.78%	0.38%	0.38%	1.15%	0.27%	3.28%	2.82%	0.50%
From 1,080,000.01 to 1,260,000.00	8.86%	0.39%	0.39%	1.16%	0.28%	3.30%	2.84%	0.50%
From 1,260,000.01 to 1,440,000.00	8.95%	0.39%	0.39%	1.17%	0.28%	3.35%	2.87%	0.50%
From 1,440,000.01 to 1,620,000.00	9.53%	0.42%	0.42%	1.25%	0.30%	3.57%	3.07%	0.50%
From 1,620,000.01 to 1,800.000.00	9.62%	0.42%	0.42%	1.26%	0.30%	3.62%	3.10%	0.50%
From 1,800,000.01 to 1,980,000.00	10.45%	0.46%	0.46%	1.38%	0.33%	3.94%	3.38%	0.50%
From 1,980,000.01 to 2,160,000.00	10.54%	0.46%	0.46%	1.39%	0.33%	3.99%	3.41%	0.50%
From 2,160,000.01 to 2,340,000.00	10.63%	0.47%	0.47%	1.40%	0.33%	4.01%	3.45%	0.50%
From 2,340,000.01 to 2,520,000.00	10.73%	0.47%	0.47%	1.42%	0.34%	4.05%	3.48%	0.50%
From 2,520,000.01 to 2,700,000.00	10.82%	0.48%	0.48%	1.43%	0.34%	4.08%	3.51%	0.50%
From 2,700,000.01 to 2,880,000.00	11.73%	0.52%	0.52%	1.56%	0.37%	4.44%	3.82%	0.50%
From 2,880,000.01 to 3,060,000.00	11.82%	0.52%	0.52%	1.57%	0.37%	4.49%	3.85%	0.50%
From 3,060,000.01 to 3,240,000.00	11.92%	0.53%	0.53%	1.58%	0.38%	4.52%	3.88%	0.50%
From 3,240,000.01 to 3,420,000.00	12.01%	0.53%	0.53%	1.60%	0.38%	4.56%	3.91%	0.50%
From 3,420,000.01 to 3,600,000.00	12.11%	0.54%	0.54%	1.60%	0.38%	4.60%	3.95%	0.50%

ANNEX III TO *LEI COMPLEMENTAR* N. 123/2006 - Tax rates and Partition of the "Simples Nacional" –- Receipts from renting of movable goods and from the provision of services not referred to in the §§ 5º-C and 5º-D of art. 18 of *Lei Complementar* 123/2006

Gross receipts in 12 months (BRL)	Tax rate	IRPJ	CSLL	COFINS	PIS/PASEP	CPP	ISS
Up to 180,000.00	6.00%	0.00%	0.00%	0.00%	0.00%	4.00%	2.00%
From 180,000.01 to 360,000.00	8.21%	0.00%	0.00%	1.42%	0.00%	4.00%	2.79%
From 360,000.01 to 540,000.00	10.26%	0.48%	0.43%	1.43%	0.35%	4.07%	3.50%
From 540,000.01 to 720,000.00	11.31%	0.53%	0.53%	1.56%	0.38%	4.47%	3.84%
From 720,000.01 to 900,000.00	11.40%	0.53%	0.52%	1.58%	0.38%	4.52%	3.87%
From 900,000.01 to 1,080,000.00	12.42%	0.57%	0.57%	1.73%	0.40%	4.92%	4.23%
From 1,080,000.01 to 1,260,000.00	12.54%	0.59%	0.56%	1.74%	0.42%	4.97%	4.26%
From 1,260,000.01 to 1,440,000.00	12.68%	0.59%	0.57%	1.76%	0.42%	5.03%	4.31%
From 1,440,000.01 to 1,620,000.00	13.55%	0.63%	0.61%	1.88%	0.45%	5.37%	4.61%
From 1,620,000.01 to 1,800,000.00	13.68%	0.63%	0.64%	1.89%	0.45%	5.42%	4.65%
From 1,800,000.01 a 1,980,000.00	14.93%	0.69%	0.69%	2.07%	0.50%	5.98%	5.00%
From 1,980,000.01 to 2,160,000.00	15.06%	0.69%	0.69%	2.09%	0.50%	6.09%	5.00%
From 2,160,000.01 to 2,340,000.00	15.20%	0.71%	0.70%	2.10%	0.50%	6.19%	5.00%
From 2,340,000.01 to 2,520,000.00	15.35%	0.71%	0.70%	2.13%	0.51%	6.30%	5.00%
From 2,520,000.01 to 2,700,000.00	15.48%	0.72%	0.70%	2.15%	0.51%	6.40%	5.00%
From 2,700,000.01 to 2,880,000.00	16.85%	0.78%	0.76%	2.34%	0.56%	7.41%	5.00%
From 2,880,000.01 to 3,060,000.00	16.98%	0.78%	0.78%	2.36%	0.56%	7.50%	5.00%
From 3,060,000.01 to 3,240,000.00	17.13%	0.80%	0.79%	2.37%	0.57%	7.60%	5.00%
From 3.240.000,01 to 3,420,000.00	17.27%	0.80%	0.79%	2.40%	0.57%	7.71%	5.00%
From 3.420.000,01 to 3,600,000.00	17.42%	0.81%	0.79%	2.42%	0.57%	7.83%	5.00%

ANNEX IV TO *LEI COMPLEMENTAR* N. 123/2006 - Tax rates and Partition of the "Simples Nacional" –- Receipts from the provision of services referred to in § 5º-C of art. 18 of *Lei Complementar* N. 123/2006

Gross receipts in 12 months (BRL)	Tax rate	IRPJ	CSLL	COFINS	PIS/PASEP	ISS
Up to180,000.00	4.50%	0.00%	1.22%	1.28%	0.00%	2.00%
From180,000.01 to 360,000.00	6.54%	0.00%	1.84%	1.91%	0.00%	2.79%
From 360,000.01 to 540,000.00	7.70%	0.16%	1.85%	1.95%	0.24%	3.50%
From 540,000.01 to 720,000.00	8.49%	0.52%	1.87%	1.99%	0.27%	3.84%
From 720,000.01 to 900,000.00	8.97%	0.89%	1.89%	2.03%	0.29%	3.87%
From 900,000.01 to 1,080,000.00	9.78%	1.25%	1.91%	2.07%	0.32%	4.23%
From 1,080,000.01 to 1,260,000.00	10.26%	1.62%	1.93%	2.11%	0.34%	4.26%
From 1,260,000.01 to 1,440,000.00	10.76%	2.00%	1.95%	2.15%	0.35%	4.31%
From 1,440,000.01 to 1,620,000.00	11.51%	2.37%	1.97%	2.19%	0.37%	4.61%
From 1,620,000.01 to 1,800,000.00	12.00%	2.74%	2.00%	2.23%	0.38%	4.65%
From 1,800,000.01 to 1,980,000.00	12.80%	3.12%	2.01%	2.27%	0.40%	5.00%
From 1,980,000.01 to 2,160,000.00	13.25%	3.49%	2.03%	2.31%	0.42%	5.00%
From 2,160,000.01 to 2,340,000.00	13.70%	3.86%	2.05%	2.35%	0.44%	5.00%
From 2,340,000.01 to 2,520,000.00	14.15%	4.23%	2.07%	2.39%	0.46%	5.00%
From 2,520,000.01 to 2,700,000.00	14.60%	4.60%	2.10%	2.43%	0.47%	5.00%
From 2,700,000.01 to 2,880,000.00	15.05%	4.90%	2.19%	2.47%	0.49%	5.00%
From 2,880,000.01 to 3,060,000.00	15.50%	5.21%	2.27%	2.51%	0.51%	5.00%
From 3,060,000.01 to 3,240,000.00	15.95%	5.51%	2.36%	2.55%	0.53%	5.00%
From 3,240,000.01 to 3,420,000.00	16.40%	5.81%	2.45%	2.59%	0.55%	5.00%
From 3,420,000.01 to 3,600,000.00	16.85%	6.12%	2.53%	2.63%	0.57%	5.00%

ANNEX V TO *LEI COMPLEMENTAR* N. 123/2006 - Tax rates and Partition of the "Simples Nacional" –- Receipts from the provision of services referred to in § 5º-D of art. 18 of *Lei Complementar* N. 123/2006

1) (r) will be determinded according to the following relation:

(r) = Payroll including burdens (in 12 months)

Gross receipts (in 12 months)

2) When (r) corresponds to the intervals of the Table V-A, where "<" means less than, and ">" greater than, "**≤**" means less than or equal to, and "**≥**" means greater than or equal to, the tax rates of the "simples nacional" regarding IRPJ, PIS/Pasep, CSLL, Cofins e CPP correspond to the following:

TABLE V-A

Gross receipts in 12 months (BRL)	(r)<0,10	0,10≤ (r) and (r) < 0,15	0,15≤ (r) and (r) < 0,20	0,20≤ (r) and (r) < 0,25	0,25≤ (r) and (r) < 0,30	0,30≤ (r) and (r) < 0,35	0,35≤ (r) and (r) < 0,40	(r) ≥ 0,40
Up to 180,000.00	17.50%	15.70%	13.70%	11.82%	10.47%	9.97%	8.80%	8.00%
From 180,000.01 to 360,000.00	17.52%	15.75%	13.90%	12.60%	12.33%	10.72%	9.10%	8.48%
From 360,000.01 to 540,000.00	17.55%	15.95%	14.20%	12.90%	12.64%	11.11%	9.58%	9.03%
From 540,000.01 to 720,000.00	17.95%	16.70%	15.00%	13.70%	13.45%	12.00%	10.56%	9.34%
From 720,000.01 to 900,000.00	18.15%	16.95%	15.30%	14.03%	13.53%	12.40%	11.04%	10.06%
From 900,000.01 to 1,080,000.00	18.45%	17.20%	15.40%	14.10%	13.60%	12.60%	11.60%	10.60%
From 1,080,000.01 to 1,260,000.00	18.55%	17.30%	15.50%	14.11%	13.68%	12.68%	11.68%	10.68%
From 1,260,000.01 to 1,440,000.00	18.62%	17.32%	15.60%	14.12%	13.69%	12.69%	11.69%	10.69%
From 1,440,000.01 to 1,620,000.00	18.72%	17.42%	15.70%	14.13%	14.08%	13.08%	12.08%	11.08%
From 1,620,000.01 to 1,800,000.00	18.86%	17.56%	15.80%	14.14%	14.09%	13.09%	12.09%	11.09%
From 1,800,000.01 to 1,980,000.00	18.96%	17.66%	15.90%	14.49%	14.45%	13.61%	12.78%	11.87%
From 1,980,000.01 to 2,160,000.00	19.06%	17.76%	16.00%	14.67%	14.64%	13.89%	13.15%	12.28%
From 2,160,000.01 to 2,340,000.00	19.26%	17.96%	16.20%	14.86%	14.82%	14.17%	13.51%	12.68%
From 2,340,000.01 to 2,520,000.00	19.56%	18.30%	16.50%	15.46%	15.18%	14.61%	14.04%	13.26%
From 2,520,000.01 to 2,700,000.00	20.70%	19.30%	17.45%	16.24%	16.00%	15.52%	15.03%	14.29%
From 2,700,000.01 to 2,880,000.00	21.20%	20.00%	18.20%	16.91%	16.72%	16.32%	15.93%	15.23%
From 2,880,000.01 to 3,060,000.00	21.70%	20.50%	18.70%	17.40%	17.13%	16.82%	16.38%	16.17%
From 3,060,000.01 to 3,240,000.00	22.20%	20.90%	19.10%	17.80%	17.55%	17.22%	16.82%	16.51%

From 3,240,000.01 to 3,420,000.00	22.50%	21.30%	19.50%	18.20%	17.97%	17.44%	17.21%	16.94%
From 3,420,000.01 to 3,600,000.00	22.90%	21.80%	20.00%	18.60%	18.40%	17.85%	17.60%	17.18%

3) To the tax rate of “simples nacional” regarding IRPJ, IRPJ, PIS/Pasep, CSLL, Cofins and CPP determined in the above way shall be added the share corresponding to the ISS that is foreseen in the annex IV of the *Lei Complementar* N. 123/2006.

4) The division of receipts regarding IRPJ, PIS/Pasep, CSLL, Cofins and CPP levied according to this annex will be undertaken on the basis of the parameters defined in the Table V-B, where:

(I) = percentual share destinated to CPP;

(J) = percentual share destinated to IRPJ, calculated after the result of the factor (I);

(K) = percentual share destinated to CSLL, calculated after the result of the factors (I) e (J);

(L) = percentual share destinated to COFINS, calculated after the result of the factors (I), (J) e (K);

(M) = percentual share destinated to the contributions PIS/Pasep, calculated after the result of the factors (I), (J), (K) e (L);

(I) + (J) + (K) + (L) + (M) = 100

N = relation (r) dividided by 0.004, being the result limited to 100;

P = 0.1 divided by therelation (r), being the result limited to 1.

TABLE V-B:

Gross receipts in 12 months (BRL)	CPP	IRPJ	CSLL	COFINS	PIS/PASEP
	I	J	K	L	M
Up to 180,000.00	N x 0.9	0.75 X (100 - I) X P	0,25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 180,000.01 to 360,000.00	N x 0.875	0.75 X (100 - I) X P	0,25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 360,000.01 to 540,000.00	N x 0.85	0.75 X (100 - I) X P	0,25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 540,000.01 to 720,000.00	N x 0.825	0.75 X (100 - I) X P	0,25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 720,000.01 to 900,000.00	N x 0.8	0.75 X (100 - I) X P	0,25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 900,000.01 to 1,080,000.00	N x 0.775	0.75 X (100 - I) X P	0,25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 1,080,000.01 to 1,260,000.00	N x 0.75	0.75 X (100 - I) X P	0,25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 1,260,000.01 to 1,440,000.00	N x 0.725	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 1,440,000.01 to 1,620,000.00	N x 0.7	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 1,620,000.01 to 1,800,000.00	N x	0.75 X	0.25 X	0.75 X	100 - I - J - K - L

Gross receipts in 12 months (BRL)	CPP	IRPJ	CSLL	COFINS	PIS/PASEP
	I	J	K	L	M
	0.675	(100 - I) X P	(100 - I) X P	(100 - I - J - K)	
From 1,800,000.01 to 1,980,000.00	N x 0.65	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 1,980,000.01 to 2,160,000.00	N x 0.625	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 2,160,000.01 to 2,340,000.00	N x 0.6	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 2,340,000.01 to 2,520,000.00	N x 0.575	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 2,520,000.01 to 2,700,000.00	N x 0.55	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 2,700,000.01 to 2,880,000.00	N x 0.525	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 2,880,000.01 to 3,060,000.00	N x 0.5	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 3,060,000.01 to 3,240,000.00	N x 0.475	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 3,240,000.01 to 3,420,000.00	N x 0.45	0.75 X (100 - I) X P	0.25 X (100 - I) X P	0.75 X (100 - I - J - K)	100 - I - J - K - L
From 3,420,000.01 to 3,600,000.00	N x	0.75 X	0.25 X	0.75 X	100 - I - J - K - L

Gross receipts in 12 months (BRL)	CPP	IRPJ	CSLL	COFINS	PIS/PASEP
	I	J	K	L	M
	0.425	(100 - I) X P	(100 - I) X P	(100 - I - J - K)	

ANNEX VI TO *LEI COMPLEMENTAR* N. 123/2006 - Tax rates and Partition of the "Simples Nacional" –- Receipts from the provision of services referred to in § 5º-I of art. 18 of *Lei Complementar* N. 123/2006

1) (r) will be determinded according to the following relation:

(r) = Payroll including burdens (in 12 months)

Gross receipts (in 12 months)

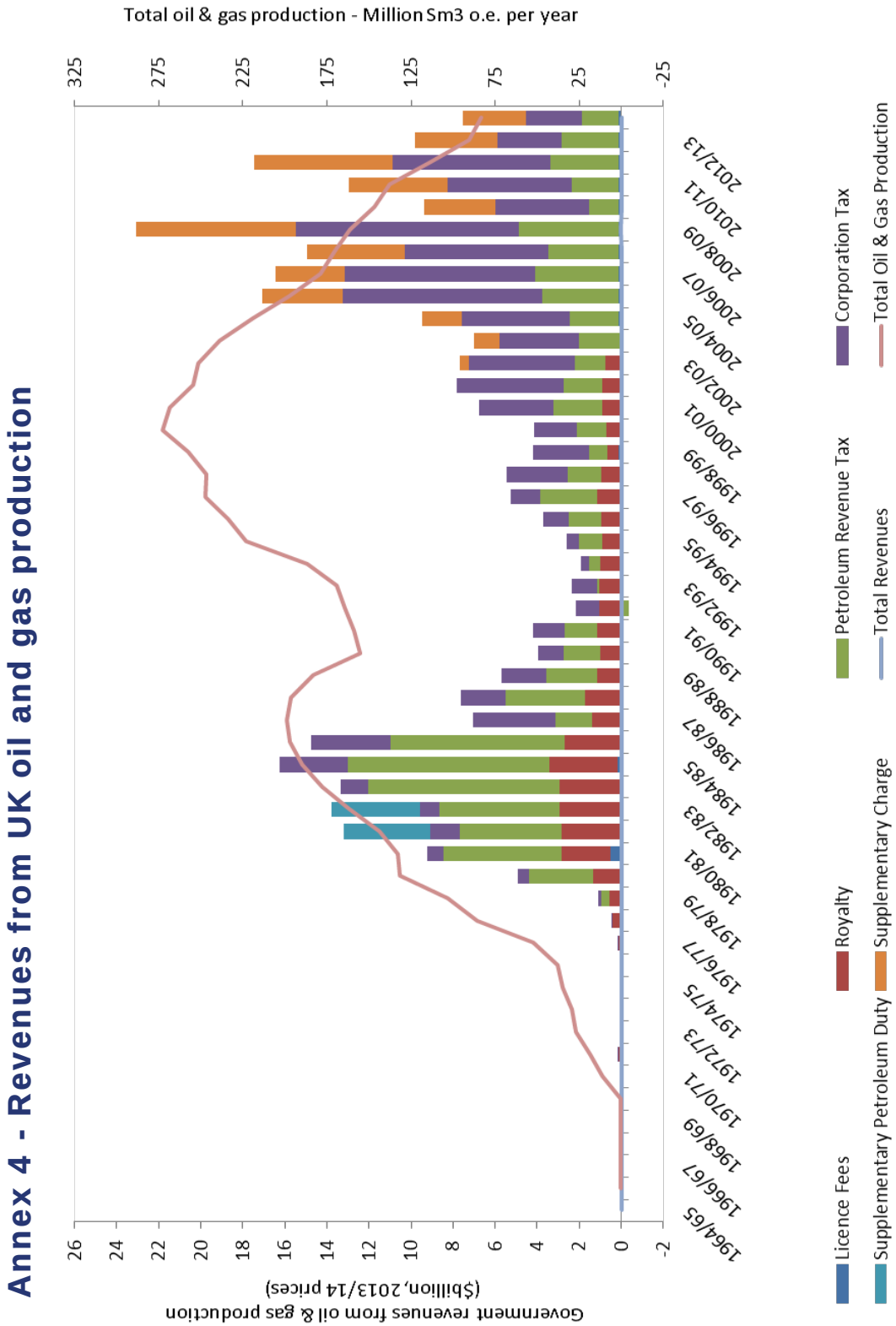
2) The division of receipts regarding IRPJ, PIS/Pasep, CSLL, Cofins and CPP levied according to this annex will be undertaken on the basis of the parameters defined in the Table V-B of annex V of Lei Complementar N. 123/2006.

3) Independently of the result of the relation (r), the tax rates of the "simples nacional" will correspond to the following:

TABLE VI

Gross receipts in 12 months (BRL)	Tax rate	IRPJ, PIS/Pasep, CSLL, Cofins e CPP	ISS
Up to180,000.00	16.93%	14.93%	2.00%
From 180,000.01 to 360,000.00	17.72%	14.93%	2.79%
From 360.000,01 to 540.000,00	18.43%	14.93%	3.50%
From 540,000.01 to 720,000.00	18.77%	14.93%	3.84%
From 720,000.01 to 900,000.00	19.04%	15.17%	3.87%
From 900,000.01 to 1,080,000.00	19.94%	15.71%	4.23%
From 1,080,000.01 to 1,260,000.00	20.34%	16.08%	4.26%
From 1,260,000.01 to 1,440,000.00	20.66%	16.35%	4.31%
From 1,440,000.01 to 1,620,000.00	21.17%	16.56%	4.61%
From 1,620,000.01 to 1,800,000.00	21.38%	16.73%	4.65%
From 1,800,000.01 to 1,980,000.00	21.86%	16.86%	5.00%
From 1,980,000.01 to 2,160,000.00	21.97%	16.97%	5.00%
From 2,160,000.01 to 2,340,000.00	22.06%	17.06%	5.00%
From 2,340,000.01 to 2,520,000.00	22.14%	17.14%	5.00%
From 2,520,000.01 to 2,700,000.00	22.21%	17.21%	5.00%
From 2,700,000.01 to 2,880,000.00	22.21%	17.21%	5.00%
From 2,880,000.01 to 3,060,000.00	22.32%	17.32%	5.00%
From 3,060,000.01 to 3,240,000.00	22.37%	17.37%	5.00%
From 3,240,000.01 to 3,420,000.00	22.41%	17.41%	5.00%
From 3,420,000.01 to 3,600,000.00	22.45%	17.45%	5.00%

Annex 4 - Revenues from UK oil and gas production



Annex 5 – Gross receipts taxes with elements of CFT

A.5.1 Comparison of US state business taxes on gross receipts base

Existing Gross Receipts Taxes

	Delaware Gross Receipts Tax	New Hampshire Business Enterprise Tax	Ohio Commercial Activity Tax (CAT)	Texas Margin Tax	Washington Business & Operation Tax
Tax base	Total gross receipts	Enterprise value	Gross receipts	Taxable margin	Gross receipts
Tax rate	0.1006 to 0.7543%, depending on the business activity	0.75%	0.26%	1.0% (reduced to 0.975% and 0.95% in 2014 and 2015)	0.13 to 3.3%, depending on the business activity
Minimum tax base	Varies by business activity	Gross receipts over $200,000 or enterprise value over $100,000	Gross receipts over $150,000	Gross receipts over $1 million	Gross receipts over $28,000
Exemptions to tax base	No	Yes	Yes	Yes	Yes
Calculation	(Total gross receipts) X (Applicable rate)	(0.75%) X (Enterprise value)	0.26% X (taxable gross receipts - $1 million)	(Gross receipts - selected deduction) X 1.0%	(Gross receipts) X (Applicable rate)
Differences in rate by industry	Yes	No	No	Yes	Yes
Industry exemptions	Yes	Yes	Yes	Yes	Yes
Applies to out-of-state businesses*	No	Yes	Yes	Yes	Yes
FY2013 tax revenue ($ billion)	$0.2	$0.2	$1.5	$4.8	$3.3
Credits against tax liability*	Yes	Yes	Yes	Yes	Yes
Customer or seller responsibility	Seller	Seller	Seller	Seller	Seller
Income sourcing method*	Cost of performance	Cost of performance	Market-sourcing	Market-sourcing	Market-sourcing

*__Applies to out-of-state businesses:__ "Yes" if the tax is imposed on entity's located outside of the state if they meet certain sales thresholds determined by the state. "No" if the tax is only imposed on entities located within the state. __Credits against tax liability:__ "Yes" if the state offers some type of tax credit to reduce the amount of tax owed. "No" if no credits are offered against the tax liability. __Income sourcing method:__ Cost of performance if the state sources sales based on where the service is performed/produced. Market-sourcing if sales are sourced based on where the buyer is or where benefit is received.

Note: New Hampshire's Business Enterprise Tax is an activity tax. The tax base, enterprise value, is based on economic outflows (compensation paid, interest, and dividends) instead of inflows (as the other states listed are).

Some states impose a gross receipts tax on certain industries such as utilities. Additionally, New Jersey imposes a gross receipts tax on petroleum products, and Pennsylvania has a gross receipts tax on Medicaid Managed Care Organizations (MCO) and private bankers. However, Pennsylvania's tax on Medicaid (MCOs) was ruled impermissible by the Office of Inspector General in 2014.

Other states, including Indiana, Michigan, and West Virginia previously had taxes on gross receipts but have since repealed them. Michigan is the most recent state to repeal a gross receipts tax, and details of the Michigan Business Tax are on page four.

Glossary:

1. Gross receipts: total amounts received from all sources during its annual accounting period, without subtracting any costs or expenses.
2. Sales factor: percentage of nationwide sales apportioned to the state and used to determine the share of an entity's profits that can be taxed by a state. Typically, this factor is found by dividing the amount of sales sourced to the state by the entity's total nationwide sales.
3. Two methods are used to determine the amount of sales an entity has to report in one of two ways:
    a. Cost of performance: sales are sourced to the state where the service is performed
    b. Market-sourcing: sales are sourced to the state where the benefit is received

A.5.1.1 Delaware Gross Receipts Tax

- Delaware's Gross Receipts Tax is assessed on total gross receipts, regardless of source.
  - Calculation: (Total gross receipts) X (Applicable rate)
- The tax rate can range from 0.1006% to 0.7543, depending on the business activity.[160]
- The tax is levied on the seller of goods or services.
- There are no deductions for the cost of goods or property sold, labor costs, interest expense, discount paid, delivery costs, state or federal taxes, or any other expenses allowed.
- When determining the gross receipts tax due, most businesses are entitled to an exclusion, which varies depending on the business activity conducted. These exclusions, provided monthly or quarterly, generally start at $100,000 per month and can be as high as $1,250,000.
- Sales factor is determined using cost of performance.
  - Delaware sources all manufacturing sales to Delaware if they were produced there (100% sales factor with cost of performance applied to tangible property).
- Credits against Gross Receipts Tax include:
  - Blue Collar Jobs (BCJ) Credit

[160] Delaware's website lists rates as high as 2.0736% for some industries.

A.5.1.2 Michigan Business Tax

- As of January 1, 2012, Michigan no longer imposes the Michigan Business Tax (MBT).[161]
- The MBT was composed of three parts:
    - Business income tax: a 4.95% tax rate on federal taxable income, as adjusted for MBT and apportioned to Michigan.
    - Modified gross receipts tax: a 0.8% tax on gross receipts minus purchases from other firms, and apportioned to Michigan.
    - Alternative small business tax: a 1.8% rate on adjusted business income.
- Modified gross receipts tax (MGRT)
    - Calculation: (0.8%) X (Gross receipts – purchases from other firms)
    - The MGRT included a cap of $6 million and a 21.99% surcharge on the apportioned business income tax and gross receipts tax before credits.
- Businesses with gross receipts below $350,000 were not subject to the MBT.
- Out-of-state businesses were subject to the MBT if they sourced more than $350,000 of gross receipts to Michigan.
- Certain industries qualified for a reduced rate, including car dealers, construction contractors, self-employed individuals, and partnerships and limited liability companies.
- Michigan used market-sourcing for services and tangible personal property.
- Credits against MBT included:
    - Investment Tax Credit
    - Compensation Credit
    - R&D Credit
    - Industrial Personal Property Tax Credit

[161] The subtraction of purchases from other firms is a characteristic of a value-added tax rather than gross receipts. Michigan previously levied a Single Business Tax that was considered the only approximation of a value-added tax in the US.

A.5.1.3 New Hampshire Business Enterprise Tax

- New Hampshire's Business Enterprise Tax is an activity tax. The tax is assessed on an entity's outflows (enterprise value) instead of inflows (gross receipts).
- 0.75% tax assessed on the enterprise value tax base
  - Calculation: (0.75%) X (Enterprise value)
  - Enterprise value tax base is the sum of all compensation paid or accrued, interest paid or accrued, and dividends paid by the business enterprise, before special adjustments and apportionment.
- Every for-profit and non-profit enterprise or organization engaged in or carrying on any business activity inside New Hampshire must file a Business Enterprise Tax return if total gross business receipts exceed $200,000 or if enterprise value tax base is greater than $100,000.
- Exemptions to the tax base: Dividends received which have previously been included in the payor corporation's or business enterprise's taxable enterprise value tax base subject to the BET and which payor is, at the close of the day on which such dividend is received, a member of the same affiliated group as the corporation or business entity receiving the dividend. Self-employment income that is retained for use in the business enterprise may also be deducted.
- The rate does not vary by industry, although non-profit 501C(3) organizations are not required to file unless they engage in unrelated business activity.
- Sales factor is determined using the cost of performance method of sourcing of service and intangible sales:
  - Tangible sales are not sourced using cost of performance. They are sourced based on delivery.
- Credits against the tax liability include:
  - Credit for Research and Development
  - Coos County Job Creation Tax Credit
  - Education Tax Credit.

A.5.1.4 Ohio Commercial Activity Tax (CAT)

- The CAT applies to all types of businesses (partnerships, LLCs, all types of corporations, service providers such as attorneys and accountants, etc.) with gross receipts of $150,000 per calendar year or more must register for the CAT.
  - Calculation: 0.26% X (Taxable gross receipts - $1 million)
  - There is essentially a $1 million minimum tax base due to the $1 million deduction from gross receipts. However, all entities with taxable gross receipts over $150,000 must register for the CAT. Those entities with taxable gross receipts under $1 million are only responsible for paying the Annual Minimum Tax of $150.
- The CAT does not apply to non-profits, financial institutions paying corporation franchise tax or financial institutions tax, insurance companies paying the insurance premiums tax, some public utilities (excluding electric companies) if those businesses pay specific other Ohio taxes, and most governmental entities.
- Exemptions to the tax base: interest (other than from credit sales), dividends, capital gains, wages reported on W-2, gifts, property receipts if the property is delivered to a location outside OH, and service receipts from sales to out-of-state purchasers or services where the benefit is primarily received outside of OH.
- The tax liability is calculated by (0.26% X (taxable gross receipts - $1 million)).
  - The $1 million exemption is effectively phased-out for entities with taxable gross receipts over $4 million if the Annual Minimum Tax (AMT) is considered.

Taxable gross receipts	AMT	CAT
$1 million or less	$150	N/A
More than $1 Million but less than or equal to $2 Million	$800	0.26% x (Taxable Gross Receipts - $1 Million)
More than $2 Million but less than or equal to $4 Million	$2,100	0.26% x (Taxable Gross Receipts - $1 Million)
More than $4 Million	$2,600	0.26% x (Taxable Gross Receipts - $1 Million)

- CAT applies to out of state businesses if the taxpayer has property in Ohio of at least $50,000; or payroll of at least $50,000; or taxable gross receipts situsedto Ohio are at least $500,000; or 25% of total property or total payroll or total gross receipts is within Ohio.
- Credits against the CAT include:
  - Job creation tax credit, job retention tax credit, credit for qualified research expenses, credit for research and development loan payments, credit for unused franchise tax net operating loss deductions, refundable motion picture tax credit

A.5.1.5 Texas Margin Tax

- Texas' Margin Tax is essentially a hybrid between a gross receipts tax and an income tax.
  - Calculation: (Gross receipts - selected deduction) X 1.0%
- The Margin Tax is a 1.0% tax on an entity's gross receipts minus the selected deduction.
  - In 2014 and 2015, there are temporary permissive rates of 0.975% and 0.95%, respectively.
- Retailers and wholesalers qualify for a reduced tax rate of 0.5%.
  - This rate is reduced to 0.4875% in 2014 and 0.475% in 2015.
- An entity is not required to pay the Margin Tax if the amount of tax computed for the taxable entity is less than $1,000; or the amount of the taxable entity's total revenue from its entire business is less than or equal to $1 million
  - Entities that qualify as passive entities are not subject to the tax, such as professional associations and partnerships
- Entities may deduct the greater of cost of goods sold, compensation, or 30% of total revenue. Certain industries, including Manufacturing, and Oil and Gas, may deduct cost of goods sold.
  - Texas has its own definition for cost of goods sold. For a company to claim this deduction, it must sell goods. Service companies are not eligible.
  - Compensation is capped at $300,000 per employee and includes certain benefits.
  - Thirty percent of total revenues are included as an option for deduction for businesses with low cost of goods sold and/or compensation amounts – such as capital intensive service businesses including transportation or telecommunications.
- Sales factor is determined using the market-sourcing method.
- Credits against Texas Margin Tax include:
  - For reports due on or after January 1, 2014, there is a R&D Credit against the Margin Tax or Sales & Use Tax.
    - Credit is 5% of the difference between the qualified research expenses incurred during the tax period and 50% of the average qualified research expenses incurred during the prior three tax periods.

A.5.1.6 Washington Business & Operation Tax

- Washington's Business & Operation (B&O) Tax is assessed on gross receipts, and the rate varies depending on the business activity. The minimum rate is 0.13 on businesses classified as parimutuel wagering, and the maximum rate is 3.3%on radioactive waste disposal companies.
  - Calculation: (Gross receipts) X (Applicable rate)
  - Major Business & Operation Tax classifications:

Classification	Rate
Retailing	0.00471
Wholesaling	0.00484
Manufacturing	0.00484
Service & Other Activities	0.015

- Firms whose annual gross income does not exceed $28,000 are not required to file tax Business and Operations tax returns if they have no other state excise taxes to report. However, any business that collects any retail sales tax must file, regardless of the amount of sales tax.
  - A small business tax credit (RCW 82.04.4451) relieves a major portion of B&O tax liability for many small firms.
  - Additionally, farming, non-profit and social service organizations, government, financial (state and federally chartered credit unions), are exempt from the B&O tax. There are also misc. exemptions such as sale or rental of real estate other than lodging and small timber harvesters whose gross income is less than $100,000 per year.
- Advancements/reimbursements, bad debts, interstate and foreign sales, and returns/allowances/cash discounts are the main exemptions from the tax base allowed, although other more specific exemptions are allowed depending on the business activity.
- Washington uses 100% market-sourcing for services other than financial institutions.
- Out-of-state businesses that do not have a physical presence in Washington and earn significant income from Washington residents from providing services or collecting royalties on the use of intangible property in Washington are subject to the B&O tax.
  - Businesses outside WA are subject to B&O if:
    - More than $53,000 of payroll in Washington OR
    - More than $53,000 of property in Washington OR
    - More than $267,000 of gross income in Washington OR
    - At least 25 percent of your total property, payroll, or income in Washington
- Credits against Washington B&O tax include:

- Rural County B&O Credit for New Employees; High Technology B&O Tax Credit; Small Business B&O Tax Credit; Multiple Activities Tax Credit (MATC)

A.5.2 Brazil (Tax on Financial Operations)

A.5.2.1 Synopsis

The Tax on Financial Operations (IOF) was originally introduced in 1966 but the system was changed to the current regime in 2007 by way of a decree. Currently "IOF" comprises four different taxes and is not solely levied on financial institutions. The four taxes are: (a) on operations of credit; (b) on operations of currency exchange; (c) on operations of insurance; and (d) on operations related to bills of exchange and securities. These taxes are levied on the value of the operations, so that no deductions are allowed and rates vary according to the operations performed.

The four types of "IOF" were created to function as instruments to steer the markets of credit, currency exchange, insurance, bills of exchange and securities. In this regard, the tax authorities consider that this tax is an efficient policy instrument.

The criticisms on the tax are centred around the tax rates which are considered to be too high putting excessive burden on the operations within the scope of the tax.

A.5.2.2 Design of the specific CFT

A.5.2.2.1 General

The "IOF" is a federal tax set up in 1966 to replace the stamp duty. At this time, the first laws to regulate the capital market were being enacted in Brazil and foreign capital was heavily taxed. This tax has both an official name, written in the Brazilian Constitution and in legal provisions, and an unofficial name, by which it is called and known by the majority of the people. The official name is *tax on operations of credit, of currency exchange and of insurance or [on operations] related to bills of exchange and securities* ("Imposto sobre operações de crédito, câmbio e seguros ou relativas a títulos e valores mobiliários"). The unofficial name is *tax on financial operations* or simply "IOF" ("Imposto sobre operações financeiras" – "IOF").

The unofficial name suggests that "IOF" is a sole tax on operations involving financial institutions. In fact, however, the "IOF" comprises four different taxes and may be levied also in operations where no financial institution is involved. The four different taxes are the following: (a) on operations of credit; (b) on operations of currency exchange; (c) on operations of insurance; and (d) on operations related to bills of exchange and securities.

Due to their steering objective, their tax rates may be changed by presidential decree and enter into force immediately, provided that the tax rates do not exceed a limit predetermined by law. This is an exception in the Brazilian tax system, given that the majority of the taxes may have their tax rates altered solely by laws enacted by the legislative power and increases in tax rate only produce effects in the next taxable year and at least 90 days after the enactment of the law.

These taxes are levied on the value of the operations, so that no deductions are allowed. The taxpayer is normally the person paying to receive a credit, to be insured, to exchange currency and so on. Yet the obligation to levy the tax is usually legally transferred to the person receiving the money – e.g. to the creditor, to the insurance company, to the person selling the foreign currency.

Although the tax was implemented in 1966, the decree with the present system is in force as from December 2007. The "IOF" is a single stage tax due only with regard to operations that take place in Brazil. It is due at the moment and in the place in which the operations occur and independently of whether the taxpayer is a Brazilian resident or not.

A.5.2.2.2 Scope

The IOF is due by all legal persons and individuals that perform one of the operations set up by law, independent of their place of residence. As an exception to the rule, credit operations between individuals are left outside the scope of the tax.

A.5.2.2.3 Tax calculation

The tax base is calculated depending on the type of IOF being charged. All types of IOF are based on the values of the operations, without deductions.

IOF on operations of credit: the tax base is the value of the credit i.e. of the loaned money.

IOF on operations of currency exchange: the tax base is the value paid for the purchase of currency.

IOF on operations of insurance: the tax base is the value of the insurance premium.

IOF on operations related to bills of exchange and securities: the tax base is the value of the emission, cession, redemption or payment.

A.5.2.2.4 Rate

IOF on operations of credit:

Maximal tax rate allowed by law is 1.5% per day. Present tax rates established by decree with regard to operations contracted by legal persons is 0.00137% per day with regard to legal persons that have opted for the "simples nacional", with regard to operations not

exceeding 30,000 BRL (approx. 8,900 EUR); and 0.0041% per day in all other cases. Present tax rate established by decree with regard to operations contracted by individuals is 0.0082% per day. Present additional tax rate applicable both to operations contracted by legal persons and to operations contracted by individuals is 0.38% independent of the operations' term. The presidential decree enumerates exceptional cases in which the applicable tax rate is zero.

IOF on operations of currency exchange:

Maximal tax rate allowed by law is 25%. Present general tax rate established by decree is 0.38%. Most relevant examples of tax rates diverging from the general tax rate:

- Currency exchange related to international loan: 6%
- Currency exchange related to the payment of imported goods using credit card: 6.38%

IOF on operations of insurance:

Maximal tax rate allowed by law is 25%. Present general tax rate established by decree is 7.38%. Most relevant examples of tax rates diverging from the general:

- life insurance: 0.38%
- health insurance: 2.38%
- re-insurance: zero
- credit insurance related to the export of merchandise: zero

IOF on operations related to bills of exchange and securities:

Maximal tax rate allowed by law is 1.5% per day and 25% with regard to operations involving derivatives.
Examples of present tax rates established by decree:

- General tax rate for redemption, cession or renegotiation is 1 % per day. The amount of tax is limited according to the term of the operation. For this purpose, the decree presents an annex limiting the tax to 96% of the revenues for one-day operations and to 3% of the revenues for operations with term of 29 days. As from 30 days no tax is due.
- Securities' operations made with resources deriving from financial applications made by foreign investors in shares of real estate investment funds and of mutual funds of investment in emerging enterprises:
- when the fund is not constituted or does not begin its regular activities: 1.5 % per day, but not exceeding 10%
- when the fund is already constituted and functions regularly: 1.5% per day, but not exceeding 5%
- Cession of shares that are allowed to be negotiated in a Brazilian stock exchange with the specific objective of making depositary receipts negotiated abroad become asset-backed: 1.5%
- Redemption of investment funds' shares before the waiting period has elapsed: 0.5% per day
- Operations with gold employed as financial asset or exchange instrument: 1% (of the acquisition price)

A.5.2.2.5 Exemption

See section A.5.2.2.3.

A.5.2.2.6 Treatment of financial expenditure in R-based CFT

Treatment of financial expenditure in R-based CFT is not applicable to “IOF” regime.

A.5.2.2.7 Net-refund position

In a net-refund situation the taxpayer may ask for restitution or is allowed to compensate the taxes paid in excess with any federal taxes or contributions due.

A.5.2.2.8 Carry forward of losses

No specific rules with regards to the carry forward of losses were identified.

A.5.2.2.9 Administrative provisions

Specific information on the administrative provisions was not obtainable.

A.5.2.2.10 Qualitative and quantitative benefits and problems

The fiscal authorities have practically no burden in administering these taxes.
It depends on the concrete tax rates of the “IOF-credit” and of the “IOF-securities”, which are frequently changed depending on the policy objectives pursued.

The obligation to pay the four types of “IOF” does not depend on the organisational form of the persons performing the taxable operations. As already stated, however, credit operations between individuals are excluded from the scope of the tax.

As previously stated, the four types of “IOF” are steering taxes, so that they can be used to foster investment, e.g. by exempting or taxing at low rates credit operations and/or operations with securities. They are neutral with respect to location choices as far as the taxes have to be paid both by residents and non-residents that perform the taxable operations inside Brazil.

A.5.2.2.11 Transitional rules

No specific transitional rules were identified.

A.5.2.2.12 International recognition

Specific issues were not identified with respect to international recognition.

A.5.2.2.13 Avoidance schemes

The main avoidance schemes involve "IOF-credit" and can be summarized as follows:

- Credit is provided to a legal person but, in fact, benefits an individual. This may occur e.g. when a loan is granted by a financial institution to a car dealership but in fact the money is used to finance the purchase of the car by the individual. The aim of the operation is the availment of the lower tax rate applicable to credits given to legal persons. In these cases the tax authorities disregard the operation and enforce the tax rate applicable to operations of credit to individuals. The administrative fiscal courts have endorsed the position of the tax authorities in these cases.

- Loan received is recorded in the balance sheet as advance payments for future capital increase, with the objective of escaping the "IOF-credit". The tax authorities consider that unless the legal person can prove that the money was granted with the objective of acquiring company's shares, the operation has to be treated as loan and consequently be subject to "IOF-credit". This position has been endorsed by administrative fiscal courts.

- Legal persons, normally related, open current accounts together instead of granting loans. In doing so, the payment of "IOF-credit" is avoided by arguing that a credit operation requires a contract of loan, which in the concrete case does not exist. Moreover, the involved enterprises say that a current account cannot be compared to a credit operation, given that in a current account the positions remain open until the account is closed. Therefore, due to the dynamism of the current account it would be impossible to say that one of the contractors is definitely a creditor or a debtor. Differently, the fiscal authorities consider that a current account can give rise to credit operations subject to "IOF-credit" even in the absence of formal contracts of loan. There is one administrative judgement favourable to the taxpayer. One cannot predict, however, whether the taxpayer's position will prevail in future judgements of administrative fiscal courts or in the judiciary.

Tax avoidance schemes tend to be disregarded by the tax authorities when involving simulation.

A.5.2.2.14 ACE or CBIT as alternatives

ACE and CBIT were not considered as alternatives to the "IOF" regime.

A.5.2.3 Motivations for implementation the CFT

The four types of "IOF" were created to function as instruments to steer the markets of credit, currency exchange, insurance, bills of exchange and securities.

A.5.2.4 Effects

A.5.2.4.1 Economic effects

These four taxes have as major commonality their steering function. In fact, they represent an instrument of monetary, fiscal, exchange, and credit policy. In this sense, for example, the taxation of currency exchange operations may be strengthened to avoid the entrance of foreign currency in Brazil or may be alleviated to achieve the opposite result.

A.5.2.4.2 Revenue implications

Specific revenue data for “IOF” could not be obtained.

A.5.2.5 Criticized aspects

Frequently the different types of “IOF” are criticized for having high tax rates. This, however, is not a problem of the tax design, but of policy decisions.

A.5.2.6 Reasons for maintaining the CFT

The four types of “IOF” are regarded by the tax authorities as efficient policy instruments.

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