Commentary: Does the United States Need an Alternative Tax Base?

James W. Childs
COMMENTARY: DOES THE UNITED STATES NEED AN ALTERNATIVE TAX BASE?

by JAMES W. CHILDS*

INTRODUCTION

IN MAY OF 1985, the author and fourteen other persons were privileged to be part of an alternative tax systems delegation trip to France, Italy, Greece, Switzerland, and Yugoslavia. The delegation consisted of the author and leading attorneys from the American Bar Association Section of Taxation, including a former Assistant Attorney General and a former Deputy Commissioner of Internal Revenue. The purpose of the delegation was to study the relationship between direct taxes and indirect taxes in the five countries involved.

Each of the five countries have income tax structures using progressive rates and brackets roughly similar to the United States. In addition, all of the countries utilize a system of social contributions embodying employer and employee tax contributions at least as extensive as the United States. Furthermore, all of the countries employ some form of indirect taxation as a major source of revenue, and therein the similarities to the American system of federal taxation diverge.

Countries which are members of the Common Market as signatories to the Treaty of Rome and are parties to the European Economic Community (E.E.C.) are required to have a value added tax (VAT). The VAT, which is an indirect tax, is a preferred tax for an exporting country under the terms of the General Agreement on Trades and Tariffs (GATT). To place a VAT in perspective, its principal purpose is to simply allocate to each country its proportionate share of the consumption tax paid by the end user. For instance, if a manufacturer assembles a bus in Italy utilizing tires from France, a body from Belgium, seats from Greece, and an engine from Germany, the VAT on each of those components is paid by the assembler when the components are purchased and charged. The VAT on such purchased components is then either deducted or credited from the tax collected from the end user before remission of the collected tax to the taxing authorities of the country of the assembler. Such a procedure allocates the consumer’s tax charge to the respective supplier country in proportion to the value added to the assembly of the bus by the

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components supplied from various countries. A VAT has been expressly rejected by the United States Department of Treasury in its report on its proposals commonly known as Treasury One.³

While discussions with the ministers of finance in all of the five countries resulted in their statement that they believed in the VAT, the author and the other members of the delegation were of the general consensus that the VAT was too costly and totally inappropriate for the United States. The Minister of Finance of Greece stated that costs of collection of taxes ran twenty times what they do in the United States. Accordingly, economy of collection of the tax is not one of the virtues of the VAT.

It is essential to understand how the VAT is a preferred taxing structure under the GATT⁴ in order to understand the negative economic impact of United States taxation policy on its trade and balance of payments. Since the cost of indirect taxes can be deducted from the price of exported products, the tax credit for such exported product is not deemed an illegal subsidy, while, on the other hand, credits or deductions for direct taxes levied or assessed against exported products are deemed to be an illegal subsidy.⁵ The cost of the business income tax on exporting businesses in the United States is a negative trading factor since the tax cost on all components are part of the economic costs of goods produced and sold in the world market. In addition, such taxes are nondeductible from United States exports as a subsidy. To use our bus example, if a United States bus manufacturer assembles a bus using tires, seats, body, and engine from different United States manufacturers, the tax load is an economic charge in the price of each component in addition to the tax cost of the end product bus manufacturer. The United States, relying on income taxes which are direct taxes, places an export burden on our exporting industries. For example, Boeing, in figuring the cost of a 767 airplane, must consider the impact of the federal income taxes in order to generate a fair return on capital and to be able to pay dividends to shareholders in addition to the hidden tax cost in the cost of goods utilized in the manufacture of the airplane.

No credit or deduction of direct taxes in producing export products is presently permitted under the GATT. Since it is possible under the existing terms of the treaty to deduct indirect taxes, such as the VAT, from the costs of exported goods, United States manufacturers, and other producers of export goods and services, suffer an economic disadvantage in world trade in a direct proportion to a foreign competitor’s indirect tax deductions, assuming a constant parity in monetary rates of exchange adjusted by any rate differential in

1Treasury report on Tax Simplification and Reform, 71 STAND. FED. TAX REP. (CCH) NO. 52, ch. 10 at 213 (Nov. 27, 1984).
2GATT, supra note 2.
United States direct taxes versus foreign direct taxes. A partial consumption tax base would certainly make Boeing more price competitive with Airbus, the European Consortium, if all other factors are equal. During further discussions in this article, the reader should keep in mind that this export factor favors the adoption of some form of an indirect tax in the United States. Economically, any tax stimulus to exports would aid our negative balance of payments and de-stimulate United States manufacturers from outsourcing manufacturing operations. Therefore, the tax impact is only one of many factors negatively impacting United States exports.

Furthermore, the United States has been greatly concerned about the "tax gap", which is the tax loss from the underground economy, under reporting of income and over reporting of expenses by filers, and illegal source income which goes untaxed. These all have caused considerable loss of revenue to the United States Treasury. In all of the countries which we visited, the tax collection people, under the minister of finance in each country, indicated that their indirect taxes were a method of trapping lost income tax revenue. The theory is that money from the underground economy or from illegal sources and other evaded taxes is eventually spent in normal commerce, whether it is money generated from illegal drug traffic, prostitution, or simply from a person who cuts wood on his wood lot and sells it for cash in the suburbs to be burned in a fireplace. When that money is spent in the stream of commerce, in any fashion, it is subject to an indirect tax. The minister of finance of each of the countries believed there was no greater nor lesser tax evasion in their respective countries than in the United States. The countries were much less concerned with tax evasion. In fact, as shall be seen in this article, some of the countries do not even have criminal sanctions for tax evasion. There is some merit to the self-enforcing aspect of a consumption tax as trapping legitimate income taxes. Consumption taxes are not to be considered as a panacea for all of our tax problems. For example, consider gratuitous transfers and how they pose substantial problems in fairly applying a consumption tax.

Unions and leftists in the United States have historically been against a national sales tax, consumption tax, or other indirect taxes on the ground that such are regressive. However, the corporate income tax is a regressive tax in so far as the consumer pays the tax in the price of the goods or services sold by the corporation, but there has not been the same political animus to that form of entity tax. A sales tax is normally thought to be regressive since it takes a greater percentage of the income from poorer persons who must purchase consumer items and have nothing left for investment or savings while the wealthier persons typically have excess income which is not consumed.

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It was interesting to find that of the countries visited, Italy, Greece, and France have socialist governments. In fact, portions of Italy are controlled by the Communists. Yugoslavia is a purely socialist country, using socialism in its generic term. Only Switzerland possessed a nonsocialist government. Switzerland's leftists viewed a national sales tax, or consumption tax, in the same light as has been traditional American thought regarding the regressive nature of the sales tax. Yet, politically leftist countries support and strongly utilize indirect taxes of a value added or sales tax type as a major source of revenue.¹

There is another disadvantage to sales or indirect taxes of any kind. They are costly to collect. The VAT is probably the costliest of all. In the United States, we can pride ourselves on a collection cost of approximately 1/2 of 1% of total revenues collected. One of the problems with a sales tax and a VAT is a hidden double tax in any turnover transactions, particularly when the tax is imposed on the purchase of plant and equipment used in the business. The end user who pays the tax in this case is the business entity which is using the plant, equipment, or other business products for business purposes to add value to products or services without diminution in the VAT paid by the business for tax paid on plant and equipment. Consequently, a capital intensive business has built into its cost of goods sold the turnover taxes which it has paid as an end user on plant and equipment utilized in the manufacture of its goods for resale. It also has to charge a turnover tax on the goods which it resells.

Therefore, while there are two major arguments for a consumption tax, there are three against it. First, the argument of regressivity is probably the most compelling negative political argument to the adoption of a consumption tax. Cost is the second, and probably the most negative economic argument. If we are to try and collect all of our tax gap lost revenue by means of a consumption tax, our collection costs will also have to increase. Our relative efficiency in collection presently generates a loss of revenue, which various sources have estimated at being between $50 billion and $200 billion a year.² Thirdly, the hidden double tax on the purchase of plant and equipment for business end use is another powerful negative economic argument.

Can the problem of regressivity be handled? Regressivity is handled in various ways as will be noted further when discussing the laws of each country. In fact, the one Communist nation, Yugoslavia, has made their sales tax absolutely progressive. (This causes extreme economic problems with any economy which is attempting to be market driven rather than planned.) The hidden double tax problem on the purchase of plant and equipment can be handled by either preserving an investment credit concept equivalent to such turnover, sales, or value added tax or by permitting the capitalization of the tax in the cost recovery basis and recoverable over the life of the asset. In-

¹In Yugoslavia 63% of total revenues.
²Henry, supra note 6.
creased cost of collection of a consumption tax appears to be indigenous to such a tax system and must be weighed against any benefits derived by adopting a consumption tax system.

Another interesting observation that was made by and discussed among the delegation members was the excellent understanding by European ministers of finance and their advisors of the United States tax system, particularly, since all of the nations visited are intensely interested in trade and export. Notwithstanding the caliber of the persons in the delegation, however, there was little of the detailed comprehensive understanding of the minute details of the tax systems of the five countries visited. In fact, before the delegation left the United States, it was discovered that there was a lack of literature in the United States available to fully analyze the ramifications of foreign tax laws. Some of the materials which are in this article's footnotes are available only in the language of the country involved and other European countries.

There is, however, private source information available on the foreign tax laws. All of the transnational accounting firms have offices in most countries of the world and have local tax specialists who analyze and write on the tax laws of each particular country. These are published in paperback and hard-bound form for circulation amongst the various offices of those accounting firms. The delegation used various sources from the transnational accounting firms for their preliminary research prior to the delegation's journey to the countries involved. Some of these publications can be found in law school and public libraries.

**JUDICIAL JURISDICTION OF TAXATION DISPUTES**

In all of the countries visited, except Yugoslavia, which has special fiscal courts, the Council of State system is utilized for the appellate process. The Supreme Court structure has appellate jurisdiction only in criminal cases. It is usually limited to disputes of the State against the citizen. The Council of State system, which was embodied in the Star Chamber in English heritage, is patterned after the French Council of State which evolved along with the split appellate court system in England prior to the political excesses of the Star Chamber and its abolition. The president of the Council of State is generally co-equal with the Chief Justice of the Supreme Court, although their jurisdiction is entirely different.

Under the French model, which is present also in Italy and Greece, the Council of State handles all appellate issues arising out of controversies between citizen versus citizen or the citizen versus the State. This includes tax appellate litigation unless it is criminal. The Council of State also has a larger political function; that is, to render advisory decisions affecting the regulatory impact of the various governmental ministers. In this way, various depart-
ments within the Council of State structure, with judges serving for long periods of time in a single department, are developed into being highly specialized within given legal areas. Tax enforcement is generally one of those areas.

There has been some discussion in the United States as to whether or not there should be specialized appellate courts for special problems. A completely different subject would be a discussion of the merits of having a supreme appellate court other than our Supreme Court to handle tax disputes in the United States. Taxation and other specialized areas, such as securities regulation, patents, and copyrights, would perhaps benefit by a closer look at the Council of State system prevalent in Europe as a system for dispute resolution.°

FOREIGN TAX CONCERNS

We have also done much to hurt our trading partners, who are most concerned with the super-aggressive California approach to collecting a worldwide unitary tax. Foreign ministers of finance fail to see why our treaty provisions in the Constitution were not upheld in the recent Supreme Court case involving the aggressive California tax collection process.° Such activities may be self-defeating for California and other unitary tax states in that foreign or multi-national corporations doing business in unitary tax states will keep the necessary records and take sufficient steps to avoid adverse state tax determinations. Hopefully, the impact of the decision will be minimal or Congress will adopt measures negating the impact in the near future. The fact remains, however, that it does concern our trading partners. It is impossible, under our federal system, for our federal government to control the taxing systems of the fifty states. However, it is likewise impossible for a government to pursue a unified fiscal policy in which taxes are not only a major source of governmental revenue to provide goods and services but also a means of directing objectives in the national economy without in some way controlling the impact on the national economy of state taxing structures.

There must be some parameters of fiscal control embodied in national tax policy which are exercised to either prevent excesses or to stimulate national policies which are essential to the survival of the nation, or to reflect national economic priorities at any given point in time.

COST OF COLLECTION FACTORS

Our tax system generates more dollars at less cost than any other tax system that the delegates studied and with a greater degree of voluntary com-
We can justly be proud of the tax education in this country in the law schools and the business colleges. Furthermore, we can be proud of the quality of the Internal Revenue Service and the professionalism of the practicing bar and accountants in creating a tax system which has filled the needs of our country in the last seventy years. It is necessary to make this statement to put the balance of this article in perspective. The following discussion is not a wholesale criticism of one of the finest taxing structures in the world, but only a discussion of some good and bad features of other countries and some ideas which we might choose to emulate or reject.

Much of the material embodied in this article was generated by the author and his fourteen fellow delegates in private conversations with finance ministers, members of the judiciary, foreign tax professionals, and distinguished professors of the various faculties of schools of economics and law. The information generated and opinions expressed from conversations will not always be identified by the titles of the persons present from the foreign nation since in some instances the opinions represented significant departures from official policy of that particular country, and a degree of confidentiality was not only expected but was requested. In some countries, the delegation did not receive information which was consistent with that received from other sources. Reconciliation of this information and opinions has been attempted.

**France**

The last country visited by the delegation must be the first country discussed. France has often been a thorn in the side of the United States in economic negotiation since World War II. There seems to be an attitude on the part of the French that their way is the only way. However, one must consider that the French have made a consistent and thorough study of United States taxing policies, laws, and procedures and know how to use our own taxing policies against us in world trade (among other trading techniques).

The French tax professionals, in particular the economists and lawyers in the French Ministry of Economics and Finance, are well schooled in American tax structure. Consequently, one finds in the Ministry of Economics and Finance, at all levels, an extreme competency of information on United States tax policies, tax laws, dispute resolution systems, and avoidance devices. France was also one of the initial signatories to the Treaty of Rome, establishing the E.E.C., which requires the signatory nations to adopt a VAT.

France’s political structure has long catered to a subsidization of the French agricultural system. In the last round of talks involving the multi-

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12 In 1984, the cost of collecting $100 was $.48, making a collection cost of less than one-half of 1%. *Annual Report, Commissioner of Internal Revenue*, 71, Table 22 (1984).

national agreement known as the General Agreement on Trades and Tariffs, French negotiators adopted an extremely aggressive stance. French policy regarding trade has generally been one to close out foreign agricultural products from the E.E.C. while promoting its own export industries.

In the United States, agriculture is the nation's largest industry. Agriculture is one of the two areas in which this nation has traditionally enjoyed a positive trade balance. It may possibly be said that for the last twenty-three years a few thousand French farmers have consistently caused considerable unemployment in the United States. Agriculture in the United States consumes over 1/4 of all the cars and light duty trucks produced, over 1/4 of all the steel produced, over 1/4 of all the rubber produced, and over 40% of all petrochemicals. Whenever there are trade barriers to American agricultural products, whether in the raw or processed state, American workers suffer.

The French in their negotiations have displayed a ruthlessness that has not been matched by American negotiators. In addition, since 1962, the French have successfully kept diplomats away from the negotiating table for multi-lateral renegotiation of the GATT. At the Economic Summit in Europe, in April of 1985, all nations except France agreed to reinstitute multi-national negotiations on trades and tariffs. One of the things which we learned in Paris is that despite their President Mitterand's statements, the French realize that they will have to go back to the negotiating table. The present economic situation in world trade is too destabilizing to stay away, when the French economy is recovering more slowly than the economies of France's trading partners. This understanding of the inter-relationship of fiscal policy with trade, vis-a-vis the United States and other members of the E.E.C., is essential to understand part of France's tax structure.

On the technical side, the French Ministry of Economics and Finance is divided into two divisions in the tax management department. One division works solely on tax policy. The second division is very similar in structure to our Internal Revenue Service and is headed by a Junior Minister of Budget. This second division has 85,000 employees and collects the VAT and all local taxes on public lands and handles the registration of deeds for French lands. In the French system, the collection of taxes is separate from the assessment of taxes. This is a product of the French Revolution. Therefore, within the tax management department, there is a wholly separate structure for the assessment of taxes. In 1985, France operated with a budget of $100 billion (U.S. conversion), and they projected $85 billion in revenue. This will result in a $15 billion (U.S.) deficit, a rather large deficit for a nation the size of France.

The VAT produces approximately 50% of the revenue. Approximately 10% ($5 billion U.S.) of the VAT has to be reimbursed to other nations under

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Which occurred in the early 1960s and was known as the Kennedy Round.
the Treaty of Rome,\textsuperscript{13} resulting in 45\% of net revenues coming from the VAT. In addition, the pension income tax, which would be the social contributions tax, equals 23\% of total revenues ($19.5 billion U.S.). This tax is not comparable to our FICA tax and would encompass not only FICA revenues, but also a large portion of general United States revenues expended in health, education, and welfare programs. The corporation tax produces approximately 14\% ($9 billion U.S.) and the tax on excises, duties, etc. approximately 10\% ($8 billion U.S.). A large component of revenue is a special tax on petroleum products to stimulate conservation. Four years ago special taxes produced less than $5 billion (U.S.) of tax revenue. The balance of the revenue projections will come from France’s personal income tax. Other miscellaneous duties equal $3 billion (U.S.) and would include the wealth transfer tax structure. The $85 billion (U.S.) revenue would convert roughly to $460 billion (U.S.) of revenue in the United States in terms of comparable size.

Transfer taxes are not applied in Europe, and particularly in France, solely on death or gift but when a sale or exchange occurs. These transfer taxes are generally in addition to any income or capital gains taxes which occur on the transfer of property. In France, the rate is 6\% of fair market value on residential properties and goes up to 16\% on commercial properties. Estate and gift taxes in France accounted for a size adjusted equivalent of $12 billion (U.S.) revenue or approximately $4 billion more than in the United States.

Under the French civil code, there are no trusts or generation-skipping devices as we know them in the United States. The inheritance or estate tax has a preferential rate for transfers in a direct line of lineal descendants. The nonpreferential rate can go as high as 60\% if there are transfers made to persons possessing zero degree of kinship. Interestingly enough, gross estate and gift taxes in France exceed gross estate and gift taxes collected in the United States by a ratio of 3:2. However, it is difficult to compare the two countries in the estate and gift tax system since the only estate and gift tax in France is the federal estate and gift tax, whereas, a principal source of state revenue in the United States is inheritance and estate taxes. The French have very complex tax legislation which is modified semi-annually by legislative action. Considering the social trauma in the United States with each new revenue proposal, it is questionable whether the United States could tolerate semi-annual tinkering with the Internal Revenue Code.

Some of the stamp taxes and registrations duties of the French go back to the Middle Ages. For instance, the stamping of gold and silver was an occasion for a levy. This was pre-French Revolution. With the Revolution, there was an attempt to get rid of some of the King’s levies, making them local taxes. They began to be assessed on undeveloped land, developed land, businesses, and personal residences.

\textsuperscript{13}Treaty of Rome, supra note 1.
The French income tax and Social Security tax dates to 1914, well in advance of our Social Security tax. This system was reformed in the 1970's in order to permit local authorities to assess and the state to collect these taxes. There is uniformity of the tax base. However, there is no uniformity of tax rates because the assessments are done at the local level. There have been substantial tax reforms in France in recent years, and the word “reform” is used in its traditional, euphemistic sense. It is a cover for tax increases. Particularly in the corporate tax area, some of these reforms apply uniformly to foreign and domestic corporations.

Real estate taxes in France are very sophisticated and complex. There is absolutely no restriction on foreign purchases of real estate in France unless the real estate is classified as being a historical monument. However, there are systems of priorities of purchaser. For instance, farmers desiring to purchase farm land are given priority. In addition, there are extensive land use regulations which affect who can and cannot purchase real estate.

There is one significant loophole in the French taxing structure, currently being studied. The French have been having trouble collecting VAT's from those individuals receiving only cash in their occupations; such as waiters, street vendors, and other service persons with no business records. French taxing authorities also concede that collection of the VAT in agriculture is a consistent and persistent problem. Finally, business failures create a problem. When a business fails, the business usually fails to remit collected VAT's causing the government to lose more revenue. There are some provisions, however, in the French tax law which somewhat parallel our trust concept of employer withheld taxes when a business fails in the United States. They have exactly the same problem with the social contributions taxes when a business fails. In some instances, there have to be lump sum assessments of the VAT, which are by government fiat rather than by actual sales. Examples of this would be cab drivers, beauty shop operators, and other businesses which deal in cash, making it nearly impossible to precisely estimate the actual sales. The rates will range from 10% to 25%. The French Ministry of Economics and Finance did concede that even with the VAT credit system, which has its own built-in checks and balances, there are some very clever schemes that arise across the E.E.C. lines which keep France from getting what it feels is its fair share of taxes. (As previously noted, the French are very sophisticated in their tax collection procedures. They even collect a VAT from Paris prostitutes, who when it was imposed went on strike. However, the strike failed.)

The Ministry of Finance and Economics in France does not think they have any greater tax gap or evasion problem than is present in the United States. However, it is believed that the VAT is a means of trapping between 80% and 95% of the unreported income taxes. The theory is, simply, that at some point tax on evaded and illegal source income is collected when such un-
taxed income is spent for goods and services and VAT is paid on such goods and services. Furthermore, when adjusted gross revenues are 45% of total revenues from consumption taxes, there is a likelihood that a very large percentage of evaded taxes will be recaptured. At birth, the French government issues two identification numbers, a social security number and a tax identification number. For most transactions, the use of one or both numbers is required which enable the government to cross check all major transactions, including banking transactions. Accordingly, France’s ability to trap and collect evaded or avoided tax through their indirect taxes is very impressive. The French goal is to achieve ninety-six percent tax compliance through the enforcement of indirect taxes.\textsuperscript{16}

It was interesting to note that it is stated policy in France to recoup income taxes through the VAT. The French Minister’s own computers give figures noting approximately a 95% compliance with income tax revenues by means of the consumption recoupment through the VAT. Therefore, they do not consider that further strong measures are required to close income tax gaps.

Since knowledge of the VAT is limited in the United States, it is important to give a comparative example. There is a great deal of similarity for a business taxpayer between the VAT in France and a state sales tax in the United States. In the United States, a business pays a state sales tax, assuming no exemptions apply, for a product which is deducted as part of the cost of goods sold from the federal income tax liability of the business. Therefore, if a business evades or avoids federal income taxes they have still paid an effectively nondeducted sales tax resulting in a recoupment of taxes due. In the United States, this becomes a direct subsidy to the individual state, bypassing the federal treasury. In a VAT country, the federal treasury receives the revenue.

For the individual consumer, the present federal tax laws provide deductions for state sales taxes for persons who itemize deductions. Therefore, if a person evades or avoids taxes, they cannot have the advantage of this deduction. Nevertheless, like the business, this is a direct subsidy to the individual state, bypassing the federal treasury. In a VAT country, the individual is given varying degrees of relief from income taxes for VAT’s paid to the federal treasury. A denial of an itemized deduction for sales taxes would provide a partial federal recoupment of state sales taxes paid on evaded income. However, the same revenue effect would be lost in the United States for businesses unless there were a federal consumption tax in some form.

Consequently, disallowing a personal deduction for state sales taxes makes a great deal of economic sense. However, such a proposal would not improve compliance by those persons and business who understate or fail to

\textsuperscript{16}Conversations with bankers and accountants in Switzerland confirmed that their independent compliance analysis supported the French government’s conclusions.
report income unless there is a federal consumption tax with full credit or
deductibility against income taxes.

In any discussion of French taxation, it is important to remember that payments to nonresidents, who are investors in a firm or corporation are generally deductible by the corporation. This is quite unlike our prohibition in the United States of a dividends paid deduction which is unlike our dividends received deduction for corporate payees. The same is not true for payments to nonresidents who are regarded as being residents of tax havens. Clearly, French dividend payments to residents of tax haven countries are nondeductible. The next question concerns how transactions are handled that are intercompany between French corporations and other corporations as part of a multi-national group. Every Big Eight accounting firm has advised its clients to make certain that inter-company transactions are at arms length and fully supported since Articles 32.8-A and 57 of the CGI are designed to attack avoidance of French taxation by artificial inter-company pricing and other transaction in relation to international transactions. France has been very careful to negotiate most of these provisions in its double taxation agreements with other countries. France also adopts a principle of constructive dividends. Such payments may come under the tax haven provisions.

In 1980, France enacted a portion of law which is designed after Subtitle F of our Internal Revenue Code. As is true with our Subtitle F, this whole procedure was done to attempt to restrict abusive or aggressive tax planning. They have, however, added an exemption system to this structure; 2.5% of the dividends paid are reintroduced as a deemed management cost. If the corporation can prove that its management costs are less than 5%, then it gets the benefit of the exemption.

An outside holdings provision provides that if the minimum holdings outside of France in tax haven countries is 25% of the total holdings then anti-double taxation provisions do not apply. The provision’s objective is to tax at the French level the worldwide economic enterprise. If the foreign tax rate is less than 2/3 of the French tax rate, the so-called tax haven surcharge becomes applicable resulting in a tax on the personal shareholders, either upstream or downstream, and on collateral holders if there is a fiduciary relationship. Our proposed modifications to corporate tax rates may cause our country to be deemed a tax haven country under French law. The tax, while assessed against the personal shareholders or corporate shareholders if there is a corporate holding company involved, is collected from the corporation from its assets in France.

2. C. Trav. art. 32.8-A, 57.
3. Similar provisions were enacted in Canada, Germany, and the United Kingdom.
The corporate tax rate in France is 50%. The burden of proof to escape the tax haven classification is on the taxpayer. The tax haven surcharge is in addition to the regular corporate tax because it is deemed to be a tax on the shareholders. In 1982, France adopted another new corporate tax which ties in with the holding company law. If a foreign corporation owns real estate in France, there is a 3% tax annually on the fair market value of the real estate unless the treaty partner will disclose the names of the shareholders so that the regular income taxes can be assessed against them.

France is one of those countries which, for businesses taxation purposes, relies most heavily on the company's financial statements. Consequently, the regulation of the accounting practice in France is extremely important. Certified financial statements for a business must be prepared by the certified public accountant in accordance with French taxing authority's rules and regulations. The delegation found that most European nations visited were moving toward the certified financial statement method of tax reporting. Informed persons with the American Chamber of Commerce in Italy and discussions with a professor at the University of Rome indicated that Italy will be utilizing certified audit disclosure provisions within two years.

Administrative appellate procedures are similar to those in the United States and seem to be as varied from area to area as they are from district to district in the United States. Taxation inspectors send what we would term a ninety day letter, which is a thirty day letter in France. If the company or business has not objected to the tax revision within the time limit, it is deemed to have accepted the adjustment.

All disputes with the tax inspector and the taxpayer are appealed to a tax committee which consists of nine people; four from business and the professions, four civil servants, and a chairman, who is a judge in the administrative court. This would be a judge from the noncriminal jurisdiction structure, which would be the council of state administrative court structure. All burdens of proof lie on the taxpayer. The tax committee announces its findings with a notice of assessment. Generally, the taxpayer then appeals by the end of the second year following the issuance of this notice. If the appeal is based on a factual appeal, it is made to the administrative court and hence on to the Council of State. If the appeal is on questions of law, it must be lodged first with the departmental director and then to the administrative court and hence on to the Council of State.

French tax law requires monthly and quarterly returns in addition to the annual return, depending upon the size of the business's or person's income. The monthly threshold is very low. It is difficult to state a given amount at which the monthly return will be required since this is determined annually. French taxing authorities have 841 fully staffed offices for 23 million tax filers. French taxing authorities calculate their collection cost between 2% and 3%
of revenues collected. Considering that the United States collection costs are approximately 1/2 of 1% of all revenues, the lowest estimates would provide a collection cost of four times our collection cost while the highest estimates would provide collection costs six times our collection costs.

The VAT rate is variable by commodity and service. This is a very complex system to administer. It parallels somewhat the progressive nature of the sales tax which was seen earlier in Yugoslavia and which will be discussed further in this article under the Yugoslavian tax systems.

France has, in addition, adopted a TCMP (Taxpayer Compliance Modeling Program) audit system very similar to ours to develop econometric models for audit purposes. Members of the Ministry of Economics and Finance indicated they borrowed our TCMP auditing procedure. Therefore, they are able to program their audit structure in such a way as to keep their collection costs lower than other VAT countries. Interestingly enough, France is the most efficient country in terms of expense of collection in relation to revenue generated of the five countries visited by the delegation. All other countries which the delegation visited had much higher costs of collection.

In France, the present marginal rate for personal taxation is 65%. Exemption rates are very complex. France has a 13 bracket structure including a zero bracket amount. Personal exemptions are allowed for the taxpayer and spouse. Like the United States, this tax is applicable to individuals domiciled in France, including foreign nationals on their worldwide income. Individuals not domiciled in France are taxable only on income which arises from a French source. The domicile of individuals in France is determined by: 1) the home or principal place of abode; 2) where the family principally resides, if in France; 3) whether the person is present in France for more than six months in any tax year; 4) whether he carries on a profession or occupation in France; and 5) whether the center of his economic interest is located in France. The center of economic interest is defined as being where the principal investments lie or from where a business is controlled by the taxpayer from which a major part of his income is derived. To determine place of family abode, school records are utilized.

Rather than personal deductions or allowances, income splitting arrangements are utilized to give families relief from income taxation. Under this system, the total taxable income of the family is divided into the number of units of the family. The tax applicable to a single unit is multiplied by the total number of units, giving the total amount of tax payable. An unmarried person is one unit. A married couple is counted as two units. Each dependent is counted as half a unit and an additional half unit if one of the first two children is a registered invalid. For the third and following children, each child is counted as another full unit. Accordingly, a joint return, i.e., husband and wife return, with three children would result in a split into four units. Children are
counted until age 18. However, if they are students, they are counted until age 25. Without any age limit, dependents include any disabled person. Surviving widows and widowers with dependent children calculate their tax as if the deceased spouse was alive. This system results in an increased degree of progressivity when there are no dependent children and higher incomes in the family unit and, hence, fewer units.

An interesting feature of the French taxation system is that family units constitute the income unit. If two of the three children are employed, their income is included with their parent’s income on the family unit return prior to the division of the tax into the units for purposes of calculation. A spouse is taxed separately if he or she is separated or divorced. All business and professional income is included, including partnership income unless the partnership has elected to be taxed like a corporation. In general, business or professional income is calculated in the same manner as corporate income for income tax purposes. However, if the spouse of a proprietor is employed in the family business, there can only be a limited deduction for the amount of salary paid to the spouse in any given year.

Employment income is generally as comprehensive as our Section 61 of the Internal Revenue Code. All costs of living, housing, education, and other expense allowances are included except for expense allowances for language tuition and transportation in the Paris area. However, income derived from outside France is not included if the foreign country possesses a double taxation agreement with France by treaty. For French employers who send their citizens abroad, foreign source income is exempt if the tax liability in the foreign country would be at least two-thirds of the French tax liability. Furthermore, the individual must work abroad at least 183 days out of twelve consecutive months.

Income from the National Profit Sharing Plan (which is required in France) is also included. However, the income may be excluded if it is not made available to the employees for at least five years, except in the case of marriage, death, retirement, dismissal, or incapacity. Furthermore, special bonuses paid to directors of corporations are taxable as if they were dividends. All pension and social security benefits are taxable, except for a minimal severance pay allowance upon retirement which is exempt. Social security benefits due to disability are not taxable; those due to sickness are taxable.

Dividends are grossed up. There is a dividend or wealth tax, which is in addition to the income tax. However, the dividend tax may be credited against the income tax due on the dividends. No credit is available on constructive dividends. In the grossing up process, the dividend tax is added to the actual dividend received to determine the effective marginal rate. Then, the dividend tax is credited against the income tax liability. The annual wealth tax is not applied to corporations. Therefore, many individuals use foreign corporations, in
particular in Switzerland, as a means of escaping the French annual wealth tax.

Stock dividends are not taxable in the hands of the recipients. However, the issuing company will be taxed under the stamp tax when the securities are registered. There is a minor dividends received credit which varies. In 1979, it amounted to 3,000 French francs for the first group of dividends received.

Interest from all sources is taxable in the hands of the recipient. However, like dividends, there is a minimum exemption if the interest is on quoted bonds or debentures. Interest derived from certain specified long-term savings arrangements and certain government bonds is exempt. At the election of the taxpayer, interest may be classified exempt, providing the taxpayer elects a special withholding tax of 25% on interest from bonds and 40% on interest from savings and other deposits.

Rental income is taxed after the related operating expenses, including interest for certain types of improvements to residential properties, is deducted. There is also a special deduction to cover depreciation, which is calculated as a percentage of gross rents and is set annually.

Under the French tax system, the offsetting of loss activity is permitted against other income for the same fiscal year. Unabsorbed losses have a five-year carry forward provision. However, losses from the renting of real property may be offset only against other rental income for the same or subsequent five years. The French have a complex system of income tax deductions. The following deductions are generally allowed:

1. social security and retirement pension contributions;
2. a flat percentage of income after social security and pension contributions to cover expenses relating to employment (unless additional expenses can be justified);
3. interest to the extent it is paid on loans to purchase or repair a taxpayer's principal residence;
4. life insurance premiums for personal life insurance for the taxpayer and each dependent;
5. expenses attributable to day care for a child dependent whether or not it is the taxpayer's child; and
6. 1% of charitable contributions.

Invalids and elderly people are allowed further deductions on a portion of their income and reasonable living allowances paid to dependent relatives other than dependent children.

In audit situations, somewhat analogous to situations where our own Internal Revenue Service would be permitted to apply the net worth theory, the taxing authorities may assess taxes based upon outward signs of wealth if dif-
different from or out of proportion to the declared wealth. These assessments are very arbitrary. The tax can be based upon three times the rental value of houses owned, 75% of the value of a new construction, and if the taxpayer has domestic servants, so much on each servant. An assessment which is based on external signs of wealth may be made where the valuation exceeds 1-1/3 times the declared taxable income.

Unlike present law in the United States, personal capital gains are taxed as part of business income at normal income tax rates if the property has been used in business. Capital gains from the disposal of most other types of assets, except listed securities, are taxed at normal income tax rates and added to the taxpayer's tax return after the indexing inflation adjustments are made to basis. Losses may be offset against gains. Gains from the disposal of the taxpayer's principal residence, or secondary residence if he does not own his principal residence, are exempt. Any interest not permitted to be deducted for acquisition of such residence may be added to basis in computing the gain.

Gains from sale of agricultural or forestry property not cultivated by the taxpayer are exempt. Gains on the disposal of furniture or household appliances and private cars are not exempt. There is a minimum exemption for casual capital gains. Gains accruing to retired persons who are not paying income tax are exempt. Transfers by death or by gift are exempt from capital gains taxation but are recovered by the transfer taxes as previously noted.

There are, however, additional sales taxes on the sales of precious metals, jewels, and objects of art unless the taxpayer elects to pay capital gains tax on those items.

Capital gains derived from the sale of securities obtain somewhat more complex treatment. For dealers in securities, gains from the sale of securities are ordinary income. In all other situations, there are three categories of taxable transactions, one of which is called "regular transactions." Regular transactions consist of gains arising from the sale or other disposal of securities which are listed on some exchange, or traded over the counter by an individual who makes regular transactions, by virtue of having an account or portfolio managed by a broker. Also included are speculative transactions where there is margin or other leveraging, transactions in security options, and transactions by individuals whose sales exceed 160% of the value of the portfolio at the end of the previous year. Capital gains from regular transactions are taxed at a flat rate of 30% unless they exceed the taxpayer's other taxable income. Such excess then will be taxed as ordinary income.

The second category is "substantial sales." If a taxpayer makes substantial sales which are not classified as regular, i.e., a complete liquidation or partial liquidation of a disposable portfolio, then gains from these sales are taxed at a flat rate of 15%.
The third category is "special circumstances." These are sales by taxpayers which are similar to substantial sales. For the owner of a 25% interest in a closely held business who has owned such interest (using the French Family Attribution Rules) during the five year period prior to the disposal, the gain is taxed at 15%. If at least 50% of the assets of an unquoted privately held company consist of real estate other than that used for the company's own industrial, commercial, or agricultural business, then the gains are taxed as if they were sales of the underlying real estate and not sales of stock. The exchange of securities on mergers, reorganizations, divisions, stock conversions, or the disposal by employee profit sharing investment funds, or other long term savings arrangements, and permanent investment funds do not normally give rise to taxable gains.

While there is generally no indexing of basis in determining gains for sales of listed securities, there have been periods in recent French history when the highest market quotations have been allowed to be used as a substituted basis for actual cost. Generally, this occurs approximately every five years. It is likely that while these adjustments are not indexed, there will be, at some future time, such a bill as was passed and put into effect in 1978, which was the last law providing for a substituted basis for listed securities. One wonders why the French are unwilling to index basis of listed securities for capital gains purposes when so many other items are indexed.

While France at the present time has no system comparable to the United States Individual Retirement Account (IRA), the delegation was advised that the French are considering the adoption of our IRA concepts. France does use a five year income averaging scheme. Furthermore, the social security tax withheld rate for employees is currently at 19%. Over 65% of the taxes paid in France are paid by 10% of the taxpayers. All social security benefits and pension benefits are indexed in some form.

Succession taxes and gift taxes are assessed on French residents on their global holdings. However, there are credits given for taxes paid to other countries. These may be modified by double taxation agreements in the various tax treaties. Under the French succession tax system, or wealth transfer tax system, there are exemptions for the surviving spouse, direct ancestors and descendants, and there is a preferential rate not exceeding 20%. Rates vary for other relatives and for unknowns can go as high as 65%.

All goods imported into France are liable for the VAT. However, in practice, the importer pays the taxes on behalf of a foreign exporter. The same is true as to services and goods. All interest and royalties are subject to the VAT except for bank interest. Royalties paid directly to an inventor are subject to the VAT. Exempt from the imposition of the VAT are direct sales by primary producers of agriculture and forestry products, educational institutions, medical and dental services, research centers, charitable and social activities
within defined categories, stock exchange transfers, and transfers which are subject to registration and transfer taxes.

The primary internal exemptions from the VAT parallel the provisions of Code Section 501 exemptions in the United States taxing structure, with the exceptions of the stock exchange transactions and transactions subject to transfer and registration taxes. A transaction which is within the exempt categories will not be permitted a credit on related supplies and services. In other words, it is impossible to have a VAT credit by purchasing items in a transaction exempt from the VAT.

Under the GATT, sales of goods for delivery outside of France are exempt from the VAT unless they are transferred or sold to countries within the confines of the E.E.C., which modifies the GATT for those signatories of the Treaty of Rome. There is also an exemption where the service or goods are sold by persons established in France to persons established in other E.E.C. member states, if such transaction is chargeable to the VAT in that country. If the services are not chargeable in the other E.E.C. member state, the goods or services are taxable in France. Quite unlike other exempt transactions, credit will be allowed for VAT's assessed on supplies or services relating to export transactions. There is also a provision that allows the suppliers to invoice the VAT as exempt invoices.

The mechanics of the VAT is one of the expensive elements in cost of collection and which results in the higher collection costs which were observed in Europe. France utilizes a credit system VAT. In other words, the VAT is not a cost element for business enterprise since the tax charged on the supplier's invoices or paid on imports represents an advance payment of the tax that can be recovered on sales or services to customers. A French business is permitted to credit the entire VAT paid on its purchases of goods, equipment, and services for use in the business. Equipment is exempt from the VAT in this situation even though the business is the end user and even though these would be capital expenditures. This credit is allowed against the business's total tax which is charged to the customers.

Since many transactions are partially exempt and also exempt from internal sales, only proportionate shares are entitled to be credited. However, there are some limitations; otherwise, deductible expenditures from the income or business tax may not be permitted as a credit on the VAT. For instance, no VAT credit is allowed for business purposes for expenditures on accommodations or entertainment of directors or employees, employee gifts, company cars, and fuel oil.

France, as in all VAT countries, requires its taxpayers to perform exten-

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*This is the principal exemption and one of the factors which gives the E.E.C. countries a distinct competitive edge in world markets of manufactured goods over those countries which rely almost exclusively on an income tax base for business taxation on manufactured goods.
sive invoicing which increases business costs as well as increases collection costs. The invoices must include: 1) the purchaser’s full name and address; 2) the rate of VAT applied to each particular item; 3) the net unit price and the total price of the goods and services invoiced exclusive of the VAT; and 4) the total amount of the VAT invoice. In most instances, businesses are required to remit and file returns of the VAT on a monthly basis.

The normal VAT rate is at 17.6% in France. However, rates can go as high as 33-1/3% and as low as 7% on different classes of goods. The higher rates generally apply to automobiles and luxury products. The lower rates apply to what would be essentially necessities, including books, newspapers, magazines, food products, public transportation, and medicines. Banking establishments are now subject to the VAT. The former turnover tax for banks was replaced in 1979.

New construction and sales of land are subject to the VAT. Leasing of unfurnished premises and time shares in such properties or condominiums are also subject to the VAT. The exemptions include sales by an individual of his principal residence, unless it is sold within five years of acquisition. The acquisition of land without the intention of development within four years is also exempt from the VAT. Land held with the intention to develop is subject to the VAT rate. If construction in fact develops within four years, the tax is a preferential rate, assessed on only 30% of the value. If the construction is not commenced, the full VAT is then due and payable plus a 1% penalty tax. If the transaction is subject to the VAT, the transfer taxes are not payable. If the transaction is exempt from the VAT, the normal transfer taxes are payable.

Not included within the scope of this article are local taxes and other business taxes. Such taxes are levied and assessed, except for transfer taxes, on the sale of real estate and the sale of a business. These transfer taxes are substantial items in France. These taxes are generally borne by the purchaser. Sales of real estate and leasehold rights are subject to a transfer tax only if they are not subject to the VAT. Generally, the transfer tax rate is 16.6%. However, the rate on residential property may be as low as 5.4%. These rates are only approximate rates since rates in France are adjusted annually.

Transfer taxes on the formation of a business enterprise include taxes on contributions of cash at a 1% rate, while noncash property is taxed at a 1% rate if the entity is subject to the corporate tax. Other assets contributed to the formation of an enterprise except real estate, goodwill, and leasehold rights are also taxed at a 1% rate if they are contributed by persons who are not subject to the corporate tax. Real estate, goodwill, and leasehold rights contributed by persons not subject to the corporate income tax are taxed at a 11.4% rate.

Increases in the capitalization of French businesses, including bonus stock and stock dividends, are taxed at a 12% rate. Additional taxes raised from the proprietors of the enterprise are also imposed at a 12% rate. Reorganizations
are taxed on the conversion of an entity at 11.4%, in addition to 100 and 300 franc fees for corporate reorganizations, mergers, and conversions. If there is an excess of shares issued by an acquiring corporation from an acquired corporation, then there is a 1.2% rate on such excess.

In the sale of a business, the inventory items are subject to the normal VAT and are not subject to the capital or transfer tax on sales. Sales of securities are taxed at a 4.8% rate except for shares in the corporations. There are stock exchange transaction taxes, new construction taxes, and regional transfer taxes. There is a payroll tax assessed on an enterprise that is not subject to the VAT on the basis of its turnover. This is a pure turnover tax, and the rates range from 4.25% to 9.35%. Taxes in these categories are normally paid monthly. Very small firms (determination of what is "very small" is annually adjusted) pay taxes quarterly. All of these taxes in France are in addition to the usual social contributions. A social contributions tax in France includes not only our concepts of health, medical, welfare, and retirement, but also includes a continuous education tax of 1.1% of total wages and salaries including other social contribution taxes. However, if the employer provides staff for continuous education, then the expenditures for the same, if they are qualified, will be offset against the required contribution.

In France, there are also apprenticeship taxes and obligatory housing taxes to provide for housing of employees for any employer having ten or more employees. In Paris and in other areas, there is a transport tax to provide for employee transportation. Overall, the French taxing structure is very complex with high tax rates. Taxes are considerable cost items in the production of goods and services. Because of the intense system of social taxes or social contributions, any apparent differences in wage rates between the United States and France are swiftly negated due to the high level of taxation for employee services. This is true in virtually every socialist country of Western Europe.

ITALY

Italy is a country which has had a high incidence of traditional tax evasion. Italy has many manufacturers of capital goods. However, the greatest number of economic enterprises in Italy consist of small shopkeepers. Small shops in Italy have traditionally avoided cash registers and documentation in order to hide income.

In discussions with Italian academic leaders and former government officials, the delegation learned that since 1978 there have been significant changes in Italian tax compliance. Italian income taxes have a top marginal rate of 47-48%, quite comparable to present marginal rates in the United States. Local income taxes in Italy vary from 8.9% to 14.7%. The VAT in Italy averages approximately 19%, which, if there were no relief provisions,
would yield an effective marginal tax rate of approximately 70%.

Traditionally, the only significant compliance procedures were imposed on those who could withhold income taxes. The substantial changes in the Italian taxing structure since 1978 have stimulated more self-compliance. In any event, the percentage of compliance is far from that obtained by the French.

The Italian system of government divides public revenues and expenditures into two ministries. The Minister of Finance is in control of revenue. The Minister of Budget is in control of expenditures. There is a special tax police with full police powers. Traditionally, it was believed that the division of expenditures and revenues into two governmental ministries was one of the factors which contributed to a lack of tax compliance in Italy.

The Italian personal income tax has rebates for personal exemptions of the taxpayer, spouse, and the dependents, which increase in amount over seven persons. Deductions are also allowed for local income taxes, rents, interest, optional social contributions, life and accident insurance, and medical expenditures in excess of 5% of reported income. For disabling medical expenses, the rate of rebate is 10%. Other permissible deductions include funeral expenses for a very close relative, alimony, expenses of attending school, and periodic payments to testamentary beneficiaries. This latter deduction is unusual since there is no concept of an estate being a separate taxable entity. The basis of fixed assets is indexed.

It has been traditional in Italian thought that only big firms be assessed VAT's. The 1982 mandatory cash register law has significantly changed this situation. The mandatory cash register law requires a receipt for every expenditure. In protest, Italian shopkeepers went on strike, but the strike was

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21 Italian taxation derives from a series of presidential decrees. Enactments of Parliament end up being numbered as presidential decrees as follows: No. 597, 9/29/73, creation of and rules relating to personal income tax; No. 598, 9/29/73, creation of and rules relating to corporate income tax; No. 599, 9/29/73, creation of and rules relating to the local income tax; No. 600, 9/29/73, general rules concerning the assessment of income taxes; No. 601, 9/29/73, rules governing tax relief and benefits; No. 602, 9/29/73, provisions concerning the collection of income taxes; and No. 605, 9/29/73, provisions relating to the tax records office and taxpayer code numbers. Laws and rules pertaining to the creation of taxes other than on income are based on a series of presidential decrees all dated Oct. 26, 1972: No. 633, the value added tax; No. 634, the registration tax; No. 637, estate, inheritance, and gift taxes; No. 641, governmental concession tax; No. 642, stamp tax; No. 643, tax on property appreciation; and No. 636, appeals procedures for income and other taxes. Hereinafter, the decrees will be cited: Italian L.D. decree number (date). All of the above decrees have been modified in subsequent years as discussed in the main body of the article. Italian L.D. No. 904 (1977). Dividends received by Italian companies from foreign associated companies have exempt 60% of such income received. The definition of affiliates for application of No. 904 is found in section 2359 of the Italian Civil Code. L.D. No. 904 (1977) excludes stock dividends from the definition of income. Rates of depreciation are established annually by decree of the Minister of Finance. L.D. No. 904 (1977) exempts mergers and reorganizations from corporate income tax. Profits arising from such exchanges become taxable at the moment of realization or distribution to shareholders.

22 Italian L.D. No. 637 (1972), method of taxation of decedents' estates.

23 Italian L.D. No. 72 (1983), "Vesentini Bis," permits revaluation of fixed assets to compensate for inflation. It is an indexing law.
broken. They now all have cash registers, but there is some thought that they
do not always ring up the sale. However, Italy has enforced its cash register
law to the point that now economists at the Faculty of Economics at the
University of Rome state that the Italian government is collecting over 80% of
its lost income taxes through the VAT. One of the ways in which the cash
register law is being enforced is by allowing taxpayers to claim a 19% tax
credit against their income taxes based on the total of their cash register
receipts retained.

Italian businessmen, utilizing supply side economics, felt that lower
marginal rates would increase compliance. This is probably true in areas where
the government is trying to preserve the integrity of its personal income tax
system. However, compliance and enforcement of the personal income tax
system requires a system of alternative taxes which reward compliance at the
personal income tax level. For example, such rewards may consist of deduc-
tions or credits for the payment of those taxes. The fiscal police in Italy are an
arm of the Department of Finance, which is in charge of revenues. In order to
enforce VAT's and personal income taxes for service providing professionals,
such as doctors and lawyers, taxpayers in this category are required to file their
appointment diaries with their tax returns.

Complaints by Italian businessmen centered around the additional taxes.
Employee social security contributions are approximately 7.8%. There are
trade union taxes and medical taxes. The delegation found wide disagreement
between different professors relative to enforcement and compliance with
Italian taxes. From the discussions, it became apparent who were members of
the current ruling coalition in the Italian government. According to the “outs,”
evasion was still rampant. In discussing matters with the “ins,” substantial suc-
cess had been made in enforcement.

In Italy, there was a rare politicization of views by professors of
economics and law which was not found in other countries visited. The follow-
ing 1982 enforcement changes in the law are significant:34

1. The criminal prosecutor was given jurisdiction to initiate prosecution
without first having a fiscal investigation by the fiscal police.
2. Suggested and mandatory penalties for different classes of evasion
were installed in the law. (It is interesting to note that this was the first
criminal sanction for tax evasion in Italy.)
3. Tax evasion prosecutions were integrated into the same criminal
system, an inquisitorial system.

In an inquisitorial system, the judge does most of the questioning, and there is
an extreme emphasis on admission of guilt and plea for mercy. Under such an
inquisition system, a person is presumed guilty until proven innocent.

In one discussion with three criminal law professors, a system more like our own criminal prosecutions was argued for in the tax field. Since bail is an exception, the common occurrence is to jail the accused in order to coerce a plea bargain by which the person admits to the judge or magistrate their guilt and willingness to make restitution to the state as a means of getting out of jail. This procedure is a powerful enforcement tool. While it has much to be said for itself in terms of yielding compliance with revenue laws, the method of prosecution in Italy is wholly abhorrent to the Anglo-American judicial system and our concepts of criminal due process.

Commonly, the fiscal police use informers to find tax cheaters. The fiscal police generally conduct the initial investigation. Then, their results are reported to the public prosecutor. The public prosecutor has the burden of deciding whether to refuse to prosecute or order further investigation. If the public prosecutor takes the case before a magistrate, the magistrate will ask questions with a strong emphasis on confession. With the accused already being in jail, the rate of convictions is substantial. Finally, appeals can be had through the Council of State which is somewhat different from the normal criminal tax jurisdiction which was encountered by the delegation.

At first under the 1982 laws, judges were not inclined to jail when the public prosecutor initially brought the case forward. Most judges looked upon tax evasion or avoidance in a rather lenient light. However, political pressure on the magistrates and public pressure through the press has changed this attitude. Currently, tax evaders are considered serious criminals. Part of this shift in views is attributable to the Italian prosecution system of targeting well known and famous persons for criminal prosecution. The public prosecutor is the one that actually issues what is equivalent to the body capias. Therefore, there is substantial public scandal when a tax evasion case is brought before a magistrate. The Italian judicial system works somewhat slowly. Consequently, many months may elapse between imprisonment and trial, and magistrates in the past were willing to let the rich and famous avoid imprisonment pending trial. Substantial adverse public reaction to this approach has resulted in the current prosecution posture.

There is no such thing as our speedy trial constitutional requirement in Italy. The faculty of the Criminal Law Institute of the University of Rome has knowledge of at least one criminal case where a person had been in prison over ten years awaiting trial. The present maximum allowable time between incarceration and trial in Italy is a very “speedy” five years.

Since 1982, the favorite defense in tax crime cases in Italy has been to shift guilt to the accountant. This defense has met with some success. However, Italian magistrates have become quite familiar with United States tax policies and law which provide that the taxpayer is ultimately responsible. This is somewhat confused by the fact that VAT’s and business income taxes
are assessed through a certified audit conducted by a certified public accountant. This is mandatory in most countries of the E.E.C. Consequently, the businessman has some grounds upon which to legitimately claim: "Hey, my accountant is the one that is guilty, not me. I told him to do it right, and he certified that he did it right. If it is wrong, he did it wrong."

Because of the blackmail effect of imprisonment prior to trial for fiscal crimes, Italy passed a law in 1984 that prohibits imprisonment unless there is corroborating evidence of a crime. The prohibition does not apply to serious crimes such as terrorism. The right to bail pending trial, which has been in the law since 1981, has not been extensively utilized since it is not constitutionally mandated. The impact of the 1984 law on the government's blackmail system can not be predicted at this time; nor can any precedential evaluation be performed on whether or not the law will give the defendants more rights in fighting the enforcement procedures.

Discussions with Italian businessmen revealed a very real terror of the fiscal police. They were terrified by the fact that they might be imprisoned on the complaint of: 1) a dissatisfied customer who claimed that sales were not rung up, 2) an angry spouse, or 3) a secret complaint by a competitor. Such fear appears to have lead to substantial tax compliance. The only question is whether or not this compliance will continue in light of the changes in the law including the 1984 prohibitions against imprisonment pending trial, unless there is corroboration. If magistrates routinely refuse to imprison accused taxpayers prior to trial, Italian taxpayers may lapse into their old evasive ways.

In the Italian system, the public prosecutor and judge are two separate divisions of the magistrate's offices. The president is a senior judge and only serves in an administrative capacity for a term of four years. The appellate process through the Council of State follows the traditional Norman concept of bifurcated appellate structures. State v. The Citizen passes through one branch of the appellate structure with all other disputes civil. The Citizen v. State passes through the other branch. The appellate system is somewhat politicized in Italy since appellate judges are appointed by the President of the Republic. The staff judges are, as in Greece and France, generally lifetime or career appointments. There are specialty courts for special subjects including bankruptcy, etc., but all under the Council of State. Incidentally, in Italy, as in most other western nations except the United States and England, tax matters are generally handled at the magistrate level by specialized tax magistrates.

In meetings with American businessmen who have a long standing business relationship with Italy and reside in Italy, some very interesting things were learned about the VAT and its impact on the income tax. We learned that the evasion of the VAT and income tax is generally handled by utilizing dummy invoices across sovereign borders with dummy corporations in other countries in the Common Market (or even outside the Common Market).
However, the easiest way to evade the income tax is with a dummy corporation in a loss position consolidated with a profitable company. Such an arrangement is analogous to that described in the *Lisbon Shops* case.\(^{25}\)

Prior to 1973, taxes were collected by private offices who retained a commission, ranging from 9% to 19%. Presently, taxes are paid to banks in almost an identical copy of the United States deposit system for withheld and employer taxes. Pension and social taxes generally run labor costs to 160% of base salary.

One interesting feature of the VAT in Italy, as in most other common market countries, is that the VAT rate can go much higher than the normal rate of 19%. The highest may be 38% while the VAT rate on some items may be as low as 2.9%. With a variable VAT rate on commodities, certain segments of the domestic economy can be stimulated while imports in other segments are restricted. This provides for a great deal of economic manipulation. It also is an open license to politicians to trigger the rates and thereby achieve social goals. Finally, it negates the VAT credit as a means of protecting the integrity of the personal income tax where the credit is a fixed 19%.

There is universal consensus that the VAT must be preserved in order to collect illegal source and otherwise evaded or avoided income taxes. The personal income tax is the cheapest to collect. However, Italian collection costs, as measured against the Minister of Finance's budget, come very close to the former commission rate paid of 10%. Traditional exporting companies in Italy often end up with a VAT deficit. This will sometimes produce a nonrefundable credit type situation which adversely affects costs of exported goods.

One very important feature of the Italian tax system is that the Minister of Finance is very helpful in preparing a target list for audits by industry or taxable income for the use by the CPA's. They do use an econometric modeling program, involving 90 categories of items for various brackets on a historical average basis only roughly similar to those constructed through our taxpayer compliance modeling program. There is a five year statute of limitations for tax evasion and avoidance. Consequently, as evasive taxpayers get close to each five year period, there is a general public demand for amnesty. Amnesty demands are already being heard for 1986. The last amnesty given was in 1981 for 1982. Amnesty is a pure forgiveness and also a system to file correct returns for the intervening years. This tends to destroy the integrity of the tax collection system and self-assessment principles.

The delegation's conclusion from Italy was that while the Italians have made great strides in increasing compliance, they have also constructed a very complex enforcement system. The only thing to be learned from Italy is the same thing learned in every other country — a consumption tax does enforce

the income tax. In summary, it is safe to say that not one member of our delegation would trade the United States system for the Italian system. We found that the Italians had borrowed much from our system. However, their criminal procedures, particularly in the tax area, were abhorrent to our concepts of justice. We viewed with concern Italy's enforcement techniques. They have, however, achieved a remarkable compliance at the expense of what we in America would term very basic rights. As we left Italy, a question remained in our minds; could the same compliance be achieved in the United States without a total overhaul of our enforcement system?

GREECE

The reception received by the delegation in Greece was extremely cordial, considering the government was in the middle of an election campaign. Greeks take their politics seriously. There was not a quiet night around Parliament Square due to the raucous campaigning, punctuated with fireworks and gunfire.

Greece is presently ruled by a socialist government headed by Prime Minister Pompedreau. His party is roughly translated as the Panhellenic Socialist Party. Currently, Greece is in transition to a VAT as part of its entry into the Common Market. The present indirect taxes, such as inheritance, tariff, stamp, and transfer taxes will be eliminated with the full imposition of a 19% VAT. The costs of collection in Greece are extremely high compared to the United States. The department of finance operates on a budget of 10% of the revenues collected. This is approximately 20 times the amount of money allocated to the Internal Revenue Service in the United States. However, unlike the United States, the department of finance also prepares the budget, regulates salaries for all government officials, and collects taxes. Therefore, the collection costs in terms of budgetary allocation cannot be equated with United States Internal Revenue Service costs.

Greece has instituted a series of criminal penalties in order to attack one of the biggest evasion schemes as in Italy and France, which is the use of dummy invoices with dummy corporations. These are considered forgeries and are subject to the criminal forgery penalties. Discussions with the judiciary indicated that the judges in the Council of State are not so certain that these penalties are the appropriate means to enforce collection.

There is widespread belief in Greece, as in other parts of Europe, that the VAT is simpler to enforce and fairer than other forms of taxation. Our delegation could take great issue with the first statement that it is simpler to collect when we compare costs of collection against revenues collected. It is obvious that the Internal Revenue Service in the United States is a very efficient collection system. While American taxpayers may complain about the manner and methods of the Internal Revenue Service, they should take great pride in the
efficiency of the Service in terms of the amount it collects for public purposes compared with its costs. It is one of the most efficient governmental departments of any of the nations of the western world.

Greece has also instituted a fine taxation enforcement system, emulating the United States' technique of coupling sanctions of incarcerations with fines. The various fine structures can go as high as 200% and 300% of the amounts determined to be deficient. The forgery penalty in Greece is incarceration for 3-5 years. However, tax evasion is not a criminal offense. Part of this is because forgery has such a broad definition, and incarceration penalties operate in a different court system from fiscal deficiencies. As in the discussions regarding France, the Greek court system follows the French model almost in its entirety. However, it was in Greece that we were able to have our closest look at the operations of this model. The President and other administrative leaders of the Council of State went out of their way to walk the delegation through the entire judicial process through a series of very long briefings.

One of the reasons why most of the countries of the Common Market frown on criminal penalties as opposed to civil fines for deficiencies is because of the dual court structure. Most jurists believe tax controversies should be handled by specialized tax magistrates and appellate judges that are part of the Council of State side of the dual court structure. It is up to the citizen, in all countries of the Common Market, to bring actions to set aside tax assessments.

The delegation was deeply indebted to the President of the Council of State of Greece and other senior administrative judges for the extensive amount of time spent with the delegation in order that the delegation would have a complete understanding of the dual appellate court structure. There were very free discussions of the weaknesses of the dual appellate court structure. For centuries, the role of the Council of State in rendering advisory opinions on either executive or monarchial actions has produced a propensity for the politicization of this branch of the judiciary structure. This problem exists today in those countries using the Council of State system, and it is still its principal weakness.

The Greek government has been able to reduce taxes during each of the last three years. The approximate collections in Greece are 800 billion drachmas. The rate of exchange as of Nov. 14, 1985, was 153.25 drachmas to one U.S. dollar. Therefore, 800 billion drachmas is approximately 5.22 billion U.S. dollars.

The principal taxes in Greece are a personal income tax and a legal entity income tax, similar to our corporation income tax. The personal income tax

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26 The rate of exchange as of Nov. 14, 1985, was 153.25 drachmas to one U.S. dollar. Therefore, 800 billion drachmas is approximately 5.22 billion U.S. dollars.

27 Greek L.D. No. 3843 (1958).
was established in 1955 under another Greek law. Both direct taxation laws have been amended several times. Codification of these laws will be completed with the phase-in of the VAT as part of Greece’s entry into the E.E.C.. Due to the acceptance of the Treaty of Rome, Greece’s several other indirect taxes will be phased out while the VAT is being assessed. Such taxes include a stamp tax on documents, a turnover tax, various consumption and luxury taxes, a manufacturing payroll tax, and gift and inheritance taxes. Transfer taxes include a property transfer tax, a real estate tax, and a tax on the transfer of mining rights.

In order to stimulate foreign investment, Greece has provided a variety of tax and customs exemptions to foreign enterprises for activities and enterprises which are conducted outside Greece. An interesting feature of the Greece tax structure is that Greek shipping enterprises are exempt from income tax.

For legal entities, tax returns can be filed on a fiscal year of either June 30 or December 31. Individuals must file on a calendar year basis. Personal income tax returns are audited on a test basis utilizing various test factors which are more intuitive than the empirical methods established by America’s Taxpayer Compliance Modeling Program (TCMP). Any disputes in the Greek taxing structure are handled through administrative hearings at the local level where the taxpayer resides. If the disputes are not resolved at the administrative hearing level, they are taken to the tax division of the Council of State court system.

There are several features of the Greek tax law which are different from the United States income tax law. To begin, the tax is a unitary tax. With minor exceptions, the total reported taxable income is subject to a single tax. This is accomplished by providing a deduction to corporations for dividends paid and credits for indirect and consumption taxes paid by individuals. All individuals are subject to the personal income tax. Legal entities are subject to the entity income tax, including local corporations, branches of foreign corporations, cooperatives, public or municipal corporations, and nonprofit organizations. In contrast to the United States taxing structure, there is no provision in Greek entity taxation for exemption from tax as is present in Subchapter T of the Internal Revenue Code for agricultural cooperatives. Furthermore, there is no exemption for nonprofit organizations and foundations similar to the exemptions provided in the Internal Revenue Code.

Partnerships, joint ventures, and other limited liability entities other than
corporations are taxed at the individual level and not as an entity. Rental income is taxed at the personal level unless there is a corporate lessor, except for farm land, forests, quarries, or mines. With income from a farm land, the base point is rents received from the farm. Then, there is a deduction of 5% of the annual rentals (which is an imputed expense of maintenance cost), other direct development charges, mortgage interest, and miscellaneous taxes payable to the government and governmental authorities.

Investment income includes dividends from domestic or foreign corporations, distributed surplus and tax deferred reserves of domestic corporations, interests from loans or bonds, and directors' fees including directors' participation in profits. There are, however, several tax exemptions from investment income under the Greek system of taxation. Initially, dividends received from companies listed on the Athens Stock Exchange are exempt. However, there is a per-company floor and an overall cap, which varies depending upon the financial condition of the country and the enactments of Parliament. The cap has ranged from a floor of 15,000 drachmas ($97.08 U.S.) with an overall maximum limitation of 60,000 drachmas ($388.34 U.S.). Secondly, dividends from Greek shipping companies are exempt from investment income taxation. In addition, interest on deposits in Greek banks or banks legally authorized to operate in Greece are exempt, as are government or government authorized bonds and other certificates of indebtedness. In order to stimulate the Greek shipping industry, interest from mortgage loans given by nondomestic entities or persons for ships under the Greek flag is exempt. Contrary to the United States' experience of violent opposition to source withholding, it is accepted in Greece on investment income.

Income from business includes operating income, profits from any business enterprise, and most capital gains which involve exchange transactions. Taxable profits are broadly defined as the difference between gross revenue and expenses incurred in the course of normal operations. Not all Greek businesses maintain acceptable books of accounts. In such situations, the taxing authorities will utilize all available information. There are imputed statutory rates applied to gross income in such situations. Special regulations apply to ship owners, contractors, real estate, and foreign tobacco trading companies.

Agricultural enterprises are treated differently from other business enterprises. Their income is distinguished from income attributable to farm land. Agricultural enterprises are taxed on the profits from the farming activity by an operating farmer. Like business income, in the event that profits cannot be determined by the books of account of the taxpayer a tax of 10% to 20% is applied to the gross income from products, which are valued at average wholesale prices rather than retail prices. There is, however, a deduction for certain personal living expenses which is dependent upon whether the taxpayer and his family are personally and primarily engaged in agricultural activities.
With salaries and wages, the tax is imposed on gross income from employment less other taxes, social security contributions, and an imputed personal and dependency exemption which is generally 30% of the gross compensation. In order to stimulate certain forms of compensation, the imputed or mandatory deductions are higher for employees engaged in the arts and journalism — mainly actors, composers, painters and artists, and journalists. Conceivably, writers of books are also included in the category of journalists. Retirement or severance payments are taxed at a flat rate of 10% after deducting a personal living floor.

Finally, professional fees are determined under an entirely different classification, although similar to the classification of arriving at income from business. Professional fees start with the calculation used for income from business, but there is an additional deduction of 25% to determine the taxable income. However, there is a maximum which varies annually. A tax of 8% is normally withheld at the source. It is quite common in Greece for the taxing authorities to impute taxable income for professionals based upon a net worth theory utilizing extrinsic factors such as standard of living, business status and reputation, and other available documentation.

Gains from exchanges are generally not taxed. Under prior law individuals were not taxed on sales and exchanges. However, currently there is a transfer tax of 11% on all real estate transfers based upon the value of the sale. A new law was enacted at the beginning of 1984 which provides for an objective valuation of the property. The tax has to be paid on the objective amount regardless of the selling price. This can result in a tax which is greater than the actual selling price when the objective value of the property is greater than the selling price. The future of this particular, and rather arbitrary, tax is unclear at this time. The Greek government has little data to determine how accurate objective valuations are in comparison to actual selling prices.

There is no transfer tax on stock. A profit on its sale or exchange is a regular income item. In other words, there are no provisions in the Greek income tax structure for the separate treatment of either long or short term capital gains. Income taxes are indexed entirely for inflation.

Transfer taxes paid on real estate are not deductible in determining other taxable income. Other allowable personal deductions on the personal income tax side are the indexed personal allowances such as social security taxes, the stamp tax, medical expenses, the mandatory pension withheld, and insurance premiums. Gift and inheritance taxes allow extensive deductions on transfers to a wife, sons, and daughters. The deductions will reach as high as 49% if transferred to nonrelatives. There are no state or provincial income taxes in Greece.

In January 1986, the VAT replaced the sales tax in Greece. Undistributed
profits of corporations are presently taxed at 49%. The income tax on exchanges by an individual is 30%. Social security contributions are at a present rate of 13.25% for the employee and 21.75% for the employer’s share, up to a maximum of 105,000 drachmas ($679 U.S.) per month. There is an additional employer tax of 6% on all wages paid by employers for those employers whose payroll costs exceed 1,100,000 drachmas ($7,119 U.S.) per month. By law, some industries are given a total exemption and other industries are given reduced rates.

As in the United States, depreciation rates are set by statute.\textsuperscript{32} Industrial buildings are allowed an 8% annual depreciation rate; other buildings a 5% annual depreciation rate; and machinery ranges from 10% to 20%. Computers, furniture, and trucks are allowed a 20% annual rate of depreciation; office equipment a 15%; and other vehicles 12%. In Greece, there are provisions for consolidation of income. However, group or multiple entity taxation filing is not permitted. Operating losses may be carried forward for three years and for five years in the case of manufacturing, hotel, and mining concerns.

Greek companies are required to make an annual distribution of dividends equal to 6% of their share capital or 35% of their net profit, whichever is higher. Exemption from this rule may be obtained by the consent of 80% of the paid-in capital. Undistributed profits must be capitalized by issuing share dividends. However, 95% of the paid-in capital can waive both the distribution and the capitalization of profit.

Because of the intense concentration of population in the Athens/Pireas area, there are regional tax incentives to encourage business and industry to locate away from the heavy population concentrations.\textsuperscript{33} These incentives vary from area to area and are extremely complex. The incentives can provide an exemption from taxable income for up to a maximum amount of 90% of annual profit. Certain special incentives can provide higher exemptions. Foreign businesses are very welcome in Greece and are protected under existing law which has been in effect for 22 years.\textsuperscript{34} For those wishing to consider transactions with Greece, there are several materials available from the transnational accounting firms which are helpful.\textsuperscript{35}

**SWITZERLAND**

In Switzerland, the delegation met with the president of the Geneva Bar Association and four specialists in taxation, as well as with representatives of the Swiss Bank Corporation and Coopers and Lybrand’s Geneva office. Addi-

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\textsuperscript{32}Greek L.D. No. 88 (1973).
\textsuperscript{33}Greek L.D. No. 1262 (1982).
\textsuperscript{34}Greek L.D. No. 2687 (1953).
Does the United States Need an Alternative Tax Base?

Swiss tax law is almost as complex as United States tax law. The taxing power is not only vested in the confederation but also in the twenty-six cantons. Cantons are roughly equivalent to our states. Over 3,000 municipalities also have a major part in taxing. Consequently, similar taxes may be levied simultaneously and independently at two or even three government levels. In addition to income taxes, the Swiss tax equity capital of a corporation, which consists of paid-in capital plus reserves and surplus reserves, including the concept of hidden reserves, which will be explained in more detail later. Equity capital of individuals; exemplified by net worth, net wealth, fortune or property, is also taxed in addition to the income of individuals.

It is impossible to draw a uniform conclusion of tax legislation in Switzerland since the system is applied on one or more of the three levels. There is a singular lack of uniformity in enforcement of various tax laws at one or more of the levels of taxation. Cantonal tax laws vary in their nature and impact, just as state taxing structures vary in the United States. Municipalities, parishes, public educational bodies, and other political subdivisions usually rely on the tax base of the canton for tax purposes even though rates are fixed independently.

The Swiss federal constitution authorizes the federal government to establish tax laws prescribing the principles on which cantonal tax legislation relating to income and capital must be based. The cantons remain free to determine tax rates, exemptions, deductions, and other matters. While the Swiss constitution permits this, no overall tax law has been passed. Federal tax burden accounts only for 20% of total tax burden. Cantonal and municipal taxes account for the remaining 80% of the tax burden for individuals in businesses.

In Switzerland, as in no other European country, tax laws embody only general basic principles. The most important issues are decided by taxing authorities and the tax courts. The delegation believed it was more appropriate to talk with Swiss practitioners than with Swiss taxing authorities for the reason that most taxing administration is handled at the cantonal level rather than at the confederation level. It was through practitioners that we were able to learn about the application of Swiss tax laws throughout the entire confederation.

The federal direct tax, or income and capital tax, has only recently been changed in name from the federal defense tax. Therefore, older treatises which refer to the federal defense tax are really talking about the same thing as is present in the current federal tax laws. There is little unified tax policy in Switzerland. To begin with, each canton has an income tax on worldwide income and net worth.
Corporations likewise pay two entity taxes; an income tax and a net worth tax on capital and reserves. Both of these taxes are progressive not only on a net profit basis but also on the ratio of income to net worth. The better the corporate performance, the higher the tax. At the present time, at the Swiss federal level, individuals pay on worldwide income a maximum rate of 11.5%. At the canton level the current maximum rate is 35-40%. The net worth tax at the Swiss federal level for individuals has recently been repealed. Corporations pay an income tax of 9.8%. The net worth tax, at the federal level, is not progressive in rate. The corporate net worth tax is progressive in most cantons. It is .725% at the present time.

At the federal level, there is source withholding on dividends and bank and bond interest at a rate of 35%. This is not reimbursed or credited to the income tax of foreign residents unless there is a tax treaty. There is no withholding for income from Euro market securities. The United States is one of the tax treaty countries. Communal taxes always follow the cantonal tax. Corporations may deduct cantonal taxes in the calculation of their federal taxes. Furthermore, federal taxes are deductible by corporations in calculating cantonal taxes. On the cantonal individual tax return, there is no deduction for the federal tax. Likewise, there is no deduction for the cantonal tax on the federal individual return.

Enforcement and compliance have been a significant problem in Switzerland in applying the net worth tax, particularly in valuing hidden reserves. However, valuations are now based on commercial, audited financial statements.

Between cantons there may be differences between allowable depreciation rates for fixed assets. Unlike the United States, Switzerland has no special capital gains rate except for real estate sales. Gains from sales and exchanges come under the federal income and cantonal tax. However, many cantons have seen fit to lower rates on profits from sales and exchanges. The net worth tax is figured on the net profits plus retained earnings. While the net worth tax has been repealed for individuals, it still exists for businesses. Therefore, a sole proprietorship still pays a net worth tax. Under Swiss law, only trades or business are required to keep books of account.

The direct tax at the cantonal level is the most important and highest yielding tax. The individual net worth tax is 21.1% at the cantonal level but will vary from canton to canton. In the Geneva canton, it is 21.1%. From a revenue point of view, indirect taxes are the most important source at the federal level. These include customs duties, subject only to the special provisions of the E.E.C. treaties. A sales tax does exist. It is not a VAT. However, it does end up getting passed along in the cost of goods sold.
The sales tax has two rates and is extremely complex. The wholesale rate is 9.2%, and the retail rate is 6.3%. It is a cascading sales tax and is effectively levied only once. The imposition of the sales tax is very mechanical, and hence there is very little litigation. Furthermore, there is a strong history and tradition of voluntary compliance in Switzerland.

All taxes must be paid in estimates if there is no withholding. Estimated taxes are based on the prior year and payable at the rate of 10% per month. For individuals, the 1985 estimated tax is based on '84 income. For corporations, the 1985-86 tax estimate is based on a two year average income of 1983 and 1984. Through our inquiries, it became apparent that the United States should not adopt this particular form of reporting system. At the present time, there are several proposals to harmonize cantonal and federal tax. Their proposals to adopt our system of harmonizing cantonal and federal taxes may be enacted within ten years.

Wealth transfer taxes include estates and gifts. They are levied at the cantonal level. At least one canton does not levy a wealth transfer tax of any kind. However, the canton of Geneva does impose such a tax. Its maximum rate, if there is a familial relationship, is 6%. If there is no familial relationship, then the wealth transfer tax is 36%.

Charitable gifts and bequests to listed charities are exempt from all cantonal taxes. There are, however, special exemptions to qualify certain gifts to unlisted charities.

Switzerland has become the holding company capital of the world. Part of this is due to a special nonresident holding company law. For qualified holding companies, dividends and capital gains are tax exempt. Furthermore, foreign source commercial profits are taxed at a flat rate of 8% in 1985 and 7% in 1986, including the communal surtax. In one canton, there is no tax for foreign source income. Swiss source commercial income of domestic holding companies is treated the same as income earned from domestic operating companies. This reflects the traditional special treatment for Swiss headquarters companies.

On two occasions, the Swiss have considered and rejected the adoption of a VAT. They do, however, have the sales tax which has previously been discussed. Though the Swiss constitution prohibits double taxes, the Supreme Court has basically reconciled this in favor of the sales tax.

Switzerland is one of the few countries of the western world that follows a single structure supreme court, as in the United States. Basically, you must pay your tax where you reside and not where the person works. The Swiss courts have adopted the same principle which is found in international law between

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37B. VERF., CONST., COST. FED. art. 41, par. 2 (Switzerland).
nations. Interestingly enough, the Swiss constitution permits individual suits by taxpayers. Such actions will bind the government in its treatment of all other taxpayers. For example, a taxpayer has standing to sue not only on his own case, but to test the system.

In Switzerland, income taxes are withheld at the source, even for foreign resident workers. This is contrary to the typical system which taxes only residents. However, through treaty with France this structure was arranged since France wanted the Swiss government to collect and remit taxes to France.38

As of 1985, all employers are required to have a private pension system. The system must have at least a plan which provides a benefit of two times the social security benefit.

Corporate income taxes are imposed at a graduated rate based upon the corporation's yield percentage.39 The bulk of a corporation's tax liability consists of cantonal taxes.40

Social security taxes are imposed at rates of 10.6% for wage earners and 9.4% for self-employed persons. Wages in excess of 69,600 Swiss francs are not subject to tax.41 Capital taxes, which have previously been stated to include the federal tax, vary from canton to canton. For instance, the capital tax rate for an individual with a net wealth of 500,000 Swiss francs ($239,733 U.S.) in

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39Income Taxes on Corporations (Worldwide profits)

<table>
<thead>
<tr>
<th>Yield (%)</th>
<th>Applicable Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>4 and less</td>
<td>3.6</td>
</tr>
<tr>
<td>5</td>
<td>4.4</td>
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<tr>
<td>10</td>
<td>6.8</td>
</tr>
<tr>
<td>15</td>
<td>8.6</td>
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<tr>
<td>23.15</td>
<td>9.8</td>
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COOPERS & LYBRAND, supra note 35, at S-142.

40Total Income Tax Burden on Corporations (Federal, Cantonal, and Municipal)

<table>
<thead>
<tr>
<th>Net Profits of (Frs.) —</th>
<th>12,000</th>
<th>20,000</th>
<th>50,000</th>
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<tr>
<td></td>
<td>($5,593)</td>
<td>($9,322)</td>
<td>($23,305)</td>
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<table>
<thead>
<tr>
<th>City Rates</th>
<th>26.66</th>
<th>28.21</th>
<th>28.51</th>
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<tr>
<td>tax</td>
<td>($1,491)</td>
<td>($2,630)</td>
<td>($6,644)</td>
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<tr>
<td>Berne</td>
<td>18.76</td>
<td>21.53</td>
<td>23.44</td>
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<tr>
<td>tax</td>
<td>($1,049)</td>
<td>($2,007)</td>
<td>($5,463)</td>
</tr>
<tr>
<td>Geneva (w/o business tax)</td>
<td>22.11</td>
<td>27.34</td>
<td>31.84</td>
</tr>
<tr>
<td>tax</td>
<td>($1,237)</td>
<td>($2,549)</td>
<td>($7,420)</td>
</tr>
<tr>
<td>Lausanne</td>
<td>24.26</td>
<td>29.83</td>
<td>29.30</td>
</tr>
<tr>
<td>tax</td>
<td>($1,357)</td>
<td>($2,781)</td>
<td>($6,828)</td>
</tr>
<tr>
<td>Zurich</td>
<td>24.67</td>
<td>34.21</td>
<td>33.92</td>
</tr>
<tr>
<td>tax</td>
<td>($1,380)</td>
<td>($3,189)</td>
<td>($7,905)</td>
</tr>
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</table>

Exchange rate as of Nov. 14, 1985, was 2.1455 Swiss Francs to one U.S. dollar. Parenthetical figures are straight U.S. dollars. Table adapted from COOPERS & LYBRAND, supra note 35, at S-142.

41COOPERS & LYBRAND, supra note 35, at S-148.
Basel is .620%, .432% in Bern, and .172% in Zurich. In Geneva and Lucerne, without the optional church tax, it is .389% and .644% respectively.

As exists in most European countries, related entities cannot file consolidated tax returns. There are several items that are currently unclear in the application of the Swiss tax laws, for example; whether or not expenditures on social security taxes by the self-employed are allowed as deductions in computing the income tax. Regulations have not been proposed on this item.

Interestingly enough, the Swiss federal government has no balanced budget provision even though the maximum rate of federal tax is prescribed in the federal constitution. Furthermore, Switzerland has a great number of service occupations, which have formed a political interest group. In recognition of this, there is no net worth tax on persons whose sole occupation is rendering services.

Private interest bearing transactions are not taxed. For example, if A sells a piece of property to B in exchange for an interest bearing note, A's interest income is not subject to income tax. However, public issue bonds, whether cantonal or federal, are not tax exempt.

Overall, the Swiss nationals believed that their extremely complex taxing structure was not nearly as complex as that existing in the United States, including the multiplicity of state taxes. While the federal constitution provides for indexing of Swiss taxes, this has failed to be adopted legislatively. A proposal is presently pending before the Parliament of the Canton of Geneva to establish indexing at the canton level. Inflation in Switzerland has only run between 1% and 4%. However, a few years ago it was in the double digits.

While there is much discussion in the United States about the Swiss bank secrecy law, it should be noted that the secrecy law can be overturned by a Swiss court order. In the tax treaty between the United States and Switzerland, there is a mutual assistance provision concerning criminal matters. For example, the United States could possibly obtain information concerning a drug dealer's deposits in a Swiss account. However, Swiss courts have held that there must be a double incrimination before the secrecy of a numbered Swiss account is revealed. Double incrimination exists when there is a crime committed under United States law as well as under Swiss law.

Tax evasion is not a crime under Swiss law. Nevertheless, the taxing authorities are not without their long arm to be able to reach the account. Swiss law has a provision which is somewhat similar to a provision that the delegation discovered in Greek law. If taxing authorities cannot get bank ac-

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*B. VERT., CONST., COST. FED., art. 41, par. 3b. (Switzerland, amended) (providing a maximum rate for individuals, with Canton taxes, of 11.5%).

count information to prove a tax deficiency, they obtain a deficiency deter-
mination, enabling them to get at the proceeds of the account through a lien
served on the bank. Even though the name and number of the account holder
may not be identified in court in discovery after the fact, it is possible to get at
the account. United States taxing authorities could use this process to obtain
liens on Swiss bank accounts for tax deficiencies incurred in the United States.

One interesting feature of Swiss bank law is that inactive accounts do not
escheat to the state. Accounts that are dormant for ten years can be pro-
scribed. However, there is a ten year notice requirement after the ten year dor-
mancy period. Therefore, the earliest possible date that an account can be pro-
scribed is twenty years after the last transaction. Proscribed accounts pass to
heirs, devisees, legatees, and persons that can be identified to receive the ac-
count. A rather macabre historical note is that in the case of Jews who were
exterminated during the holocaust of World War II, a special law had to be
passed allowing their Swiss bank accounts to escheat to the International Red
Cross.

In discussions with the faculty of The University of Geneva, the delega-
tion pursued questions involving historical methods of accounting since it is
apparent that the Swiss tax system relies heavily on certified statements for its
tax audit procedures. In addition, the delegation was curious as to whether or
not Swiss accountants followed the generally accepted accounting principles
that exist in the United States. With some differences, Swiss accountants do
follow generally accepted accounting principles, using historic costs as the
basis for calculating net worth and for establishing reserves.

The establishment of reserves is the way to effectively average income,
and virtually every business does it. A company is allowed to depreciate its
assets, while establishing up to a 100% reserve for this purpose on an accrual
basis. The reserve is a deductible item in calculating net worth and taxable in-
come. Virtually every business establishes a reserve. Generally accepted ac-
counting principles in Switzerland are not established by the professional
organization but by the government, and they have the force of law.

Depreciation in Switzerland is based on useful lives. However, guideline
lives are provided. There is some flexibility. Being unable to effectively average
their income and net worth, young aggressive companies end up being taxed at
higher rates more often than established capital intensive companies. As
previously noted, it is unlikely that the indexing provisions that were recently
put into the Swiss constitution will ever become law. No citizen has the right
to force the inactment of such a law. Once enacted, however, a citizen has the
private right to challenge the law or its application.

The biggest evasion in Switzerland seems to involve hidden reserves.
Open reserves equal hidden reserves. There are reserves which the taxing
authorities may question, such as; 1) excess reserves, 2) extraordinary reserves,
3) contingent reserves, and 4) special reserves. The reason they are called hidden reserves is that they disappear in the profit and loss account.

There are basically three methods for establishing reserves which hide income in the profit and loss account on an accrual basis of accounting. One is by having appreciated assets. Remember that historical costs are the legal form of accounting in Switzerland. The second method is to have faster than normal depreciation. Actually, a plant or piece of equipment has a far longer useful life than the period in which the reserve is set up. The third is to establish unreasonable contingency reserves for bad debts, taxes payable, accounts payable, and products and sales warranties. Therefore, the taxing authorities generally closely examine appreciated assets, accelerated depreciation rates, and contingency reserves as a method of uncovering hidden reserves that increase the net worth.

Since the accounting profession is so important for compliance with tax laws in Switzerland, it is traditional for accountants to have handled tax problems. Historically, the government, on the other hand, never hired accountants or lawyers. Clerks were hired to be tax auditors. Recently, the federal government has begun to hire qualified people. Within the last ten years, lawyers have been hired by the government for tax enforcement. Rather obviously, there is tremendous conflict between the older civil servants who have only a clerk's background and the younger lawyers that are now in the tax enforcement area. Most positions opened through retirements are now being filled by lawyers.

The development of econometric models and artificial intelligence for audit purposes is in its infancy in Switzerland. Part of the problem with compliance in this regard is that at the present time, the federal income tax is collected by the cantons and remitted to the federal government. Therefore, there is very little federal litigation on the application of the federal tax law. It is almost solely determined by the cantonal courts. The only auditing that is presently being done by the federal government is the auditing of the canton's books. The situation is so loose that if it were present in virtually any other country in the western world there would be wholesale evasion.

The ethic of paying what is due, which seems to be part of the Swiss moral structure, results in an amazing degree of self-compliance. Economists with the Swiss banking corporations were absolutely convinced that there was approximately an 85% voluntary compliance factor in Switzerland. It is not only immoral but unthinkable for any Swiss businessman, who would consider himself a gentleman, to evade taxes.

There is a strong likelihood that a body of matured case law will emerge from the Swiss courts in the next twenty to fifty years. It is now being developed. Recently, the Federal Supreme Court decided that a taxpayer can appeal directly to the Supreme Court if there is a double taxation question.
under the Swiss federal constitution. The complexity of Swiss tax law is definitely one that should not be emulated in the United States. Yet, it is patterned after the United States. With only twenty-six cantons or states, it embodies every bit of the complexity that is present in trying to mesh our federal tax laws with the laws of fifty different states. Without the strong ethic of compliance, it is likely that, unless additional criminal penalties are added and additional funds are expended for enforcement, the Swiss experience with a complex system which is interdependent upon state and federal action will eventually follow the way of United States noncompliance.

The great value of the discussions in Switzerland was not in terms of a comparative analysis of Swiss tax law with United States tax law, but in discovering the records that are kept by the Swiss banking corporations regarding the economies of most of the western world, and even many of the Communist and eastern block nations. Swiss bankers are the bankers of Europe. They are very precise. They keep excellent records. Their computers are well programmed. They have all forms of econometric models. The information that was learned from the Swiss bankers about other taxing systems was extremely important. Since all banks in Switzerland are general partnerships with the owners personally liable, there is great incentive for the Swiss bankers to take the time and trouble to correctly evaluate taxing, revenue, and expenditure systems for virtually all of the nations of the western world and most of the eastern block.

Swiss bankers perform both commercial banking functions and investment banking functions and are the brokers for bonds and public issues. In addition, they are the clearing house for Euromarket securities. They are the financiers of enterprises, governments, and persons throughout Europe and much of the Middle East. Geneva is a money center. As is true in New York, money center banks keep excellent records.

Quite unlike New York, however, the Swiss were willing to share business information. They could tell us about virtually every bad loan in the third world, for example; why it was bad, what the revenue problems were, and what the expenditure problems were. They also had done thorough analysis of United States securities. Part of the reason for having done such an analysis was because 80% of the Euromarket securities derive from the United States and are United States issues. They range from either federal, state, and local governmental issues to many corporate issues. Swiss Bankers function as investment bankers since there is no legal prohibition to the combining of such functions as there is in the United States. It was from Swiss bankers that the delegation learned that turnover taxes, which are consumption taxes, trap 85%, on the average, of evaded income taxes.

The United States' huge noncompliance problem is a factor the Swiss consider when determining whether to invest in United States securities marketed
in the Euromarket. Since the Swiss banking houses are the actual underwriters, their reputation and profits ride on the accuracy of their determination of the stability of securities. They are greatly concerned about the United States lack of compliance in revenue collection. As noted earlier, under Swiss law private banking houses are general partnerships. Therefore, whenever a private Swiss banking house underwrites an issue, they are staking their financial lives on the accuracy of their analysis. This potential risk of liability makes anyone who sits and discusses these matters with Swiss bankers most assured that they have turned every stone to analyze public securities correctly.

If our delegation was not convinced before Geneva that the United States needed some form of national turnover tax for compliance purposes, it became obvious in Geneva. In Geneva, the Swiss correctly pointed out that the heavy reliance in the United States on income taxes without any form of turnover tax renders the United States manufacturers and businesses noncompetitive in world markets. Swiss bankers and accountants revealed that there is approximately a 10% price differential built into a Boeing 767 when sold in the world market versus a similar Air Bus consortium aircraft with virtually identical labor costs. Why should America do business with its hands tied behind its back because of its taxing structure?

The Swiss are also extreme realists about our ability to gain trade relief that allows us to provide income tax credits and subsidies for exported goods when we negotiate on modifications to the GATT. The Swiss simply stated that such modifications will not occur. Too many countries have competing self-interests. These comments and others impressed upon us a realism that the taxing structure in the United States needs not only to be reformed, but also re-examined as to the manner and method of taxation.

**YUGOSLAVIA**

While Yugoslavia was not the last stop on the delegation’s itinerary it has been placed last here because of its unique character as a nation emerging into a market driven economy. It was the middle stop after Italy and Greece and before Switzerland and France. What makes knowledge of the Yugoslavian tax structure useful for an analysis of American taxes? Simply, Yugoslavia is a nation torn with external debt exceeding its gross national product. It is a Communist state embarking on a unique experiment in public economics, that of a Communist state functioning in a market economy. Yugoslavia has a unique taxing structure which has failed to produce the necessary revenues to service the nation’s external debt.

Because of political considerations, the Yugoslavian economy has neglected equity markets and has been financed almost entirely upon leverage. This is similar to the United States agricultural economy which has, for various reasons, not tapped American equity markets to solve its financial
growth problems. In Yugoslavia, political considerations and the concept of Communism and state ownership of the means and manner of production have kept out equity capital. Just as a deteriorating economy has caused severe financial strains on the United States farm credit system, so also has a deteriorating world economy caused severe financial strains on the Yugoslavian economy.

In order to rectify this situation, the Yugoslavian government has undertaken serious studies of taxation in free market economies (or as they choose to call them, "market driven economies") in order to attempt to raise the public revenues necessary to service the exterior debt and to work with the International Monetary Fund (IMF). Many of the restrictions on expenditures that are present in Yugoslavia today are due to IMF requirements. Consequently, taxing policies which are being implemented result from empirical study and observation. The Yugoslavian experiment tends to prove the theory of the Vienna School of Economics that a controlled economy can only function if there are free economies upon which to build economic models.

One of the economic models is state revenues. State revenues are gathered by taxation and/or profit making enterprises. If a country's economy is to be market driven, then the method of gathering state revenue must be exclusively taxation. It is this tremendous transition in the nature of the Yugoslavian economy, while still embracing a communist political system, that makes the study of the Yugoslavian tax structure a unique experiment and of concern to the western world.

Our meetings in Yugoslavia were with the State Secretary of Finance, members of the faculty of economics, and members of the faculty of law at the University of Belgrade. The Yugoslavian government intended to learn as much from us as we attempted to learn from them. It is interesting to note that tax-laws in Yugoslavia are not published per se. There is a unique compact between the various republics and the self-governing provinces that comprise the country of Yugoslavia which could only be obtained in typed draft form. The writer of this article was permitted a copy in the Serbo-Croatian language. It is only one of few extant copies that are not totally classified as a state secret. In fact, the copy was obtained only with the express permission of the government. Such a state of affairs indicates the relative stage of development of the publication of laws in the country of Yugoslavia.

Except for the judiciary in Greece, perhaps the warmest reception that our delegation received was in Yugoslavia. However, the Communist presence was always felt. Particularly, in downtown Belgrade, there was docked a Russian cruise ship that traverses the Danube from the Black Sea. Nevertheless, the Yugoslavians went out of their way to strengthen their ties to the western world as part of their political experience and very much a part of their economic experiment.
What is striking about the Yugoslavian tax system is that it is totally decentralized. The sales tax is only at the federal level. There are federal, republic, and local taxes. The Yugoslavian government considers its tax system to be an instrument for social and political policy. Consequently, its characteristics are totally interrelated with the social system and its goals. There are presently six independent republics and two self-governing provinces.

All of the tax laws are republic and provincial laws. The republic and provincial laws assess the taxes, control the tax rates, determine the exemptions, and define who qualifies as taxpayers. Therefore, the eight units, consisting of the six independent republics and the two self-governing provinces, have the right to develop their individual tax systems. However, they are harmonized with the central tax planning policy embodied in the compact. Consequently, since the harmonization is governed by the compact, there are roughly the same rates and the same kinds of taxes in each one of the eight governmental units.

Through taxes, the government hopes to obtain all of the revenue necessary for social and other needs of the country. Tax policy is used to stimulate or destimulate various areas of economic activity. While the Yugoslavians seem to be very proud of the fact that there is no welfare system, there is a hidden problem. A person must work nine months to qualify for social programs, including unemployment compensation. Consequently, many young people are unable to obtain jobs, and Yugoslavia's biggest export, at the present time, is leasing people to other countries.

Only certain types of private enterprise are allowed within the country. There are also two classes of taxes that we have become familiar with, direct and indirect taxes. However, these are further divided into what are known in Yugoslavia as social and private sector taxes.

In the social sector, the organizations or firms pay all the tax. It is similar to the corporate income tax but assessed against the state owned entities. There is also a personal income tax on employees. In the private sector, the rates are generally flat not progressive. There is a capital tax, which is a tax on capital acquisitions. The income tax applies to all persons on income from all sources, social and private. It is the only progressive tax.

In order to understand the Yugoslavian tax system, it is necessary to analyze each tax on a step-by-step basis. Each activity gets its own tax, hence the ability to stimulate or destimulate each single economic activity. If a tailor in a state plant also makes a suit privately, then his private activity is taxed by that activity. Rental income is a capital tax, not an income tax. Any enterprise that employs nine or more persons must be a social enterprise, that is, an instrument of the state.

Wages in Yugoslavia are very low. The average sales tax is 30%. The average income tax is 10%. Both amount to a 40% average tax rate. There is
no permitted offset from one activity to another. For example, a loss on one activity cannot be deducted from a profit on another activity, or against a social wage income tax.

The Yugoslavian concept of harmonization means an equal distribution of economic activity, not wages, amongst the population. In order to determine income for tax purposes from agricultural items, a five-year averaging concept is utilized. This is done to stimulate profits based on a five-year cost. In other words, what Yugoslavia is attempting to do is to stimulate domestic agricultural production. In most of the independent republics and self-governing states, agriculture is a private sector activity. There are some communes on the Russian model, but very few. At the present time, Yugoslavia is a net grain importer. Accordingly, tax policy is utilized to stimulate the agricultural sector of the economy.

Sales taxes are hidden within the price of the goods except for certain luxury items, such as imported cars. Food and other necessary goods have no sales tax. At the present time, the Yugoslavian government is embarking on a slow change to direct taxes as a larger percentage of total tax revenues. In other words, Yugoslavia is striving towards a greater percentage of income tax collections rather than indirect sales taxes. This is designed to stimulate economic activity.

It is interesting to find within the compact harmonizing the tax structures wide differences among the six independent republics and two self-governing provinces. In some of the independent republics, medicine is considered almost entirely private sector. In others, medicine is almost entirely public sector. The practice of law is perhaps in the same category. In fact within a given independent republic, there may exist a private sector and a public sector within the same area of economic activity. While this would seem strange in terms of producing different rates of taxation, it does not. There is very little difference in the tax that an individual pays, regardless of the republic and whether or not in the private or social sector.

While what has just been noted about the Yugoslavian economy may be true for individuals, it is not necessarily true for enterprises or juridical entities (i.e., corporations, partnerships, etc.). This is particularly the case in those areas where there is an enterprise acting under the joint venture law. Enterprises acting under the joint venture law, are not taxed on their means of production. The capital tax is a capital income tax or capital revenue tax. It is at a somewhat higher rate, with the intention of making it progressive. What is the joint venture law? The joint venture law is designed to tap foreign capital markets with equity capital and still preserve, to some extent, the economic basis of Communism as well as its theoretical political justification. Simply stated, the joint venture law permits a foreign enterprise to enter into an agreement with a social sector enterprise. Social enterprises are known as “organiza-
tions of associated labor” which operate in what are called “self-managing communities of interest.”

Consequently, a public enterprise manufacturing auto parts, which will qualify as an organization of associated labor, can enter into a joint venture with General Motors, as has been done. Yugoslavia manufactures certain engines for General Motors in Europe. General Motors then uses those engines in cars which are built and have a distinctive “J.” These cars can be reimported back into Yugoslavia.

In order to tap foreign capital markets and as an incentive for foreign investment in Yugoslavia, exemptions based on length of time and amount of investment are granted to an investing company. A foreign investor may now own more than 50% of an enterprise under the new joint venture law. This may be the way that Yugoslavia finds its way out of the economic doldrums. Remember, the economy has traditionally worked on leverage. It has never tapped foreign capital markets. The new joint venture law guarantees rates of return for the foreign investor and freedom from taxation based upon the length of time that the capital is left in the country. These are substantial incentives for foreign equity investors.

Passive income in Yugoslavia is subject to a flat tax of 30%. This would include interest and dividends. Because of a 900% rate of inflation, most persons immediately convert any payments that they receive in Yugoslavian dinars into dollar accounts in local banks which bear interest. They are taxed at a flat rate of 30% on their interest. Interestingly enough, if a person has enough money to buy Eurobonds, there is no withholding tax. All banks are social enterprises. However, they allow individual ownership of foreign currency and interest bearing accounts.

Dividends received from foreign equity holdings in countries which have a Yugoslavian tax treaty are taxed at 15%. With other countries, which includes the United States, the rate may range between 10% and 15%. If a United States resident in Yugoslavia has income, he is only taxed on income that is effectively connected to the trade or business in Yugoslavia.

Yugoslavia, as a country, encompasses both aspects of the old Hapsburg and Ottoman Empires. In fact in Sarajevo, there is one street in which you can literally cross from Europe to Asia. Even though Yugoslavia was formed after World War I, it did not gain importance in the world family of nations until after World War II. While Joseph Broz Tito was an avowed Communist, both the British and the United States agreed to provide him with supplies, personnel, and technology during World War II since his band of partisans were the only real resistance to Germany. Tito emerged from World War II a national hero and a unifying factor in this multi-faceted nation. In 1948, Tito decided that Yugoslavia should have the right to decide its own form of socialism. This view was heresy to the Union of Soviet Socialist Republics.
Tito and the other leaders of Yugoslavia, in forging this unique experiment, developed the concepts of "self-managing communities of interest" and the "organizations of associated labor." There is no entity in the western world that is comparable to this concept. There is also no concept equivalent to it in the eastern block nations. Perhaps the only description of the "organizations of associated labor" is its similarity to a congregational type of church in the United States. The companies themselves are in the trust of the employees for the common good. Consequently, reinvestment of profits range between 25% and 50%. Some of their enterprises are highly profitable.

JAT, Yugoslavian Air Transport, is one such enterprise, showing substantial profits in the past. Others are Yugo-Exports, which purchases from foreign farmers fibers and woven goods utilized in the manufacture of exported clothing and shoes. In a rather unique experiment, all of the members of the delegation checked their shoes. Over a third of the members had shoes that were made in Yugoslavia. Then, part of the delegation was sent to scour the downtown shops of Belgrade to see if the same shoes could be obtained. They could not be found. They are made solely for export.

The basic problem facing the Yugoslavian people is that rates of inflation have been running far ahead of granted wage increases. Last year the maximum wage increase that could be granted for most profitable industries was 25%. Yugoslavia is a country in which per capita GNP ranges between $1400 and $1500 per year.

As mentioned earlier, Yugoslavia's largest export is the export of workers. So far the country has not been able to reconcile this with their social system. Furthermore, they have been unable to deal with the harnessed capital and savings that guest workers earn while overseas.

Another basic feature of the joint venture law, added recently due to the rate of inflation, is that guaranteed tax free rates of return to be earned have inflation increments in them. They are not based on cost. In other words, if GM invests $1,000,000 and is allowed to have a rate of return of 10% and inflation of 100% makes that worth $2,000,000, the next year they would be allowed $200,000 free of tax rather than simply $100,000. Businesses are never sold, but there are mergers.

Another term heard in Yugoslavia in place of "organizations of associated labor" is the term "basic association of unified labor." The two really mean the same. The social compact referred to earlier which governs the harmonization of taxes was concluded in 1984. In addition to the income and sales taxes, there are other systems of social contributions for health, education, and pension funds.

The "self-managing communities of interest" are more than economic entities. They are the communal living structure. They represent the local city.
government or neighborhood government even within a city.

As is presently designed, the tax system redistributes 18% to 20% of total national income. National income is not to be confused with GNP. National income represents the value of receipts of all persons. In addition, the self-managing communities of interest, i.e., the local neighborhood city political entities, redistribute an additional 20% of total national income. With the addition of social contributions for health, education, and pension funds, the figures become rather dramatic.

It was interesting to hear how critical the members of the faculty of economics and faculty of law were of their government, particularly in the presence of the State Secretary of Public Finance and members of state security. Academic freedom is preserved. However, academic salaries being a maximum of $300 (U.S.) per month are not enough to attract most United States professors. The criticism of the former government policies by the faculties of economics is that their thrust has been on monetary policy. Both the faculties of law and faculties of economics believe that the thrust of government economic policy should now rest on fiscal policy.

Yugoslavia is moving closer toward tax policies similar to the United States. Nevertheless, they intend to retain their turnover tax and sales tax, which is not a VAT, as a means of enforcing compliance. There is also a policy of encouraging the growth of small scale private business with a complete exemption of tax the first year and declining exemptions thereafter. This includes freedom to invest in equipment. Importation of income producing equipment is exempt from all customs duties. There are wealth transfer taxes. However, if there is a farmer-to-farmer transfer by means of inheritance or sale, the rates are very low.

Private enterprise currently comprises 15% of GNP in Yugoslavia. Their income tax has an automatic three-year averaging. Yugoslavia has special economics courts. Furthermore, they do have bankruptcy and tax courts. Their dispute resolution system functions rather independently of state action. The country is making great strides to comply with the very stern restrictions of the IMF. In no country were we accorded the courtesy and genuine sharing of ideas by the highest officials of state as we were in Yugoslavia.

Of all the third world nations, only Yugoslavia is trying to become a viable trading partner and economically self-sustaining in a capital fashion. The monitors for the IMF of Yugoslavia have high hopes that the Yugoslav economy will survive. For our political purposes, it is essential that the Yugoslavian economy survive. It is our strongest trading partner in the Balkans.

CONCLUSION

After returning to this country to prepare this article for publication, the
The author had much time to reflect on the materials and notes obtained by the delegation and to consider the proposals for tax reform being considered by the House Ways and Means Committee during the Fall of 1985.

It is apparent that many members of Congress do have an appreciation of our trade problems and the relation of our tax policies to the trade balance deficits. Equally apparent is the awareness of many members of Congress concerning our voluntary compliance problems. However, less apparent is an appreciation that the corporate income tax is a regressive consumption tax which destimulates export activity. Furthermore, less apparent is Congressional recognition that the corporate income tax does recoup some evaded or avoided income taxes from consumers through the price charged for products sold. However, as long as corporate tax revenues yield only 10-12% of total government revenues, they will not provide an effective recoupment of all evaded or avoided income taxes.

What are the lessons to be learned from this study of the alternative tax systems of sample countries in Europe? Some form of turnover tax; either a sales, transfer, or value added tax; needs to be adopted in order to enable our export industry to compete with those countries utilizing the same. Failing the adoption of this form of tax, our nation must negotiate modifications in the GATT, providing that deductions, credits, or exemptions for income taxes in export are not illegal subsidies. To negotiate the latter is about as likely as finding a snowfall in the sun. However, current proposals for tax reform, in effect, hold such negotiations hostage to our changes due to the radical reduction in corporate rates.

If, and only if, we get the desired result in the new GATT negotiations, we should consider a significant increase in the percent of revenues collected from the corporate income tax as a means of recouping avoided income taxes. However, this should be accompanied by a lowering of marginal rates to a level which matches any personal rates to provide a tax neutrality in the choice of business entity.

At the federal level, perhaps the best way to recoup avoided taxes is to eliminate certain business deductions thereby forcing a higher price for the products sold. If the tax cost embedded in the price of goods approximates 25%, then there is significant recoupment to the federal treasury. However, deductions for state and local sales taxes should be abolished to prevent such recoupment from being a direct subsidy to state and local taxing authorities which utilize a sales tax for revenue purposes. Avoided federal taxes should be recouped only to the federal treasury. (The debate on deductibility of all state and local taxes is an entirely different matter and not appropriate to a discussion of consumption taxes for recoupment purposes.)

The investment credit should be preserved to avoid a double taxation on purchases of plant and equipment. Since corporate income taxes are a hidden
form of consumption tax, customers pay the tax in the price of goods purchased in order to provide an after tax income to investors. This approach is superior to allowing the corporate income tax paid on plant and equipment to be capitalized, since the period over which the cost is recovered is an interest free loan to the federal treasury and is a disincentive to economic growth.

Finally, if there is no success at Geneva with the GATT, this country should adopt a nonregressive turnover tax with a personal consumption credit. A turnover tax would provide export credits and the necessary recoupment of 85-95% of our tax gap. The hidden double tax on the purchase of plant and equipment would be avoided by retaining the investment credit. In this light, the deduction at the personal level of state and local sales taxes should be eliminated since it doubles the benefit encompassed by the personal consumption credit. The personal consumption credit can be adapted in a variety of ways; (1) increased personal exemptions, (2) a modified flat tax with lower marginal rates of not more than three brackets, or (3) a larger zero bracket amount.

In short, meaningful tax reform and expanded growth hinge on Geneva and a major overhaul of our tax system.