UNIVERSITY OF GLASGOW

A COMPARATIVE STUDY BETWEEN THE TAXATION OF COMPANIES IN THE UNITED KINGDOM AND EGYPT WITH PARTICULAR REFERENCE TO UNITED KINGDOM BASED MULTINATIONAL COMPANIES OPERATING IN EGYPT

VOL.I

BY

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IN THE NAME OF GOD,
MOST GRACIOUS,
MOST MERCIFUL

Abstract

Taxation plays a major role in economic activity, as a prime source of revenue and as a tool of economic mangement for all governments in either developed or less developed countries.

This thesis contains a comparative analysis of the tax treatment of companies in the United Kingdom(UK) and in Egypt. The study is particularly concerned with the effect of taxation on investment and financial policy decisions of UK multinational companies operating in Egypt, and incentives which have been offered by the Egyptian Government to attract foreign investors to operate in Egypt.

The comparison is made by examining both the UK and the Egyptian positions, with emphasis on UK experience in applying different systems of corporation tax. The purpose of this comparison is to identify the most appropriate system of company taxation for a developing country.

The impact of taxation on business in Egypt has been examined by using survey techniques supported by content anlaysis and ratio analysis where possible. However, use has had to be made of information published by the General Authority for Investment and Free Zone (GAFI). The survey has been carried out with particular reference to Egypt, and the findings are also supported by analysis of interested academic staff in the Universities in Egypt as well as opinions of administrative staff in both Tax Administration and GAFI. A separate examination was undertaken of the

perceptions and responses of Multi-National Corporations (MNC's) operating in Egypt.

The structure of the thesis is thus as follows:

Part one provides a general introduction involving a over-view of the taxation of companies with reference being made to the separate legal entity of the company; different forms of companies, and their tax treatment. The specific analysis of the taxation of companies in the UK includes an outline examination of company profit measurement and the problems associated with the taxation both of profits and company distributions. Double taxation, both economic and juridical, is considered as are the needs and methods for mitigating such double taxation. Reference is also made to aspects of tax avoidance and evasion in the UK and Egypt.

Part two examines the Egyptian tax system and its effect on the Egyptian economy before the Egyptian Revolution and up to now. It also analyses the tax treatment of companies under the old and new systems. As part of this the meaning of distributions is considered, as is tax treatment of dividends.

Part three focuses on the Egyptian policy on foreign investment which was promulgated to attract foreign investment by offering many inducements including tax incentives. This part also discusses the concept of the multinational company and the taxation of such companies. Issues such as transfer pricing and taxation of return on investments in the form of dividends and interest form part of this.

Finally discussions and conclusions contained in chapter fifteen embody suggestions for reform both of tax law and investment laws in Egypt as a means of enabling more effective incentives for investors to operate in Egypt.

I WOULD LIKE TO DEDICATE THIS THESIS TO MY MOTHER , MY WIFE (SAMIHA) AND MY FAMILY FOR THEIR PROLONGED PATIENCE, ENCOURAGEMENT AND UNDERSTANDING OVER THE YEARS

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Abbreviation Used

ACT	Advanced Corporation Tax
APB	Accounting Principles Board
BTR	British Tax Review
CAA	Capital Allowance Act
CGT	Capital Gains Tax
Cmd	Command Papers
Cmnd	Command Papers
CPT	Corporation Profit Tax
CT	Corporation Tax
CTA	Company Tax Act or Corporation Tax Act
CTR	Corporation Tax Rate
ECC	Egyptian Commercial Code
EDT	Economic Double Taxation
EPD	Excess Profits Duty
EPL	Excess Profit Levy
EPT	Excess Profit Tax
FA	Finance Act
FIFO	First In First Out
FII	Frank Investment Income
FYA	First Year Allowance
GAFI	General Authority for Investment and Free Zones
IIT	Individual Income Tax
IR	Inland Revenue
ITR	Income Tax Rate
LIFO	Last In First Out

LPA	Limited Partnership Act
MCT	Mainstream Corporation Tax
MNCs	Multinational Companies
NDC	National Defence Contribution
ODP	Open Door Policy
PT	Profit Tax
Para	Paragraph
RBM	Reduced Balance Method
Sched.	Schedule
SLM	Straight Line Method
S.	Section
SSAP	Statments of Standard Accounting Practice
TA	Tax Act
UK	United Kingdom
WDA	Writing Down Allowance

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INTRODUCTION

CHAPTER ONE

A GENERAL REVIEW OF THE TAX TREATMENT OF COMPANIES ACCORDING TO UNITED KINGDOM AND EGYPTIAN TAX SYSTEMS

Chapter One

A general review of the tax treatment of companies according to United Kingdom and Egyptian tax systems

1.1: Introduction

In their quest for economic development, the poorer nations of the world, such as Egypt, need to develop a public fisc, and in particular a tax system which is compatible not only with economic, social and political systems, but with other financial policies in particular, as well as with the overall economic policies of the state in general.(1)

Taxation plays a major role in economic activity as a prime source of revenue and as a tool of economic management. Taxes are also major recurrent outgoings for businesses, including multinational companies (MNCS). Economists and tax experts have debated the need for tax systems for many years, mostly at a theoretical level, but without coming to any consensus. Some have expressed deep scepticism about the usefulness and feasibility of tax systems in poor nations. Others agree that the role of tax systems is, at most, limited, while a third group believe such systems to be a necessity while granting that they are usually difficult to administer in poor nations and could not be expected to perform as well as in rich countries.

The role of taxation in the past was essentially confined to coverage of public expenditure. Thus, the financial purposes were the main concern of taxation to the exclusion of any direct objectives in the economic or social fields. However, in the light of the developed and enhanced economic role of the state coupled with the evaluation of economic and financial objectives, a concomitant change in the role and function of taxation has taken place. Consequently taxation has become an instrument of economic and social planning as it has been increasingly resorted to as a means for directing investment, the checking of inflation and in redistributing incomes and wealth, as well as other goals which go beyond its traditional function.

More specifically, in addition to raising the revenues required for financing the public sector, the tax structure of a developing country should seek to curtail superfluous consumption; to provide resources for governmental use or capital accumulation; to discourage investment in projects which have little benefit on growth; to furnish incentives and to engage in economic behaviour which favours development. In other words, the tax system ideally should provide a set of major incentives to work, save and invest.

In Egypt the forms of taxation, particularly company taxation, are important at the present transitionary stage when efforts are being channelled towards the rapid economic development of the country. One unmistakable sign of this is growing industrialisation. For several decades in the past, companies have played an increasing part in the economic life of both developed and developing countries and this can be expected to continue.

In every country the form of company taxation has been the subject of both academic debate and political experimentation. The existence of a separate corporation income tax on companies has been defended on a variety of grounds and this form of taxation seems to be a permanent element of most countries tax structures. This is due to the intervention in public policy towards corporations to influence their behaviour. The increasing dominance of corporate forms of enterprise has led to this separate form of taxation(2) and is seen as a major element in the rise in the rate of economic growth. However, the incidence of CT and its effects upon economic areas such as growth, stability and income distribution have led to a great deal of intellectual dispute and disagreement among economists leading to repeated and various suggestions for reforming the system of corporation tax.

The Egyptian tax system, especially the company tax system, has for long been in need of major reform. Year after year successive Finance Acts attempted to close loopholes, to relieve injustices, to impose new penalties and to grant new incentives, but these piecemeal reforms have not been developed on a systematic pattern and have added to the complexity of the law.

It is perhaps important to mention here that up to 1981, the Egyptian company taxation system was similar, approximately, to the British system which operated before the introduction of CT in 1965. Since then, the British Government has itself changed its company tax system twice, once in 1965 and then in 1973. In Egypt, on the other hand, up to 1981 companies had paid commercial and industrial profits tax at a rate of 39.7 per cent. An individual paid at source tax on movable capital assets at a rate of 40.55%.

In the seventies, the Egyptian Government introduced a new policy the so called Open Door Economic Policy (ODP), to encourage Arab and foreign funds to invest all over the country. Because of the amendments which were made to the Tax Law No. 14 of 1939 and for other reasons the Minister of Finance established a technical committee on tax modernisation to carry on the technical work of reform. There were many discussions of the Egyptian Tax Modernisation Group 1978-1980 and reports on"Egyptian Tax Modernisation Project" were presented by consultants of the Egyptian Tax Modernisation Committee. They reached a consensus that a separate tax on corporations should be established.

In 1981 the Tax Law No.14 of 1939 was repealed by the government, which replaced it with the new Tax Law No. 157 of 1981. Companies according to the latter (tax) law, have been subjected to corporation tax (CT) at the tax rate of 32 per cent for industrial companies and 40 per cent for commercial companies.

Corporation tax in both UK and Egypt produced a significant amount of revenue; in fact, the CT proceeds during the year of 1984 were £6883 mn. in United Kingdom(3) and for the same year were LE2023 mn.(4) in Egypt(5).

As a rule, CT is both administratively and politically preferred as it is easier to collect a given amount of revenue through a separate tax on corporate profits than through additional taxes on personal income. A great amount of the total revenue comes from the largest corporations, which generally tend to have the best records and are the easiest to deal with administratively.

It is therefore appropriate that in Egypt where companies are making high profits, the state should partake of those profits through the instrumentality of the law of company taxation to meet its wider requirements. The purpose of this study is to attempt to see what system of company taxation will be the best suited and indeed the most responsive to Egypt's national policy objective. Indeed, the choice of any particular system of CT for Egypt will have to be made on the basis of providing for conditions in the country. In addition, this study attempts to answer the following questions:-

- What is a corporation for tax purposes?
- Why should a corporation be taxed?
- What results follow from the imposition of tax on corporations?
- What are the other results of changes in the respective CT systems in Great Britain and Egypt?
- What specifically, are the economic effects of CT?
- Has its pattern or volume been affected by saving and investment?
- Has there been any effect on the way in which the corporations are financed?
- To what degree has foreign investment in Egypt been stimulated?

- Is there a serious double taxation problem from the taxation of corporate income and the subsequent taxation of dividends paid to the shareholders?
- If so: Has tax law any rules to prevent or alleviate it?
- What is the best way to prevent tax avoidance and tax evasion?

For the purposes of the above, the thesis will be concerned with the taxation of the profits of companies and of distributed dividends. I shall examine mainly the historical evolution of the United Kingdom (UK) Corporation Tax system in order to establish its virtues and defects at its various stages and on the other hand I will consider Egyptian Company taxation to evaluate its suitability, if any, to the present conditions in the country. I will also look ahead in the light of British experience at some possible future developments in the field of Egyptian Company taxation.

Finally, it therefore becomes necessary for a proper appraisal of Egyptian company taxation to examine the structure of UK corporation tax law for guidance, more especially as there is a serious paucity of decided cases on company taxation (especially in MNCs) in Egypt so that one is unaware of the drawbacks and shortcomings of the present systems.

This thesis will start by considering the concept of a corporation for tax purposes, it will then be divided into three parts:

Part one will deal with United Kingdom Company Tax systems.

Part two will deal with Egyptian Company Tax systems.

Part three will deal with field study and will cover the future reform of Egyptian Company Tax system and findings.

1.2: The concept of corporation as a separate entity for tax purposes

The word "corporation" comes from the Latin corporare as a meaning 'to form into a body'.[6] A corporation has been defined by the encyclopedia of social sciences as a form of organisation which enables a group of individuals to act under a common name in carrying on one or more related enterprises holding and managing property and distributing the profits or beneficial interests in such enterprises or property among the associates, its share is transferable, its life independent of the lives of the individuals, its debts do not usually create any liability for the latter. [7]

It is really a voluntary association of certain people who pool their resources together and undertake some type of activity for the express purpose of making profits. If the members of a corporation choose to function thus, it is because of the many benefits that this form of organisation confers on them. The corporate form of organisation has become so popular a feature of the world of business and in all countries with a free economy that the corporation is almost the dominant type of the business structure.

The concept of company and its types according to British Law

The word "company" has no strictly legal meaning. It is difficult accurately to define a corporation, it is almost impossible to give a clear and correct definition of a company. In the case of Re Stanley, Tennant v. Stanley

Buckley J., said. [8]

> "The word company has no strictly technical meaning. It involves, I think, two ideas - namely, first that the association is of persons so numerous as not to be aptly described as a firm, and secondly, that the consent of all the other members is not required to the transfer of a member's interest. It may, but in mmy opinion here it does not, include an incorporated company. The words "corporation or company" here mean, I think, an incorporated body or an unincorporated body which is "municipal, commercial or otherwise" and which is of such a kind as not to be what is commonly called "a firm".

On the above view, the words "company", "corporation" are wide enough to include municipal corporations and commercial or business carrying on companies abroad. [9]

On the other point, the Company Act of 1908 recognises as companies some purposes of the Act those which are constituted regulated by Act of Parliament, contract of co-partnery, cost book regulation, letters patent, or royal charter. Some of these are corporations and some are not.[10]

Evans F. attempts to give a definition of a company as "A company is an association of two or more individuals united for one or more common objects, whether incorporated or unincorporated..." Lord Hailsham gave the same definition as above, he said:[11]

> "The word 'company' imparts an association of a number of individuals formed for some common purpose, such an association may be incorporated (that is, a body corporate with perpetual succession and a common seal) or it may be unincorporated."

The definitions above include an incorporated company which is a legal person separate and distinct from the individual members of the company and an unincorporated company which has no such separate existence and it is not in law distinguishable from its members.

The Taxation Dictionary defines the company as:
"An association of persons formed for the purpose of business or undertaking carried on in the name of association, each member having the right of assigning his shares to any other persons, subject to the regulations of the company". [12]

Therefore, according to these viewpoints we accept the Buckley idea that the word "company" has no strictly technical meaning, it has a variable meaning and can be used in many ways. The meaning depends on the context.

There follows an examination of separate legal entity of the company, of the forms of business organisation and a classification of these forms for tax purposes.

1.3 The separate legal entity of the Company

For the purposes of the law, the definition of a legal person is not always confined to a human being so a legal person can be described as any person, human or otherwise, who has rights and duties at law i.e. who can seek the aid of the court and against whom the aid of the court can be sought by others.

A human being is a legal person all his life, i.e. from birth to death, but it is important to remember that for some purposes he has pre-natal rights and the courts protect him even before he is born while for other purposes his rights remain enforceable after death for specified periods. While all human beings are legal persons, not all legal persons are human beings. Non-legal persons include corporations.

Buckley L.J. said in the Court of Appeal in Continental Tyre and Rubber Co. (G,B.) Ltd. v. Daimler Co.[13].

> "The artificial legal person called the corporation has no physical existence. It exits only in contemplation of law. It has neither body, parts, nor passions...It can be neither friend nor enemy. Apart from its incorporators it can have neither thoughts, wishes, nor intentions, for it has no mind other than the minds of the corporators."

and Lord Parker had the same idea mentioned above, he said:

> "A Company is not a natural person with mind or conscience... no one can question that a

corporation is a legal person distinct from its shareholders."

The famous case which clearly established the independent legal personality of the company is Salomon v. Salomon and Co. Ltd.(14).

Thus the company is a person in the eyes of the law, quite distinct from the individuals who are its members. The company as a legal personality is described as an artificial person in contrast with a human being.(15)

The same principle established by the House of Lords in Solomon's case applied in the case of Lee v. Lee's Air Farming Ltd.(16). Although the argument was that "a workman is a person employed under a contract of service" it was further argued that no compensation was due because Lee and Lee's Air Farming Ltd. were the same person, but the Privy Council applied Salomon's case and said that Lee was a separate person from the company he formed and compensation was payable.

English Law refuses to impute to companies those characteristics of natural persons which appertain to their human and social nature, and which may form the basis of a vast range of individual rights and duties. In particular, at law a company is recognised as having no physical attributes and no mind of its own(17).

Moreover, Salomon's case opened new and wide possibilities to the small businessman and its importance in the world of commerce is immeasurable. As Gower said.(18)

"This decision opened up new vistas to company

> lawyers and the world of commerce. Not only did it finally establish the legality of the one-man company and showed that incorporation was as readily available to the small private partnership and sole trader as to the large public company, but it also revealed that it was possible for a trader not merely to limit his liability to the money which he put into the enterprise but even to avoid any serious risk to the major part of that by subscribing for debentures rather than shares. This result seems shocking".

The corporation is a construction of law established by the authority of the state and presumably operating within the confines of its charter from that state. While it depends on its shareholders, directors, and officers for its organisation and operation, the corporation has been accepted as having a separate and distinct existence as a "person" in the eyes of the law for centuries. Consequently, corporations have been permitted to take, hold and dispose of property, make contracts, and to sue or be sued in their own names. All rights enjoyed by a corporation are vested in the corporate name and not that of any involved individual. Also any responsibilities or obligations of a company are charged in the first instance to the independent corporate entity, rather than to the people behind and within it.

The purpose of the corporate form is just and foremost, to provide for continuation in interest; whereas individuals grow old and die, corporations simply grow old. As the original owners and managers leave the service of the corporation, new shareholders, directors and offices take their places, continuing the functions of the corporate entity.

An additional advantage of the corporate form which has proven to be more popular than the potential for perpetual existence is the limited liability which it has provided for shareholders, directors and officers. Being a distinct 'person', the corporation must see that any debts or other responsibilities are satisfied by the appropriate application of the assets.

Moreover, it is a fundamental concept of English Law that a company is a 'person' and as such an entirely distinct and separate entity from its member. Goyder G. stated that "a company is a formal legal arrangement governing the relationship of the parties in a business."[19]

According to the viewpoint of taxation, the existence of corporation tax has been defended on a variety of grounds and this form of taxation seems to be a permanent element of most countries in their tax structures. Professor Musgrave stated the different viewpoints toward the CT. He said:[20].

> "Treasuries like the corporation income tax because it is a convenient way to get revenue. Labour Unions like it because they think it falls on profits and makes the tax structure more progressive. Businessmen do not mind it because they tend to believe that the tax is

passed on, and consider it objectionable only when management decisions are interfered with...still others view it as an instrument of economic policy, "and he concludes," for these and other reasons, an absolute corporation tax has remained popular and continues to receive support from both liberal and conservative circles, but all this, alas, is an explanation, not a justification for such a tax."

The controversial issue in the debate is derived from the question: Are the corporation and its shareholders really synonymous? In attempting to answer this question, politicians, economists and businessmen alike differ among themselves. The law, as mentioned, provided the corporation with a legal personality. Therefore, the independent legal personality of the company is a well known principle established years ago.(21) The company as a legal personality is often described as an artificial person in contrast with the human being who is described as a natural person(22).

The fiction theory, whose principle English advocate is Salmond, regards the legal personality of entities other than human beings as the result of a fiction. Real personality can only attach to individuals. Corporations, although they cannot be the subject of rights attached to individuals, are treated as if they were persons(23).

From the above discussion, it will seem that the natural result shows the company as a legal personality. However, does the corporate income belong to the corporation or to the shareholders? If it belongs to the former then a justification for a separate tax on corporation exists; but if the latter then there is no justification for its existence.

Two diametrically opposite views have been used by each side to support their views:

Viewpoint One

Behind the company lie the individuals who own it, and some people argue that it is these individuals who should be taxed on the profit, especially as the corporation is no more than a legal intermediary between the shareholder and the income. It is creating a production process. A corporation in comparison with other forms of enterprise, is considered to be the form adequately equipped to sustain the increasingly large scale of operations demanded by changing technological and economic conditions, and it is clear that businesses would have been constrained in their attempts to raise capital and in the extent of their activities if the corporate form had not been devised. The law provided a corporation with a legal personality separate from that of its shareholders. However, it remains an artificial creation and even though shareholders may have only limited control over their corporation, they are the ultimate recipients of the income, and the ones who have the taxable capacity. Therefore, the existence of separate tax on corporate income and the absence of any link between the personal and corporate taxes are unjustified. Professor Musgrave says[24].

> "All taxes are ultimately paid by people, and equity deals with the distribution of the tax bill among individuals or families. Corporations as such cannot bear the ultimate burden. They are important legal entities and powerful decision making units but they do not have a taxable capacity of their own. Even though shareholders may have only limited control over their corporations, they are the ultimate recipients of the income and the ones who have the taxable capacity. If the tax is not shifted, it is the shareholders who pay it, including the tax on undistributed profits as well as on dividends, and if the tax is passed on, it will be paid by consumers or workers".

Thus, according to this view, the corporate personality is just a convenient short-hand expression to convey the attributes of these associations of persons and the company is subjected to corporation tax on behalf of its shareholders.

Viewpoint Two

There is a second school of thought where the approach is in line with the law, which recognises the corporation as a legal entity separate from its shareholders. The company is a 'person' in the eyes of the law, quite distinct from the individuals who are its members. Hence it is capable of enjoying certain rights and discharging certain duties[25]. The company as a legal personality owns its own property in which the shareholders only own shares, and any income to the company belongs to that separate legal identity which should be taxed. It is sometimes compared to a river because, just as a river is the same river "though the parts which compose it are changing every instant", so also a corporation is the same corporation, though the people who own it may change from time to time. Therefore, the existence of CT is justified on its own merits and hence should not be closely integrated with the personal income tax. Professor Van den Temple says:[26]

> "Modern industrial development has meant that notably the public share company of which the shares are quoted on the stock exchange, when seen from an economic and social point of view has an existence of its own, independent of that of the shareholders".

This viewpoint accepts that the interest of the corporation is to be found in the sphere of production and that it may not coincide with the shareholders' interest.

The view which is adopted in most tax systems is that of the separate legal identity and therefore most companies are subject to CT. The corporation, therefore is no more than a legal intermediary between the shareholder and the income creating production process. A corporation is considered to be the form adequately equipped to sustain the increasingly large scale of operations and it is clear that businesses would have been constrained in their attempt to raise capital and in the extent of their activities if the corporation form had not been devised.

In the light of this view which is adopted by UK statutes, the company is seen as a separate legal entity. It is no surprise to find that in some cases, mainly in connection with taxation, the courts have held that a comany is capable of having a domicile and can have a place of residence. As Macnaghten said in the case of Gasque v. IRC.[27]

> "A body corporate cannot have a domicile in the same sense as an individual any more than it can have a residence in the same sense as an individual. But by analogy with a natural person the attributes of residence, domicile and nationality can be given and are, I think, given by the law of England to a body corporate".

and Lord Loreburn L.C. said in the case of De Beers Consolidated Mines Ltd. v. Howe.[28]

> "In applying the conception of residence to a company we ought, I think, to proceed as nearly as we can upon the analogy of an individual.

But still the company is an artificial person that cannot eat or sleep, therefore the residence of a company is in fact determined according to where its central management and control actually abides.[28]

Perhaps the most important arguments for a separate tax on corporation income arise from the fact that corporations usually do not pay out all of their income in the form of dividends. If all profits were paid out in dividends, corporate profits could be taxed in a straightforward manner as part of the income of shareholders. However, the non CT solution creates problems when some profits are retained in the corportion. These profits are usually returned because corporate managers or shareholders, or both, think they will be useful to the company and will probably increase the future profitability of the company. Higher future profitability or its prospect, is likely to increase the market value of the companies shares. For the shareholder, the increase in share prices are realisable capital gains and are thus in effect income. If capital gains are not taxed, or if they are taxed at lower rates than income this creates problems of horizontal equity between taxpayers.

On the other hand, in both Great Britain and Egypt, CT produces a significant amount of revenue. As a rule it is both administratively and politically easier to collect a given amount of revenue through a separate tax on corporate profits than through additional taxes on personal income. In Egypt, most of the revenue comes from a small number of relatively large companies, mostly organised in the corporate form. A great amount of the total revenue comes from the largest corporations, which generally tend to have the best records and are easier to deal with administratively.

In the light of the discussion above and in my view, it is obvious that the corporate personality is at once similar to, and distinct from, the individual personality. Just as the individual earns and pays taxes, the company also earns and has to pay tax. Moreover, the foremost trait of the modern corporation is the separation of ownership and control. Furthermore, the corporation is a separate legal entity and it is also treated as a separate taxable entity.

Some conclusions for the first chapter can now be drawn:

(1) Although there is no strictly legal meaning of a "company" in both countries (Great Britain and Egypt), the definition of a "company" according to British Law is I think, more precise than the definition of a "company" according to Egyptian Laws. Therefore, we can accept the following definition of a "company" for tax purposes.

"An association of persons formed for the purpose of a business or undertaking carried on in the name of the association, but excluding a partnership".(29)

(2) The types of company in both countries are approximately the same, except the public company ~~shares~~ which are owned by individuals according to British law, and belong to the State according to Egyptian Laws.

(3) Partnership is a legal personality according to Scottish and Egyptian Laws, while not a legal personality according to English Law.

(4) The company has been regarded as an entity distinct from the individuals who own it and those who direct its

activities.

(5) The company as a legal entity has the power to sue and to be sued in its own name.

(6) The shareholders are not entitled to the income of the company unless a dividend is declared or other distribution made.

(7) The assets of the company are distinguished from those of its shareholders.

(8) The company continues to exist irrespective of changes in its membership.

In the case of <u>IRC v. Blott</u> we can deduce some of the facts mentioned above:

Holden said:[30]

> "A shareholder is not entitled to claim that the company should apply its undivided profits in payment to him of dividend. Whether it must do so or not is a matter of internal management to be decided by the majority of the shareholders. He cannot sue for such a dividend until he has been given a separate title by its declaration. Until then, no doubt, the profits are profits in the hands of the company until it has properly disposed of them, and it is assessable for income tax in respect of these profits".

(9) The company continues to exist irrespective of changes in its membership.

1.4 Forms of Business organisation

English Law provides two main types of organisation for such associations, the partnership and the incorporated company registered under the Companies Acts.[31]

(1) Partnerships

General partnerships

Under the Partnership Act 1890 a partnership is the relation which subsists between persons carrying on business in common with a view of profit.[32] Although the partnership is normally established by express agreement between the partners, the existence of partnership is determined not by the nature of their relationship. Thus section one of the Partnership Act determines that business includes every trade, occupation or profession. The minimum of the number of partners is not less than two partners and in most cases no more than twenty. The liability of partners is unlimited.

(2) Limited Partnership

A limited partnership consists of one or more general partners and one or more limited partners by virtue of Section 4(2) of the Limited Partnership Act (LPA) 1907.[33] The general rule is that a limited partnership must not consist of more than 20 persons. Although in a general partnership the liability of each partner for the firm's debts is unlimited, it is nevertheless possible for certain partners to enjoy limited liability. To achieve this it is necessary to register the firm as a limited partnership under the LPA 1907. This form is rarely used, however, as there must be at least one general partner with unlimited liability and none of the limited partners may take any part in the management of the firm.

(3) Registered Companies

Any two or more persons may form themselves into a company by following the simple procedure for registration set out in the Companies Act 1948. The company so formed acquires a legal personality independent of its members, and each of the members will normally enjoy limited liability for the company's debts.

The registrar of companies must allocate to every company a number known as the company's registered number, under the Companies Act 1985 S.705 (1).(34) He may, in addition, allocate to any company a letter which is then deemed for all purposes to be part of the registered number. The word 'company' includes (i) An overseas company, and (ii) any incorporated or unincorporated body to which any provision of the Act applies by virtue of SS.705, 718 and (iii) Management is separated from membership, and members, as such, have no power to bind the company Working capital is more easily raised, for example, by issuing different classes of shares or by borrowing money against the security of a floating charge on the assets.

(4) Private Company

This is a logical development from the partnership, and frequently found where a family business has needed to expand beyond the resources of the partners, but the founders have needed to retain control. Such companies are restricted to fifty members and must have at least two, restricting the right to transfer shares.[35]

Accordingly section 2 of Companies Act 1967 abolished the status of exempt private companies. All companies however small are now bound to file accounts with their annual return and no company may make a loan to a director.

(5) Public Company

This is a form that embraces the very largest manufacturing units in the private sector. The mass production of such things as steel, motor cars and chemicals generally needs more capital than can be raised by fifty shareholders although there are some substantial and nationally known firms which have remained private companies. A public company must have at least seven members, shareholders may dispose of their holdings at will and the company may appeal to the public for funds.

The directors of public companies are usually unknown personally to members of the share-buying public, so it is necessary for stringent control to be exercised over company formation and behaviour to protect shareholders from fraud. Such control is provided by the Department of Trade and Industry (formerly the Board of Trade) and the Registrar of Companies within the framework of the Company Acts of 1948 and 1967.

(6) Limited and Unlimited Companies

The provisions of the Company Acts are in all significant respects equally applicable to public and private companies after incorporation. In particular since 1967 a private company has enjoyed no exemption from the obligation to publish annual accounts, although smaller private companies are relieved from disclosure of certain specific items.[36]

The usual form of business organisation which undertakes large scale operations is called a limited company. The principal attraction of this business unit is that shareholder liability is limited to the nominal value of the share held. The facility was conferred by Act of Parliament in 1856. In this way a large number of people can contribute funds to an enterprise without risking their entire personal possessions. Furthermore the company has its own legal existence quite separate from that of the shareholders, so its continuity is not threatened by the death of one of them. Such companies name always end in the word 'limited'.

The Company is unlimited when it does not have any limit on the liability of its members.S.1(2)(c) of Company Acts 1985.[37]

1.5 Classification of business organisation for tax purposes

According to the UK Tax system the tax treatment of partnerships and limited partnerships differ from the tax treatment of companies. The main features of partnership taxation is.[38]

(1) Although a partnership is not a separate legal entity like a company, a joint assessment is made in the name of the partnership in respect of its trading income under S.52 F.A of 1970

(2) Trading income is computed in accordance with the normal rules of income tax. Partnership, salaries and interest on capital charged in the accounts are added back in the computation as they are allocations of profit.

(3) Trading income is allocated to the partners after taking into consideration salaries and interest on capital and profit sharing ratios pertaining to the year of assessment. The total allocation is earned income, except for a sleeping partner.

(4) Each partner must file an individual tax return in the normal way. Personal relief is usually given against non-trading income first.

(5) Capital allowances are available in respect of partnerships assets and these are deducted from the adjusted profits before any allocation is made. Capital allowances claimed on non-partnership assets are deducted in the individual partners' personal tax computation

(6) The normal basis of assessment for income arising under schedule D cases (i) and (ii) applies, that is the preceding year bases.

On the other hand, the Company as a separate form of business is subject to corporation tax, according to U.K. Tax Law.[39]

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CHAPTER TWO

GENERAL REVIEW OF COMPANY TAX SYSTEMS

Chapter Two

General Review of company tax systems

2.1 Introduction

It will be obvious that a number of countries have been changing from one system of company tax to another [1]. The choice of a particular system has been dictated by both domestic and international considerations. The incidence of the various company tax systems and their effects on companies and shareholders differ markedly, thereby raising important questions for legal and economic policy considerations for the states in their choice of particular systems.

Two main issues arise from the domestic policy consideration which have led governments to choose one system of company taxation rather than another and the consequences which they believe have followed from their choice. Firstly, the policy question of how far "economic double taxation" should be mitigated and, secondly, if it is to be mitigated, the more technical question whether this should be done at company level (split rate system) or shareholder level (imputation system)[2].

International considerations have also played an increasingly important part in influencing the choice of governments as to which system should be adopted. These considerations concern, in particular, the impact of a system upon the balance of private capital transactions, upon the form taken by private direct investment from abroad upon the government's share of revenue from international investment income arising within its own frontiers or according to its residents from abroad.

The effects of taxation on inward and outward movements of portfolio and direct investment capital can be very different according to the system in force and to the adaptations made to it with the balance of payments in mind and also according to the systems in force abroad. Some of the effects on the tax positions of investors (individual and firms) are deliberate. Others are more as a consequence of the method of taxing dividends[3].

The company tax system could have an influence on national policy objectives in that it is deemed necessary, to examine these systems critically because of the relationship between company tax systems and national objectives, in order to show their relative advantages and disadvantages, specially from the standpoint of a developing country.

Many different approaches can be made to the whole concept of corporation tax. There are those who regard a system which imputes the whole of the corporation tax to the shareholder as a system which constitutes a nil rate of company tax on distributed profits coupled with the full rate being charged on the shareholder[4]. Another view is that such a system results in a full rate being levied on the company whether profits are distributed or not, with complete relief to the shareholder for the tax already suffered.

The study of these matters requires the discussion of the three broad types of company tax systems. These are the 'classical system', the 'two rate system' and finally the 'imputation system'. They will be treated in that order

2.2 The Classical system

The classical system (the separate system) means that company profits are taxed at the same rate whether they are distributed or undistributed. Companies deduct income tax from dividends and pay it on behalf of the shareholders to the Inland Revenue so that there is a complete separation between corporation tax and personal income tax.

The classical system owes its name first to the fact that it was the prevalent company tax system in Western Europe after the Second World War and second, to the legal interpretation of the corporate personality as a distinct separate entity from the shareholders.

This system avoids creating a situation where a non-resident in receipt of dividends from the country applying can be treated differently from a resident. Where the same system is applied in the other country, the flow of profits between them is not affected on either side by considerations of the right to tax credits or to a lower rate of tax. Other considerations, just as under other systems, will still have an effect on investment yields of course; for example, profits earned abroad may be taxable in the country of residence only when they are repatriated, and withholding taxes paid abroad may not be fully recoverable.

Briefly, the classical system taxes the total profit of the company equally, whether distributed or not. No income tax relief is given to shareholders for corporation tax paid. Low and higher income shareholders pay the same corporation tax, but, possibly a different income tax on their dividends. One of the merits of this system is the easy collection of a great amount of revenue. In addition to the legal interpretation of the corporate entity, the supporters of this system emphasize its simplicity in many respects. Its administrative simplicity lies in the fact that it consists of one flat rate on all profits of the corporation and the distributed part of profits is taxed under the personal income tax without providing any relief. Keeton and Frommel said.(5)

> "It is said that one of the merits of the classical system is its simplicity...I could perhaps illustrate this simplicity by saying that I do not really need to elaborate any more on our present tax system".

Moreover, the advantages of a corporation tax, according to this system, where it favours retained profits, are that it would promote saving and investment. The incentive is to retain profits regardless of whether or not they are invested. It may become easier for some companies to finance growth out of retentions, but it will become correspondingly more difficult for other companies to expand by raising new capital.

The disadvantage of the classical system is the problem of economic double taxation between company and shareholders.

This system is operated in its pure form in Australia, Denmark, Luxembourg, the Netherlands, Spain, and Switzerland. In its slightly modified form, it is found in Iceland and Sweden, Austria, Finland, Japan, Norway, Portugal and the United States (US)[6].

2.3 The Two-Rate system

The two-rate system, also known as the double rate, two-tier system, owes its name to the fact that two different tax rates are applied to corporate profit, as described in the Green Paper, one the higher, applies to the retained profits.

In the words of the Green Paper on the Reform of corporation tax, the two-rate system is described as follows[7]-

> "Under a two-rate system, distributed profits would be liable to corporation tax at a lower rate than undistributed profits. In addition distributed profits would be paid under deduction of income tax and this tax would be paid over to the Inland Revenue and would be advance payment of shareholder's own eventual tax liability".

The system was employed in Germany for a long period (1953/76) and the rates of CT applicable in Germany were 15 per cent on distributed and 51 per cent on undistributed profits[8]. Recently this system was replaced by a combined system of full imputation rate systems. The reasons why Germany replaced it are first, its desire to fully alleviate economic double taxation of dividends, and second, to obtain a stronger bargaining power in its negotiations with other countries as far as international double taxation is concerned.

The existence of two tax rates applied to corporate income creates the so-called "shadow effect".[9] This implies that where all profits were distributed they would be taxed, not at the nominal tax rate, but at the effective tax rate, which is higher.[10] This is so because the tax paid on the distributed profits is deemed to be paid from retained profits which bear a higher tax rate. For example, in Germany, the nominal tax rate on distributed profits was 15 per cent, whereas the effective rate was 23.44 per cent.

2.4 <u>The imputation system</u>

Under the imputation system the company is taxed at a flat tax rate for the total amount of profits, irrespective of whether they are retained or distributed. The Green Paper describes the 'Imputation System" as follows:[11].

> "Under the imputation system,, all profits, whether distributed or not, would be liable to corporation tax at the same rate, but part of the tax on the distributed profits would be available to be set as a credit against the shareholder's own tax liability and could in

appropriate circumstances be repaid to him".

The system is called imputation and owes its name to the fact that part or all of the corporation tax paid by the company related to the distributed part of profits is ascribed or imputed to shareholders.

The main features of this system are as follows:[12]. Firstly this system is used as a means of achieving specific objectives which it would be difficult or impossible to achieve by other methods. For example, France uses it as a means of promoting the function of the capital market; Canada uses it as a means of making share ownership attractive and American economists see it as a crucial part of the conduit theory[13]. Secondly, from a political point of view, this system constitutes a compromise between the two extreme views of integration. Thirdly, full integration would result in a greater drop of government revenue. Finally, the partial elimination of economic double taxation may reflect uncertainty regarding the incidence and shifting of the CT. In the words of the White Paper[14] "we consider it likely that some level of CT is shifted to consumers in the price which they charge for their goods and services".

According to this system, credit mechanism works at the shareholder level and it takes place in two stages. In the first, the shareholder includes in his income tax declaration not only the net amount of dividend which he received but this amount plus the amount of credit received. At the second stage the credit is off-set against the final tax liability of the shareholder[15]. The result of this is that the shareholder is taxed at the progressive personal income tax rate as far as the distributed part of profits is concerned.

2.5 A comparison of the systems

The choice between these systems is a matter of the differing goals which the government tries to achieve. Inevitably some factors may represent the secondary goals of government and the final choice is a compromise between the principal and collected goals. The latter may include tax evasion and tax avoidance, tax shifting, flexibility for the government for exercising its counter cyclical policy and revenue policy.

Principal goals include allocated efficiency, equity and income distribution...etc.

The classical system does not differentiate between residents who invest at home or abroad, since the residents get no credit or special rate treatement when they invest at home. Under other systems, which give some kind of relief in respect of domestic corporation tax paid out , they do not extend it to foreign corporation tax and there is a logical presumption that investment at home, of residents, is encouraged.

Therefore, where direct investment is concerned, the situation can differ. As regards inward direct investment, according to the split-rate system foreign firms are encouraged to set up subsidiaries rather than branches; the imputation system discourages both the setting up of branches and subsidiaries whilst the classical system appears neutral between the two. The systems as such have no effect on outward direct investment, though it may be noted in passing that outward direct investment is usually discouraged either because of the overspill problem or because of intermediary withholding taxes paid in the country of investment but not fully credited[16].

Apart from its possible effects on investment flows, the choice of system may have an effect on revenue sharing between countries. When the same rate of withholding tax is levied under a tax treaty by a country with a split-rate system and a country with another system and the latter employs the credit method of eliminating double taxation, it is the Treasury of the other country which gets the benefit of the relief granted by the country with the split-rate system.

Finally, other tax features may be of considerable importance for international decisions such as corporate and personal income tax levels, the basis of computation of tax liability or the practices adopted by the country operating the various systems[17].

Chapter Two : Reference

(1) The following are some of the changes that took place or were proposed during the last twenty years:
1962 Neumark Report recommended split-rate system for European Communities.
1965 U.K. replaced the pre 1965 system by a classical system which was replaced by the imputation system in 1973
1965 France replaced a former classical system by an imputation system.
1966 Carter Report recommended that Canada adopt fully integrated imputation to replace the partial imputation system.
1968 Austria replaced classical system by split-rate system.
1968 Netherlands renounced its intention to abandon separate system.
1968 Italy proposed to replace its schedular system by classical system.
1970 Norway replaced classical system by split-rate system.
1970 Consultant Report of the European Communities recommended classical system as their harmonised system.
1971 Germany announced possibility of replacing split-rate by full integrated imputation system.
1971 Canada proposed to adopt a more extreme version of the imputation system (33 1/3 per cent instead of 20 per cent credit).
1972 Ireland put out a dicussion paper recommending adoption of an imputation system.
For more details see <u>Company Tax System in OECD Member Countries</u> 1973.

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PART ONE

THE TAXATION OF COMPANIES IN THE UNITED KINGDOM

Highlight for Part One

The purpose of this part is to review the company tax system in the United Kingdom. This inevitably involves an analysis of existing knowledge but by evaluating the development of United Kingdom company taxation we will be in a better position to understand the various systems of corporation tax that have been devised and the purpose underlying such systems. Consequently we will be more competent to point out their virtues and defects.

Thus the current part is divided into four chapters:

Chapter Three - General scheme of Company Taxation in the United Kingdom.

Chapter Four - Income Measurement for Tax Purposes

Chapter Five - Taxation of Overseas Profits

Cahpter Six - Tax Avoidance and Tax Evasion

CHAPTER THREE

GENERAL SCHEME OF COMPANY TAXATION IN THE UNITED KINGDOM

Chapter Three

General scheme of company taxation in the United Kingdom

3.1: Introduction

Corporation tax is chargeable on all companies resident in the U.K., which includes not only a body registered under the Companies Act, but also any body corporate or unincorporated association, but does not include partnership. As the taxes statute has not defined "residence" for company taxation purposes it has been necessary for the courts to provide a working definition so that the scope of tax could be known. Thus the Courts in numerous cases, have decided that a corporation resides where "it keeps house" or"does its real business" at "where it exercises its central management and control".(1) In this legal view, it has become possible to say whether or not a particular company is resident in the U.K., and whether or not it is liable to U.K. tax both on its domestic and overseas profits.

Non resident companies trading in the U.K. through a branch or agency are subject to corporation tax. It is necessary, in considering the present form of U.K. company taxation, to look at the historical evaluation of U.K. company tax systems.

In the light of this, we propose to discuss in this chapter the three major periods in the history of the U.K. company taxation. Also we shall attempt to make comparisons between the three systems of company tax showing their relative advantages and disadvantages.

These systems are:

(1) The pre 1965 period,

(2) The Classical system (1965 to April 1973, and

(3) The Imputation system (CT from 1973 onwards).

3.II The Pre - 1965 periods

Before 1965 Company taxation was in fact part of a tax system which contained only income tax and virtually no progression. It was a form of taxation at source, the idea being that the corporation recovered the tax for itself when it distributed the income among the members. In para. 50 of Royal Commission, June 1955. (2)

> "The arrangement which assesses corporate bodies to income tax upon their gross profits before payment of any dividend but requires those who draw dividends therefrom to submit to a proportionate deduction in respect of the income tax chargeable on the corporation is as old as Addington's Income Tax Act of 1803. Corporate taxation, then, began as part of tax system which contained only income tax and virtually no progression."

Income tax was introduced by Pitt in 1799. When income tax was re-imposed by Addington in 1803 he introduced the income tax schedules into his Act of that year. Therefore companies, as taxable persons, became subject to income tax from that time.

Companies were liable to income tax at the standard rate on their total income, irrespective of the amount, just like individuals but unlike individuals they were not allowed the benefit of personal reliefs and allowances.(3) The of their income tax liability and the company could retain the sum deducted as part of its own fund. Accordingly, companies were allowed to deduct a sum equivalent to tax at the standard rate and to retain the same as part of their funds. This sum was retainable where no income tax had actually been paid, where, for instance, in those circumstances where the profits had been relieved from liability to income tax by capital allowances or by losses brought forward.

Thus the profits of a business carried on by a company were taxable against the company under the schedules of charge and were not taxable again,[4] after distribution, in the hands of the shareholder because the dividends were treated as a distribution which derived from profits which had already been taxed at the source. In the case of Neuman v. CIR Lord Wright said.[5]

> "A shareholder was not separately taxable (disregarding sur-tax) on a dividend as a profit individual to himself under Schedule D."

At the same time the company was permitted to deduct from the dividend the proportionate part of its income tax liability and the company could retain the sum deducted as part of its own funds. In the case of Broadbury v. English Sewing Cotton Co. Ltd. Lord Phillimor said.[6]

> "Apparently for revenue purposes a joint stock company was treated as a large partnership, so that the payment of income tax by a company discharged the

quasi-partners."

So, it should be mentioned that the company was at first treated as the agent of the Inland Revenue (I.R.)through which it collected the individual's liability to income tax. Thus the company was paying income tax on behalf of its shareholders.(7)

However, from the shareholder's standpoint, his income was treated as consisting of the gross sum without allowing for the sum which the company had deducted and the relevent tax was attributed to him in his account with the Revenue. He was therefore entitled to claim against this tax any of the personal allowances and reliefs which were due to him, and would thus obtain repayment of the whole or part of the tax. If, on the other hand, his total income was so small that he was exempt from tax or taxed at the lower rate of income tax, he could recover the income tax which had been deducted from the dividend S165 of the Income Tax Act of 1842(8).

Thus, it can be seen that companies in this period were regarded as convenient tools for taxing the aggregate income of the individual members, the idea being that it was much easier to tax the collective income of the shareholders in the hands of the companies before distribution, than to tax its aliquote parts in the hands of the several shareholders widely dispersed.

Through the definition of the companies' residence, overseas income was taxed on a remittance basis, but only in those special cases where no part of the activity that produced them took place in Britain. The measure of the income for the purpose of assessment was only that which was brought over to Britain, section 100 of the Income Tax Act (ITA) of 1842. Pickering and Prest hold the view that the remittance basis was introduced by the decision of the House of Lords in 1889. They said;

> "The uncertainty on this point was finally resolved by the decision of the House of Lords in the Colquhoun v. Brooks where it was held that there were 'insuperable difficulties in giving full effect to universal language' of the predecessors of the cases IV and V provisions, and the remittance basis was established."(9)

In the case of Colquhoun v. Brooks an English resident had invested a large sum in a business of glass, oil and colour merchants and storekeepers in Melbourne, Australia. In 1884-1885 he received £3000 from this business in England but the Inspector of Taxes contended that his true profit from it for the year included a further £9219 which had not been remitted. It was held that the Inspector was wrong because although the Act was worded in wide terms, it contained no machinery for the assessment of the profits of a trade carried on entirely outside the U.K. Tax was held to be chargeable only on the amount of income received in or remitted to his country.(10)

In fact section 100 of the I.T.A. of 1842(11) provided for the taxation of overseas income on a remittance basis under schedule D. Under the case V of Sch.D section 100 of ITA of 1842 tax was chargeable on the possessions in the British plantations of America or in any other of Her Majesty's Dominions out of the U.K. and foreign possessions and was assessable on a sum not less than the full amount of the actual sums annually received in the U.K. In the case of Colquhoun v. Brooks Lord Macnaughton said: (12)

> "Upon the whole therefore I have come to the conclusion that the profits and gains arising from the respondent's Melbourne business fall under the "Fifth case" of schedule D. of Income Tax Act 1842", and are chargeable accordingly on the actual sums received in the United Kingdom."

Additonal Company Taxation

The treatment of additional taxes on company profit from 1915 onwards must also be considered. There were six methods of imposing excess levy on the profits of companies which were introduced and later repealed. These different mthods included:

(1) Excess Profits Duty (EPD) which was introduced in 1915[13] and retained until 1921.[14]

(2) Corportion Profits Tax (CPT) which was effective from 1920[15] to 1924.[16]

(3) National Defence Contribution (NDC) 1937[17] to 1947[18]

(4) Excess Profits Tax (EPT) 1939[19] to 1946[20]

(5) Excess Profits Levy (EPL) 1952[21] to 1953[22]

(6) Profit Tax (PT) 1947[23] to 1966[24]

The Excess Profits Duty was intended to be a special tax in respect of business profits which had increased during the war period. The EPD applied to all trades and business of any description carried on in the UK or carried on elsewhere by a company resident in the UK. The profits arising from a trade or business were separately determined for purposes of EPD on the same principles which determined the profits or gains of trade or buinesses for the purposes of income tax.

After the First World War, the willingness to pay tax which had existed during the war ended and avoidance and evasion of tax increased and the Government's revenue consequently decreased despite the fact that profits were unreasonably high.

In 1920 the Budget introduced a new tax called Corporation profit tax.[25] The rate of that tax was 5%. The rate was reduced to 2.5% on profits accruing after 30th June 1923.

This tax (CPT) applied to the profits accruing after 31st December 1919 to (1) A British company[26] carrying on any trade or business or undertaking of similar character including the holding of investment. (2) A foreign company carrying on (in the UK) any trade or business or any undertaking of a similar nature[27] so far as those profits arose in the UK.

Profits for CPT purposes and were the actual profits arising in the accounting period and computed on the same principles as the profits of a trade would be computed for the purpose of income tax under Sch.D. whether such profits were assessable to income tax under that schedule or not.[28] Excess Profits Duty paid for the same accounting period was allowed as a deduction in computing profits for CPT purposes.

Corporation Profits Tax was not in any way a high profits tax. It imposed a burden similar to that already imposed by income tax Sch.D. It was a poor affair, uneven in its incidence and easily evaded.[29]

It was also criticised as a tax which was to the advantage of the rich and disadvantageous to the poor who were taxed more heavily than the wealthy.

So in 1924, the Chancellor of the Exchequer announced his intention to abolish CPT. This repeal left the company again liable only to income tax at the standard rate, which was 4 shillings in the pound, with the basis of assessment on its trading profits on the preceding year basis as with individuals. In fact only the 1926 Budget altered the basis of assessment under Sch.D from three year average to the preceding year basis, Section 29 (1) of F.A. of 1926.

In the 1930s the revenue law caught up with this separation and companies began to be taxed in a different way from individuals.[30] As is frequently the case with taxation, the change was associated with the need to finance warfare. In 1937 the need for extra revenue, especially when defence expenditure arose and business profits increased, drove the Chancellor of the Exchequer to introduce a new business tax called the National Defence Contribution (NDC), which was merely another version of CPT.

This tax was intended to be a tax not on the company's profits but on its rate of expansion. The rates of charge would have varied according to percentage of growth so that if there had been no growth of profits, no charge would have been made.

According to NDC corporation profits of less than £2000 were exempted from NDC. Also there were further improvements in EPT. There was a new minimum standard, which provided a more ingenious and useful exemption from EPT. The minimum standard was defined as £1000, or £1500 per working proprietor, up to a limit of £6000.[31]

The profits liable to NDC were computed by taking the adjusted profits for income tax purposes and adding:

(1) the net annual value of premises owned and occupied for the trade.

(2) investment income not received from bodies corporate liable to NDC and

(3) excess directors' renumeration if the company was director controlled. The principles of the Income Tax Acts under which deductions were not allowed for interest, annuities or other annual payments payable out of profits, were not followed in computing profit for NDC purposes.

Moreover, a new business tax entitled "Excess Profits Tax" was imposed[32] aimed at taxing profit in exess of the peace-time rate of 60 percent.

The reasons for the profits tax were as follows:-[33]

(1) there was the need to find some means of reducing the loss to the Exchequer arising from the termination of the 1939-45 war. Therefore, EPT (which was a temporary tax to meet an exceptional emergency) had the effect of taking in tax a large portion of the company's profits.

(2) profits tax was generally associated with the policy of restraining inflation in the sense that its differential rate encouraged the retention of company profits and discouraged their distribution; and

(3) the tax was linked with a long term objective of encouraging productive investment in the form of ploughed-back profits.

Despite these salutory objectives the profits tax was severely criticised by the majority of the members of the Royal Commission on Taxation (1955). They said:[34]

> "a tax on profits, the effective rate of which varies according to the proporation between those retained and those distributed is not calculated to produce an equitable distribution of the tax between different companies, because though they are equally free to make profits, they are not equally free when it comes to distributing them."

They also questioned the proposition that an advantage can be gained by more retention of profits.

The dissenting members of the Royal Commission, on the other hand, argued in defence of the profit tax. They said.[35]

"We consider that, in the special circumstances of the post war years, the measures taken since the war by successive Government for the prevention or discouragement of dividend increases were an ineluctable necessity in order to maintain full employment without serious inflation. The measure of wage restraint, in the years 1948-50 would not have been attained without dividend restraint, and to prevent an enormous untaxed increment to the wealth of a particular group in the community. The social and economic inequalities which such a shift in the distribution of wealth would have created would not have been compatible with the sense of fairness and equity of a modern democratic community."

In 1951, the new Conservative Government which was formed in October of that year(36) presented its Budget in March 1952(37) and announced its intention to reduce government expenditure and make a significant start in reducing taxation.

The first tax measure was the imposition of a new levy on companies entitled "Excess Profits Levy" (EPL), designed to prevent "the fortuitous rise in company profits because of the abnormal process of rearmament.(38) It was therefore, imposed to operate only during this exceptional period.(39) Thus EPL was introduced by Finance Act of 1952, and repealed as from January 1, 1954.[40]

EPL was imposed on all companies and other bodies corporate, or unincorporated societies except for any trade or business carried on by a company as personal representative, certain overseas companies, S.37(4)FA 1952, and cerrtain one-man companies whose incomes had been apportioned for surtax purposes.[41] Individuals and partnerships were not affected by EPL. For EPL purposes, a company's profits and losses were computed in the same way as for profits tax, S.45 of F.A.1952. The rates of profits tax were accordingly reduced to 22.5 percent on distributed profit and 2.5 percent on undistributed profits, S.33 of F.A. 1952. Therefore these differential rates were highly criticised by the Royal Commission on the Taxation of Profits and Income.[42] Thus it was recommended by the Commission that the differential rates should be brought to an end[43] and that the tax be converted into a flat tax rate on the total profits of a company.

However, as from April 1st 1958 the two-tier profits tax on companies was abolished so that all profits of corporate bodies were taxed at a flat rate of 10 percent. The underlying purpose for this change was purely economic to increase investment in fixed assets by encouraging the retention of profits in the business. As the Chancellor of the Exchequer, in introducing the change, said:[44]

> "This is generally agreed to be a desirable reform. Those responsible for the management of industry and commerce have emphasised to me

> most strongly that it would strengthen the financial structure of industry, improve the supply of capital to firms which needed it most, and help to remove distortions in company finance. This will all help in modernising and expanding our industrial system. It will also greatly simplify the tax code and work of administration."

So the situation at this point in time, i.e. 1958, was that companies paid profits tax on their whole profits whether or not distributed. This tax was also not repayable to shareholders. In addition, companies were also liable to income tax at the standard flat rate.

Companies were subject to the complexities of the commencement and cessation provisions and they were influenced every year by the alteration of the rate in the personal sector.(45) Furthermore, complexities were due to the fact that profits tax was on a current year basis whereas income tax was levied according to the preceding year basis.

These complications, caused by the existence of two taxes, income tax and profits tax, levied generally on the same income, and the fact that the present system for taxing corporate profits did not provide sufficient incentive to companies to plough back profits, led to the 1965 Reform.

Moreover, the main characteristics of the pre-1965 system were as follows:

(1) the company profits were chargeable to income tax at the standard rate and in addition to profits tax and then to flat

rate profits tax,

(2) at one time the distribution of profits was encouraged and, at another time it was penalised (profit tax with differential rates) and

(3) capital gains and receipts as such were not taxable but the old concept of the tree and the fruit had been eroded over the years.[46]

3.III Classical system

Up to 1965, companies paid income tax and profits tax (at a rate of 15 percent since 1961), thereby paying more tax than would be due from the shareholders as individuals. Where an individual received a dividend from a Company, the income tax paid by the company was treated as an advance payment of income tax due from the individual who had to reclaim the tax and add to it according to the rate for which he was assessed on his total income. [47]

A number of arguments were put forward to justify this tax.

In the 1961 Budget speech, the Chancellor of the Exchequer, Mr Selwyn Lloyd, announced that he was asking the Board of Inland Revenue to undertake a future examination of the possibilities of combining company income tax and profits tax into a single corporation tax. He was confronted at once with the adverse recommendation of the majority of the Royal Commission.[48] He would not be deterred by the difficulty which was stressed in the Report (House of Commons Official Report) that of the possibility that the companies tax might become lower than the standard rate of income tax. He also said there was a great complication in the case of dividends paid by one company to another.

In 1963, the Chancellor, Mr Maudling,[49] in his Budget said that his predecessor had referred to the question of amalgamating income tax and profits tax into a single corporation tax.

In April 1964, the Inland Revenue had published a White paper, in which a Scheme for an accounts basis for Income Tax on company profits(50) was set out which described for accountants, economists, businessmen and others, the very considerable transitional problems of bringing company income tax (assesed on the profits of the previous year) into line with profits tax (assessed on the profits of the current year). Once this difficult transition had been made, it would then have been comparatively easy to bring in a corporation tax which would rationalise the structure of the system whilst preserving its general effects.

In 1965, Mr Callaghan's proposals involved far-reaching changes in the substance as well as the form of the tax system. Some of these changes were deliberate, some perhaps accidental, and some of these could have been avoided by more careful drafting. For example, the proposed CT would penalise dividends compared with profits retained by public companies. It taxed companies more heavily than partnerships, and growing private companies more heavily than public companies. It imposed heavy penalties on the income from overseas investment, but in a somewhat random and haphazard way, and it made preference dividends much more expensive than debenture interest, altered the investment policy of Charities, and discouraged portfolio investment in the U.K. by foreigners. The merits of a CT were not to be confused with a quite separate issue of the changes in the level and incidence of taxation which Mr Callaghan had taken this opportunity to introduce.

The main objectives of change and reform in the company taxation were:

(1) To modernise the arrangement for taxing companies by establishing a separate system of company taxation, so making the company taxation more responsive to fiscal policy to aim at influencing the economy through the corporate sector;

(2) To simplify the company tax system and remove a number of anomalies which had led to significant tax avoidance and to influence distribution policy in favour of the ploughing back of large shares of company profits into productive investment;

(3) To modify a number of features of the pre-1965 tax system said to favour investment overseas compared with investment in the U.K. The most important of these features, perhaps, was the question of relief for foreign taxes. Under the pre-1965 tax system, there was no tax charged on dividends as such. Credit for overseas tax was thus available to reduce or even extinguish the whole of a company's liability to profits tax and income tax on its income from abroad. At the same time, the liability of its shareholders to standard rate income tax on their dividends was regarded as having been satisfied by the company.

(4) The preceding year's basis for the assessment of income tax from companies profits under the pre-1965 Code was not very satisfactory. Furthermore, complexities arose due to the fact that profits tax was levied on a current year basis whereas income tax was levied according to the preceding year basis.[51] Tiley said:

"Profits under the two taxes were computed

> differently. Not only was profit tax levied on current as opposed to a preceding year, but some items were deductible in computing profits for profits tax which were not for income tax."

The above complication, caused by the existence of a two tax rate system, income tax and profits tax, which levied tax on the same income, did not provide sufficient incentive to companies to plough back the profits. It thus became clear that changes were inevitable. A number of commissions were set up to enquire into the income tax acts with the aim of suggesting a panacea for these ills. Moreover, the status and position of companies had been extensively changed, progressive rates and personal allowances had become more and more important and a basic feature of the tax system. As quoted in Hansard, Mr Callaghan said:[52]

> "These changes have made obsolete the idea that companies and individuals should be treated for tax in the same way."

The Finance Act of 1965 changed the previous system of company taxation in two fundamental aspects:

(1) It abolished the charge to income tax and profits tax on a company's profits and introduced a charge to a new tax which was known as Corporation Tax (classical system).[53] According to the new tax, all companies resident in the U.K. became liable to CT.[54] A company not resident in the U.K. would not be chargeable unless it carried on a trade in the U.K. through a branch or agency.[55] Individuals and

partnerships were not liable for CT, except that a company which was a member of a partnership would be chargeable in respect of its share of the partnership profits[56]

(2) It imposed liability to income tax on the distributions which a company made. CT became chargeable for a financial year ending 31 March at a rate to be fixed by Parliament each year. Financial years are referred to in the Corporation Tax Acts by naming a single calendar year, being the calendar year in which the financial year begins. S.,89(2)(e) of F.A. 1965. Thus the "financial year of 1966" means the year ending 31 March of 1967. The rate of CT for the financial years 1964 and 1965 was 40%. So CT was levied at a lower rate than the combined rates of income tax and profits tax. The rate of CT for future financial years was expected to be fixed by the Budget Resolutions immediately following the end of the year, and to be embodied in the Finance Act giving effect thereto. Although the rate of tax is fixed for financial years, assessments are made on companies profits of their accounting periods. Where an accounting period straddles two financial years one which has a different rate of tax from the other, a time apportionment of the profit has to be made so as to impose each rate on a proportion of profits corresponding to the proportion of the accounting period which falls in each financial year, S.49(3) 1965.

All the income (except the dividend and other distributions received from companies in the U.K.) and all chargeable gains of the company are chargeable to CT., S.47(1). Income for this purpose means income within the meaning of the Income Tax Acts, S.89(3),[57] whether in the form of trading profits, investment income or any other kinds of income, and chargeable gains means chargeable gains within the meaning of the Finance Acts relating to capital gains tax. The CTA use the word "profits" as meaning a company's income and chargeable gains, SS.46(5)(6) and 47(1). Therefore, a company was to be liable to CT on its total profits i.e. both income and capital gains and was required under a new schedule F. not only to deduct income tax at the standard rate on distributions but also to account for the tax deducted to Revenue. The shareholder's position was to remain unchanged: the distribution in his hands was still to be regarded as having borne income tax at the standard rate. Thus, if he was exempt or liable to income tax at less than the standard rate, he was to be entitled to claim the appropriate repayments, but if he was a standard rate taxpayer, no further payment was to be required of him, and if he were a surtaxpayer, the grossed-up amount of the distribution was to be included in his total income for surtax purposes.

The underlying purposes of this tax were as might have been gathered earlier, firstly to modernize the arrangements for taxing companies by establishing a separate system of company taxation so as to simplify the system and remove a number of anomalies which caused significant tax avoidance. Secondly, to create a framework under which companies would be encouraged to retain profits for expansion, rather than distribute as dividends to their shareholders. As the

Chancellor said:[58]

> "It gives a strong incentive to all companies to plough back more of their profits for expansion. Finally, the incentive to cut costs and to raise efficiency through new investment are much stronger."

The CT scheme variously known as the classical system separated the taxation of companies from that of individual shareholders. Section 47 of F.A. 1965 provided that companies were to deduct or deemed to deduct income tax at the standard rate from the dividends they paid to the shareholders and to account to the revenue for the dividend tax so deducted so that in the hands of the shareholders the dividends had already borne income tax. The deduction of income tax at source also applied to the receipt and payment by companies of yearly interest, royalities and annual payment etc. Therefore, there was corporation tax on the profits of companies and income tax on the dividends it distributed thereby, "separating the tax on companies from the tax on individuals."

Dividends and other distributions paid by a company resident in the UK are chargeable to income tax under Schedule F, the tax being collected from the paying company, which has the right to deduct income tax at the standard rate and the obligation to account to the Commissioners of Inland Revenue for the tax so deducted, S. 47 of F.A. 1965. Thus companies have to pay their dividend gross, in part to the shareholders, and in part to the Inland Revenue, instead of net of income tax as under the previous system.

The charge of income tax under Schedule F extends to dividends paid out of capital profits as well as to dividends paid out of revenue profits. It also extends to the issue of bonus redeemable preference shares and bonus debentures, and the repayment of share capital to the extent to which the amount or value repaid exceeds to the amount paid up on the shares and to certain other distributions of a special character, sch., 11 of FA 1965, and sch. 5 para. (13) of FA 1966. it does not extend to distributions in respect of share capital in winding up, S.47 (5) of FA 1965.[59]

The Finance Act of 1965 introduced other basic principles, for example, assessments to CT were to be made on a company's accounting period of a maximum length of twelve months from its commencement, that is, on a current yearly basis[60] and not on a preceding year assessment as was the case in the past.

It is interesting to consider the implication of changes in CT structure for company formation. Companies which were director-controlled for profits tax purposes, and those that were liable to have their income apportioned among their members for surtax purposes were fused into one extended class, to include other types of closely controlled companies, with a new name "close company".[61]

The 1965 Finance Act included special provisions for closely controlled companies to deal with the temptation to withhold profits from distribution, which would be greater under the CT system because income tax, as well as surtax would be avoided, whereas under the 1958 system only surtax was avoided. Provisions were included to impose income tax and surtax on a closely-controlled company, i.e., a company controlled by its directors, or five or fewer participators, which failed to distribute a reasonable proportion of its profits, having regard to its needs for maintaining and developing its business. The 1965 changes, in combination, altered the circumstances and levels of profits at which it became advantageous for tax purposes to trade as a company rather than as an individual, or in partnership.(62)

The close companies were subject to restrictions on deduction for directors remuneration in computing for CT purpose. They were liable to income tax on the shortfall in distributions. The shortfall was arrived at by comparing a close company's distribution for an accounting period with what was called "the required standard", and the amount by which the distribution fell short of the required standard was called a "shortfall". A shortfall was therefore, treated as if it were a distribution made by the company and so income tax became chargeable on the company accordingly.(63) If a close company made any loan or advanced any money to a participator or an associate of a participator (if he was an individual) it incurred a liability equivalent to the income tax on the grossed up amount of the loan or advance.(64)

In computing CT chargeable for any accounting period, there are allowed as deductions against total profits charges on income paid after the year 1965-66 in the form of annual interest and annuities and other annual payments from which deduction of income tax is authorised by the Income Tax Acts, provided that such payments do not rank as "distributions" and are not charged to capital, S.52 of FA of 1965. It is this rule allowing interest to be deducted in computing profits for CT purposes which makes it cheaper for a company to pay interest rather than dividends. The Company will have to account to the Commissioners of Inland Revenue for the income tax deducted, S.48 of FA of 1965, instead of being allowed, as under the former system, to retain the income tax if the charges on income were paid out of profits brought into charge to tax.[65]

According to the classical system, the credit for overseas tax was limited to the company's own CT liability on its profits. In other words, it did not allow this credit to pass through to the shareholders' liability on the dividends they received so that it could not give them a credit for tax they had not in fact paid.

Other modifications introduced by the classical system included the withdrawal of the overseas trade corporation scheme under which a U.K. Company operating overseas might secure exemption from U.K. tax on its trading profits. Also withdrawn was the allowance of relief for underlying tax, i.e. the tax borne by an overseas company on its profits, in the hand of a portfolio shareholder. The pre-1965 tax system in the U.K. had charged a higher rate of tax on inward investment than most other developed countries and the introduction of CT, in conjunction with the renegotiation of double taxation agreements served to bring this charge into line with general practice.[66] Therefore, there were some fundamental changes in the schemes of relief in respect of foreign and U.K. taxation formerly available to companies operating abroad e.g. some compensation in the form of "overspill relief" was given to U.K. companies with overseas interests to make up for the tax credit in respect of foreign tax paid by the company which was now restricted to CT. Thus the shareholders had to pay the full tax on their dividends.[67]

Also, a company should not be subject to capital gains tax in respect of gains accruing to it so that it is liable in respect of them to CT.[68] The Revenue has been given power to recover the liability from the recipient of the capital distribution in cases of failure on the part of companies to pay the tax involved.

The main advantages of the classical system are:

(1) Its simplicity of administration, and

(2) Its fiscal neutrality in many respects. The most important aspects of its neutrality are:

(a) The classical system imposes the same rate on distributed and retained corporate profits, but companies had to bear the gross cost of distributions.

(b) The classical system does not discriminate between resident and non resident shareholders.[69]

(c) Dividends distributed by a resident subsidiary company to a resident or non-resident parent company are basically treated alike.

(d) The classical system was to encourage companies to raise capital by loan issue, e.g. of debentures, rather than by share issues interest payment but not distributions, were deductable from total profits.

3.IV Imputation system

In 1971, a new Government announced its intention to reform the sturcture of CT in order to remove the discrimination against distributed profit. In a Green Paper issued at that time it was pointed out that[70]

> "The changes must have regard to the timing and direction of developments in company taxation within the European Economic Community."

Since the introduction of the CT in 1965, company profits had been taxed in two stages, once when the profits were earned (CT) and again, as a separate source, when those profits, or a part of them, were distributed to shareholders (income tax). The distributing company was under an obligation to deduct income tax (IT) before payment and to account for such deductions to the Inland Revenue. It therefore was much criticised both here and on the continent of Europe for over taxing distributions, under taxing retentions, and interfering with the working of the capital market.[71]

The Green Paper set out the various methods by which the reform of the structure of CT might be achieved, and a select committee of the House of Commons considered these alternatives, and made recommendations. The Green Paper intended to promote discussion of alternative systems but expressed the Government's preference for the two-rate system under which distributed profits would attract a lower tax rate than undistributed profits, i.e. the two-rate system, the distributed profits of a company would be taxed at one rate, and its undistributed profits at a higher rate. In this way the shareholder would continue to bear income tax on his dividend income, regardless of the CT paid by the company, and the machinery for deducting and accounting for income tax on the distribution would, presumably, remain in being. Under the alternative proposals of the imputation system, a company would pay CT on its profits, distributed or undistributed, at a uniform rate but the shareholder would be entitled to have part of the company's tax imputed to him, so as to discharge, wholly or in part, the tax which would otherwise be levied on him in respect of that income. The tax deducted from dividends and paid to the Revenue would represent an advance payment of the company's liability to corporation tax.

There would be little to choose between the two systems if the problems were confined to those of companies operating in the U.K. and their U.K. resident shareholders, but in the field of international taxation the two-rate system would have unwelcome implications. Whatever system was adopted, double taxation agreements with other countries would have to be renegotiated. The adoption of the imputation system would carry with it a higher rate of tax on company profits than would the alternative and would strengthen the position of those who were negotiating on this country's behalf with those countries where company profits would be taxed at similar levels. Also, with the need to harmonise the tax systems prevailing or to be adopted within the EEC, the select committee decided to choose "imputation system" and the Government accepted that recommendation.

Under the imputation system a company's profits are taxed at a flat rate, assume 50 percent, and part of company's tax is allowed to the shareholder as a credit against his personal tax liability on his dividend. Under the two-rate system, no tax credit is given to the shareholder, who has to pay income tax at his personal rate on his dividend, but the tax on the company's profits is charged at a reduced rate to the extent that the profits are paid out as dividends.

The effect of the two-rate and imputation systems as were proposed in the UK compared with the classical system which operated in the UK from 1965 until 1973 is illustrated in the example shown below, where it is assumed that the company makes a full distribution of its profits, CT rate is 40 percent according to the classical system and 50 percent according to the two-rate and imputation systems, and income tax rate is 30 percent.

<u>(a) According to the classical system</u>

	£	£
Profits		100
Corporation Tax	40	
Less Distribution Relief	-	
		40
Dividend		60

Income Tax (60 x 30/100)		18
Net income of shareholder		42

This figure illustrates the major objection to the classical system because it involves the double taxation of dividends. The double taxation arises because the dividend is subject to both corporation tax and income tax .

(b) According to two-rate system

	£	£
Profits		100
Corporation Tax	50	
Less Distribution Relief	21	
	-	29
Dividend		71
Income Tax (71 x 30/100)		21
Net income of shareholder		50

(c) According to the Imputation System

	£	£
Profits		100
Corporation Tax	50	
Less Distribution Relief	-	
		50

Dividend		50
Income Tax	21	
Less Imputation (ACT) 3/7	21	
		00
Net income of shareholder		50

The example above illustrates that the two-rate system and the imputation system are identical in their effects, and this point also emerges when various other aspects of company tax are considered, for example, as in double taxation relief. Both systems attempt to alleviate part of the double taxation of dividends either by giving shareholders credit for tax paid by the company or by charging a lower rate on distributed profits than on undistributed.[72]

The Green Paper intended to promote discussion of the alternative systems mentioned above. The Committee pointed out that they had confined their enquiry to a consideration of the Government's intention to reform the structure of CT in order to remove the discrimination against distributed profits. The Committee did not examine the arguments for or against Advance Corporation Tax (ACT) nor those for or against discriminating against distributed profit, but they took some account of developments in company taxation with the European Economic Community (EEC).

As indicated in the example above, the two-rate and the imputation systems can both be designed so as to afford relief from double taxation of profits earned by U.K. companies overseas up to the limit of U.K. corporation tax.[73] The Select Committee had recommended that the imputation system, rather than two-rate system, should be adopted, and it seemed likely that the Government would agree with this view, although it was contrary to its own original expressed preference. The Select Committee was mainly influenced by international considerations in reaching its conclusion. In the U.K., therefore, it would be more likely that the imputation system would eventually form the basis of tax harmonisation in the EEC, of which it was due to become a member in January 1973, because it would itself adopt an imputation system.

The question was referred to a Select Committee which recommended the imputation system, largely because the inevitable renegotiation of a double taxation treaty would be made easier.[74] The recommendations were implemented in the Finance Act (FA) 1972, and came into effect in 1973.

Under the imputation system the company is treated as paying part of its CT in advance when it accounts for ACT on its dividend and the payment in advance is deemed to be income tax deducted from the dividends as far as the shareholder is concerned.

The ACT paid by a company on distributions made by it in an accounting period would be set against its liability to CT for that period. It should be noted that only distributions made in the accounting period were counted not dividends declared for that period but paid after the end of it.[75]

But the limitation is that ACT may be set off against CT on income, and not against tax on chargeable gains. For this purpose charges on income, management expenses and other deductions of a general nature in the CT computation, must be attributed to income, not to chargeable gains. If these deductions equal, or exceed the income therefore, no set-off of ACT may be claimed for that accounting period. There is another limitation for the amount of ACT which can be set against the CT liability, again excluding the chargeable gains. This is equal to the following:-

Maximum ACT set off = 30% (Corporation tax income Sched. D charges on income). [76]

For the purpose of determining the maximum amount of ACT, set-off charges on income are deducted from the corporation tax income first and then the chargeable gains. This is contrary to the normal rule that such charges are deductable from the total of CT income and any chargeable gains. For example, A Ltd., company had an accounting period ending 31st March 1986. It has the following profits chargeable to CT.

	£
Sched., D	850,000
Chargeable gains less abatement	
(10,000 -1/4) 2,500)	7,500
	857,500
Less charges on income	7,500
	850,000

A dividend of £800000 was paid on the 20th March 1986.

For computing the mainstream liabilities are:

(1) Maximum Act set off:

Sched.D. Case 1	850000
Less charges on income	7500
	842500

(29% X 842500 i.e. £ 244,325)

		£
Corporation tax payable:		
850000 X 35%		297500
Less ACT set off		
ACT on franked payment	326761	
Maximum set off	244325	244325
Surplus ACT	82436	
Mainstream liability		53175

In the above example the maximum ACT criteria applies, and this has given rise to what is known as a surplus of ACT. The remaining ACT on the dividends paid in 1986 which can be set off in another accounting period will be £ 326761 − £244325 = £32436.

From the above restriction the ACT on distributions in an accounting period cannot be fully used against the CT of that period. It may however, be used to reduce the CT liabilities of earlier periods and repayment may be claimed accordingly. The accounting periods available are those beginning in the six preceding years,[77] and the later or latest of those periods must be dealt with before the earlier or earliest. The same restrictions on set-off will apply to a preceding period as they will to the period in which the ACT originates, and to obtain this relief the company must claim within two years after the end of that originating period,[78] S.85(3), which declared:

> "That is to say, advance corporation tax which cannot be set against the company's liability to corporation tax for that period because the company has no income charged to corporation tax for that period ...the company may, within two years after the end of that period, claim to have the whole or any part of that amount treated for the purposes of this section ..."

ACT which cannot be utilised for set-off in the period in which it originates, and which has not been used for an earlier period, should be carried forward to subsequent periods, without time limit. S.85(4) of F.A. 1972. In whichever period it is used, the same rules restricting the set-off will apply.

Income tax will continue to be chargeable on all dividends and other distributions made by a U.K. resident company, unless specifically exempted. Where a tax credit attaches to a distribution, the amount chargeable to income tax will be the distribution plus the credit. This much is made evident in the new Sched.F, T.A..1970.[79] Here and elsewhere a distribution is to be taken as its amount or value, thus covering the case where it takes some form other than cash S.87(2) F.A. 1972.

Persons, including companies, resident in the U.K. will be entitled to tax credit, but only in respect of qualifying distributions received from a U.K. resident company. The tax credit will be such proportion of the distribution as corresponds to the rate of ACT in force for the financial year in which the distribution is made.[82] S.86(1)and (2). Where a distribution is deemed to be the income of some person other than the recipient, the residence status of that other person will determine the entitelement or otherwise to tax credit.

Where a distribution does not carry with it tax credit, if it is a non-qualifying distribution, or the recipient is not resident, it will not be assessed to income tax at the basic rate. It will be subject to assessment at the additional rates, but without any notional addition for tax credit. It will not be available to cover taxed charges under SS.52, 53, T.A. 1970 and S.87(5) of F.A. 1972. There was a provision to obviate the double taxation of a bonus issue which, having borne income tax as a non-qualifying distribution would become liable to tax again when redeemed. S.87(6) The essential elements in the imputation system were contained in the F.A. 1972, SS.84 to 111. These can be summarized in the following points:

(1) A Company pays CT at a single rate on all its profits

whether distributed or undistributed, S.84 F.A 1972, provides that company making a qualifying distribution including dividends shall be liable to pay ACT to the Inland Revenue (IR) at the basic rate.

(2) Such advance payments made by a company in respect of any distribution in an accounting period shall be set against its liability to CT on any profits in that accounting period and shall accordingly discharge a corresponding amount of the liability.[80]

(3)A United Kingdom resident of a distribution in respect of which ACT has been paid is entitled to a tax credit.[81] An individual recipient is therefore entitled to set the tax credit against the income tax chargeable on his total income for the year of assessment in which the distribution is made. Where the credit exceeds that income tax, he shall have the excess paid to him.[82] A shareholder who is a basic rate taxpayer will not be required to pay an advance tax on his distribution. If he is liable to tax at the higher rates or to the investment income surcharge, the credit must be included for the purpose in his total income.

From April 1st 1973 the classical system of corporation tax was replaced by an imputation system. On April 6th 1973, Unified Tax replaced income and surtax. Under the imputation system a company pays CT at a flat rate subject to special provisions for small companies on all its taxable profits, which include its chargeable gains whether distributed or undistributed. A company distributing profit in the form of dividend or other distributions makes to the

Inland Revenue an advance payment of CT.

Where a company paid a dividend or made a qualifying distribution[83] after April 5th 1973, an imputation credit of three/sevenths (3/7) of the amount of the distribution was attached to it. The company at the same time became liable to pay an ACT of an amount (also) equal to three/sevenths of the distribution except to the extent to which there was franked investment income (F11). So the introduction of the imputation system required some changes in the treatment of distributions and the main requirements of the system were summarized as follows:[84]

(1) The company would pay CT at a single rate on all its profits whether distributed or undistributed.

(2) The company would not deduct income tax from payment of dividends.

(3) When companies paid dividends to shareholders, they were required also to make an advance payment of CT at a rate of 27/73ths in 1987 of the actual dividend paid to the shareholder.

(4) Advance payment made by reference to distributions in an accounting period would be set against the CT liability of the company on profits for that accounting period; and

(5) The recipient of a distribution in respect of which ACt was payable would be entitled to tax credit. For example: If a company paid a dividend of £73 to shareholder, it would be required to pay 27/73 of this amount, £27, as an advance payment of CT. The shareholder would be treated as if he had a tax credit of £27 with the result that if he is liable to

the higher rate of tax or investment income surcharge, this will be made on the aggregate sum of £100, being equal to the dividend of £73 which he has received, together with the tax credit of £27. On the other hand, a taxpayer who is liable to income tax only at the basic rate of 27 percent, would pay no tax on his dividend. A shareholder who is not liable to tax would be able to claim repayment of his tax credit. It will be appreciated that the company will be obliged to pay ACT if it pays a dividend, without regard to whether it has a liability to CT in the normal way. For instance, it may not be liable to CT as its total income for the purpose of the tax may be nil because of high capital allowances, although it may have a profit for the purposes of commercial accounts and may therefore, pay a dividend. Alternatively, it may pay a dividend out of its profits from an earlier year.

The White Paper, (Cmnd.4955) states that the imputation system is one under which[85]

> "Part of the company's liability to corporation tax is imputed to the shareholder, i.e. is treated as satisfying the basic rate income tax liability of the shareholder. The mechanism by which the imputation is given effect is the tax "credit" which is conferred on each resident shareholder when a qualifying distribution is made to him."

In general, distributions for the purposes of the imputation system follow the provisions in SS.233 to 237 of the Income and Corporation Tax Act 1970, but there is a distinction between qualifying distributions in respect of which ACT must be paid, resulting in a credit being conferred on the recipient, and non-qualifying distributions which are payable without ACT and carry on tax credit.[86]

ACT is not a withholding tax but is exactly what it says, an advance payment of CT. In the majority of cases the payment of ACT will not affect the company's total ultimate liability but it will bring forward the actual date when part of this liability has to be met.[87]

Any qualifying distribtution plus ACT is referred to as a franked payment. The amount of value of dividends and other qualifying distribtutions received by a U.K. resident company from another U.K. company plus the tax credit is known as franked investment income. Where a company making a qualifying distribution has received F11, advance corporation tax is only payable on the amount of the qualifying distribution corresponding to the excess of the franked payment made by the company for the period over the F11 received. Any excess of F11 over the amount of franked payments made in the accounting period may be carried forward indefinitely.

The principal purpose of requiring a company to pay ACT in connection with the payment of dividends is to ensure that the Revenue can never be required to grant an imputation credit unless they have collected at least a corresponding amount of tax from the company. In other words, ACT creates a double tax credit (a) against the company's liability for CT and (b) against the shareholder's liability for income tax .

The corporation will also continue to be under an obligation to deduct and account for income tax when paying charges on income such as interest. It will, however, no longer be required to deduct and account for income tax on distributions. The change in CT system which came into operation in April 1973 rendered it necessary to make some alterations to the treatments of groups concerning the treatment of group income. Accordingly section 91 of FA 1972 provided that for subsection (1) of section 256 there was to be substituted a new subsection (1) which was set out in part 11 of Sch.15 of the 1972 Act and which has effect from 5 April 1973. Where a company resident in the U.K. receives dividends from another company also resident here, and the company paying the dividend is a 51% subsidiary of the other, or they are both 51% subsidiaries of another resident company, or the compay paying the dividends is a trading or holding company owned by a consortium, the members of which include the company receiving the dividends, then that company and the company paying them may jointly elect that those dividends shall be exluded from sections 84(1) and 86 of the FA 1972, and are accordingly not included in reference to franked payment made by the company paying the dividend of the F11 of the company receiving them. They are therefore, to be known as group income of the recipient company.(88) part 11 of Sch.15 includes new subsecton (4) and (4A) in substitution for the subsection (4) of section 256,(89) to operate from 6 April 1973. These deal with the position which can arise where companies wrongly omit to pay ACT, possibly because of an invalid election. Accordingly the new subsection (4) provides that where a company purports by virtue of an election under S.256 (1) to pay any dividends, without paying ACT, or by virtue of an election under S.256(2) to make any payment without deduction of income tax, but ACT ought to have been paid or income tax ought to have been deducted, as the case may be, the Inspector may make such assessments, adjustments or set offs as may be required for securing that the resulting liabilities to tax, including interest on unpaid tax of company paying and the company receiving the dividends at payments are, so far as possible, the same as they would have been if the ACT had been duly paid or the income tax had been duly deducted.(90)

The imputation system provides a special lower rate to certain small companies whose profits do not exceed a specified level. A small company is defined in S.95 F.A 1972 as any company whose profits for any accounting period do not exceed the lower maximum amount. Where the profits are greater than the lower maximum amount, but less than an upper maximum amount, then the mariginal relief provisions apply.

For the purposes of determining whether or not the small company rate is to apply, then profits are defined to include the following.

(a) Profits on which corporation tax is chargeable, i.e. corporation tax income and chargeable gains;

(b) Franked investment income, excluding any distribution for group companies, and

(c) The basic rates and relevant maximum amount of past five years as follows:

Financial years	Rate	Lower level	Upper level
1983 to 31.3.1984	30%	£100,000	£500,000
1984 to 31.3.1985	30%	100,000	500,000
1985 to 31.3.1986	30%	100,000	500,000
1986 to 31.3.1987	29%	100,000	500,000
1987 to 31.3.1988	27%	100,000	500,000

Under the imputation system special treatment has been applied to chargeable gains to include Unit Trusts and Investment Trusts.(91) Chargeble gains were included in a company's total profits for any accounting period and were reduced by a fraction, and the full corporation tax rate was applied to that reduced amount.(92) For instance, companies resident in the U.K. are liable to CT in respect of their chargeable gains. The tax payable is paid as CT and, not capital gains tax, it is provided that the amount of tax payable by a company must not exceed that payable as an individual. To achieve this the capital gains of a company are to be reduced by "such, a fraction as Parliament may from time to time determine". The reduction rates at past five years as follows:

Financial Years	Reduction Rate
Year to 31.3.1983	22/52
Year to 31.3.1984	2/5
Year to 31.3.1985	1/3
Year to 31.3.1986	1/4
Year to 31.3.1987	1/7

The normal rate of corporation tax is applied to the reduced gains. Chargeable gains will have deducted from them for the purpose any allowable capital losses incurred in the same accounting period, or brought forward capital losses, which must be deducted from capital gains before applying the fractional reduction.

Income arising from possessions outside the U.K. not being income consisting of any emoluments of any office or employment, are liable to CT under the case V. of Sched.D. A company's income which has borne foreign tax will remain the subject of a credit for that tax up to the amount of the CT attributable to that income. For this purpose, a company's foreign income will be reduced by charges on income, management expenses, etc., but if there are other profits against which those charges may be set, only to the extent that the company may decide to allocate the deductions between the foreign income concerned and chargeable gains as it thinks fit. S.100(4)(5).[93]

If a U.K. company carries on a trade overseas, whether through a branch or subsidiary company, then if control is exercised by the U.K. company, the foreign income is chargeable to CT under Sch.D. Case I or II, and not case V. For tax credit purposes the corporation tax attributed to a source of foreign income will be the corporation tax as reduced by ACT which can be set against it. If there are other sources of income, the company may allocate the ACT between the various categories of income (but not chargeable gains) as it thinks fit, within the prescribed limits for each part of the income, S.100(6).[94] In this way the company can ensure that the amount of foreign tax which goes unrelieved will be reduced to a minimum. Nevertheless, companies with major sources of overseas income taxed at higher rate which aim to distribute a high proportion of those profits, will find that the new system offers fewer advantages to them than to companies with similar levels of profit derived from the U.K.

The parent company will be chargeable to CT in respect of any dividend income received and this will carry with it the availability of unilateral or double taxation relief.[95] The Finance Act of 1984 enacted provisions whereby certain U.K. resident companies with interests in a controlled foreign company may be charged on CT on an apportionment of the profits of the controlled foreign company. SS.82-91, and schedules 16-18 of Finance Act 1984.

Organizations liable to corporation tax

Corporation tax, as mentioned, is chargeable on:
(1) All companies resident in the U.K.
(2) Non-resident companies trading in the U.K. through a branch or agency.

The term "Company" includes not only those incorporated under the Companies Acts, but also any body corporated or unincorporated association, SS.238(1) and 526(5) T.A.1970, such as a Sports or Golf Club, or Social Club. The profits of the latter which are classified as mutual profits, i.e. income arising from its trading relationships with its members, may be excluded from the charge. But where, for example the club receives interest on bank deposits or other investments it will be chargeable to CT and income tax.

The case of The Conservative and Unionist Central Office v. Burrell (Inspector of Taxes)[96] emphasized that the Conservative Party was not an unincorporated association and, as such, it was not chargeable to CT. Although the Crown accepted that the Central Office was not itself an unincorporated association, and Vinelott J. adjudged that the Central Office was nothing more than an administrative unit of the Conservative and Unionist Party and therefore not liable to CT, on the other hand, Lawton L.J. confirmed the Central Office was an unincorporated association and indeed subject to CT. He said:[97]

"The special commissioners had decided that Central Office was an unincorporated association and as such was chargeable to corporation tax on its profits under the provisions of SS.238(1) and 526(5) of the Income and Corporation Tax Act 1970."

The main organizations liable to CT are as follows:

(1) Companies resident in the U.K., and this includes foreign owned companies operating in the U.K. through resident companies.

(2) State owned corporations such as the Bank of England.

(3) Unincorporated associations. These are not defined but may be taken to include any form of Club or Society including voluntary associations.

(4) A branch or agency of a non-resident company.

(5) Building societies, provident societies, and insurance companies - special rules apply to these organizations.

(6) Registered Friendly societies (where exemption from CT can be obtained in certain circumstances) and

(7) If a company enters into a partnership then it is charged to corporation tax in respect of its due share of the partnership profits.

Main organizations exempt from corporation tax

The main organizations exempt from corporation tax are:

(1) Partnerships.

(2) Local authorities.

(3) Approved superannuation schemes.

(4) Charities.[98] A charity which is defined as "any body of persons or trust established for charitable purpose" is exempt from CT. If a charity carries on any trade then any

profits arising will be exempt providing that

(i) they are applied solely for the purposes of the charity, and (ii) either the trade is exercised out of a primary purpose of the charity, or the work is mainly carried out by the beneficiaries of the charity.

(5) Agricultural and scientific societies

(6) The British Museum, subject to certain restrictions, and

(7) The Crown.[99]

<u>The Imputation System as seen by the Company</u>

From the viewpoint of the Company, the imputation system will work in this way.

(1) Whenever profits emerge in the form of a dividend or other qualifying distribution, the company must pay ACT equal to 3/7ths of the distribution in 1973 or 27/73ths in 1987.

(2) The CT on the company's profits will be assessed at the rate of 50 percent in 1973, which reduced to 35 percent in 1987, and normally becomes payable nine months from the end of that accounting period, or if it is later, thirty days from the date of the issue of the notice of assessment.

However, the advance payment will be set against the CT assessed on the profits of the accounting period so as to reduce the amount of tax then payable. It may help in the discussion of the imputation system to describe the amount of tax payable after the end of the accounting period, as reduced by an ACT, as the mainstream tax bill. For example, a company with income of £600,000 will be assessed after the end of the accounting period to £300,000, (assume the Corporation Tax Rate (CTR) is 50%), CT. If it pays to its shareholders a dividend during the period of £73,000 it will be required at the same time to pay to the Inland Revenue ACT of £27,000 (27/73). The advance payment will be set off at the end of the year so as to reduce the mainstream liability to £273,000.

The imputation system and shareholder

The effect on the U.K. resident shareholder can be described as follows:

Instead of receiving a net payment representing a gross dividend from which income tax has been deducted, he will receive a dividend of a stated amount which will carry with it a tax credit. This credit must be included in his income for tax purposes, but, as it will correspond in amount to 27/73ths (suppose the basic rate is 27 percent), of the dividend, it would serve to satisfy the basic rate charge at 27 percent on the total of dividend plus credit. The basic rate taxpayer will not therefore, be asked to pay additional tax on the dividend. A shareholder who is not liable to tax can claim payment of the credit, if he is liable to tax at the higher rates or to investment income surcharge, the credit must be included for this purpose in his total income. Under the imputation system the company will declare and pay to the shareholder a dividend of £70 which will carry a tax credit of 3/7ths = £30; any liability to the higher rates of tax or to the investment income surcharge will be on the aggregate of £70 plus £30 = £100.

ACT and the shareholder's tax credit form the core of this system, they are the essential link between the company's corporation tax and the shareholder's own tax liability. In this way a single rate of 'imputation' can be applied to all distributions regardless of the effective rate at which the company is liable to tax. In its absence there would be difficulties where dividends are paid out of profits which, for one reason or another, have not borne UK corporation tax in full. Clearly it would be in such cases to give the shareholders a credit for tax which has never been paid, and the select Committee therefore, regarded some such preliminary payment as an essential element in the imputation system.

General structure of imputation system

The main features of the imputation system are as follows:

(1) The Company pays CT on all its profits and gains whether distributed or not, generally at a flat rate. A special lower rate applies to certain small companies whose profits do not exceed a specified level. This rate was initially fixed at 29 percent for the financial year 1986, as opposed to the normal rate of 35 percent for the same year.

(2) When a company distributes profits it makes a payment of tax, called "Advance Corporation Tax". As the name implies, this is an advance payment of CT and the amount paid is set against the company's eventual CT liability for the period in question. Initially, the rate of ACT was set at 29/71ths,

for 1986, of the amount of the distribution.

(3) A shareholder who receives a dividend, or other distribution, is liable to personal income tax upon the amount of the dividend plus the advance CT paid in respect of it, but receives a "tax credit" for that tax, so if all shareholders paid income tax at the basic rate, that would be the end of the matter. But some shareholders have higher marginal tax rates and others, lower, and this complicates matters somewhat, because we have to calculate the amount of extra tax or a refund which is due.[100]

(4) The corporation tax rate is chargeable on profits whether distributed as a dividend or not.

(5) Within certain limits the payment of advance corporation tax in an accounting period is set against the company's liability to corporation tax on its taxable profits for that accounting period.

(6) The shareholder is regarded as having imputed to him, a tax credit equivalent to the amount of advance corporation tax payment, which is also equal to the basic rate of income tax. Any income tax liability which he may have at the basic rate is thereby satisfied.

(7) Income tax as such is not deducted from dividends. However, it is deducted from annual payments such as loan or debenture interest, royalties and deeds of Covenant.

V. A comparative analysis of company tax systems

In this section, comparisons and conclusions concerning the three types of systems, i.e. classical, two-rate and imputation systems, are made. This is done on a theoretical level and the comparison demonstrates the following main points:-

(1) the resemblance between the three tax systems;

(2) the three systems and legal forms of enterprise;

(3) the three systems and economic double taxation;

(4) the three systems and choice of financing; and

(5) the three systems and distribution profits.

Resemblance of Company Tax Systems

In respect of CT, the three tax systems have many important similarities which are as follows:

(a) All of them include a synthetic, progressive individual income tax which affects the income of natural persons, including the dividend income.

(b) The Corporation tax is an independent tax on the profits of entities;

(c) The CT is imposed on the entire profits of share companies;

(d) The CT is at any rate partly a 'real corporation tax' in the sense that it is imposed without trying to prevent economic double taxation. But the economic double taxation is moderated according to the two-rate and imputation systems;

(e) None of the three tax systems is neutral in respect of the legal form of the enterprise. The individual income tax is in all systems progressive and the CT proportionate.

Company Tax systems and Legal Forms of Enterprise

An important object of any CT is providing neutrality in terms of fiscal consequences in selection of the form of doing business. Thus, small and medium size businesses should be able to choose their legal form solely for economic and legal reasons disregarding taxability, and as regards the possibilities of expansion financing corporate business.

Forms of business organization may also be influenced by the sturcture of the corporation tax rate (C.T.R.), whatever the system. A lower rate for small profits may encourage the growth of a number of small companies controlled by a group, except where the benefit of the reduced rates are available only to one member of a group[101]

Because of the nature of the proportionate corporation tax and the progressive individual income tax (IIT), none of the three tax systems is completely neutral with respect to choosing a business form, e.g., as the marginal rate of IIT increases, it may seem desirable to do business in a corporate form. The choice should be made, however, taking into account the necessity of dividend distributions which may result in a more or less significant double taxation of such distributions depending on the system chosen.[102]

The individual income tax is in all systems progressive and the CT proportionate. When the income of individual entrepreneurs increases, the difference between the mariginal burden of the individual income tax and rate of CT becomes increasingly significant. In total, where circumstances which make the corporate form more advantageous than the direct conduct of the enterprise, the size of the profit is an important factor, but numerous other circumstances are also important, such as the amount of the deductible compensation of the management and the necessity of distributions by the share company which again are subject to incme tax.[103]

It will be sufficient to note that the two-rate and the imputation systems are more neutral than the classical system in so far as both the prospect of fiscal advantage and the prospect of fiscal disadvantage in consequence of the transformtion of the business into a share company becomes smaller. There is less advantage because the rate of the CT on retained profits is higher in the two-rate and imputation systems than in the classical system, and the distance to the top-rate of the individual income tax smaller. There is less disadvantage because the EDT on distributed profit is moderated in the other (two-rate and imputation) systems.

With regard to the problem of financing enterprise expansion in comparing the corporate form to the sole trader, the advantages to the former in this respect tend to be less in the two-rate and imputation systems because the pressure to make distributions erodes in part the ability to self-finance.

The three systems and choice of means of financing

Non-fiscal consequences should determine decision-making in respect of the means of financing. As between equity and loan financing, fiscal discrimination can be observed in the usual deductiblity of loan interest and the usual non-deductibility of dividend distributions, i.e. interest on loan capital is deductible in computing the taxable profit, while the interest on the equity capital, or on the paid-in capital, is not deductible (This is generally true in all three systems). This difference in fiscal treatment could be a stimulus to the use of finance by loan capital instead of financing with equity capital.

In choosing a particular means of raising finance a number of factors are involved and taxation is one of them. In the survey, our field study in Egypt, about 75% of the firms (MNCs) replied.[104] " Yes" to the question ("Have taxes any effects on your borrowing policy decision?")

Under the classical system, no part of dividends can be offset against liability to CT and on the other hand, interest on loan capital is tax deductible and its relative attraction theory enhanced. The classical system tends to encourage self-finance rather than distribution of profits.

With the imputation system, dividends are partially deductible for CT purposes, e.g. if £100 paid out as gross dividend reduces the final CT liability by £27 (assuming personal tax rate (ITR) is 27%), while £100 paid out in interest would reduce it by £35 (assuming the CTR is 35%). Moreover, the two-rate imputation systems are all neutral as between retentions and distributions.

From a theoretical viewpoint the idea of a more neutral attitude of the fiscal attitude in respect of the choice between the use of equity capital or loan capital is attractive. Whether the effect in a concrete situation can be considered as favourable or unfavourable is dependent on whether or not the total number of factors which determine the method of financing, prove to lead to a degree of financing with loan capital which evokes drawbacks.

At the first glance, from table (3.1), it might appear that the tax system has influenced the issue of shares or of debentures. According to the classical system the issue of debentures was greater than the issue of shares for the first few years of the classical system, but this trend did not continue for long.

Under the imputaton system, the issue of shares is to some extent encourged as compared with the classical system. Table (3.1) below shows that the issue of shares is much greater than the issue of debentures following the introduction of the imputation system.[105]

The three systems and distributed profits

Academic argument relating to distributed profits centres on two questions: firstly as to whether dividend decisions are actively made by companies or whether dividends are residual funds after meeting requirements for reinvestment, and secondly, as to whether the value of the company and its share prices are affected by the proportion of earnings distributed.[106]

Miller and Madigliani have argued that.

> "...the irrelevance of dividend policy given investment policy is obvious, once you think of it... in a rational and perfect economic environment.. values are determined solely by 'real' considerations, - in this case the earning power of the firm's assets and its investment policy - and not by how the fruits of the earning power are packaged for distribution."

They further postulate that any shareholders in need of current income can always sell part of their holding and so substitute home-made dividends for corporate dividends or that a company will attract a clientele of shareholders whose dividend expectation match its payout policies.

Company tax systems assess distributed profits differently from undistributed profits. When a company is charged CT on its profits and shareholders are again charged on dividends received, the effect is that distributed profits are taxed twice while retained profits are charged only to CT.[107] To the extent that such retained profits are reflected in share prices, capital gains will arise. If capital gains are taxable, these will usually be chargeable at the time of sale of shares, which may of course be at a much later date and often at concessionary rates.

The Classical system is expected to promote a greater retention of profit. Thus the aim was to encourage re-investment of profit at the expense of distribution, so as to accelerate the growth of investment by the corporate sector. On the other hand, if no distribution is made, the retained profits, which give rise to capital gains on realization, will be taxed at a later date.

The two-rate and imputation systems aim at encouraging the distribution of dividends so as to re-activate the capital market, and reduce reliance upon financing out of ploughed-back profits.

Table (3.1)

Net issue of share and net issue of debenture and tax systems

Years	Net issue of shares £	Share price index (Indus:trial 500 shares	Net issues of deben:ture £	Rate of redemp:tion of deben:ture loan stock	Tax systems
1964	157.6	113.31	241.3	000.00	Profit
1965	62.7	113.31	357.0	7.07	Tax & IT
1966	121.8	107.59	422.4	7.70	Classical
1967	60.9	114.92	337.6	7.56	system
1968	298.5	162.4	194.1	8.24	" "
1969	176.6	160.5	336.2	10.30	" "
1970	39.1	142.2	142.2	10.50	" "
1971	149.0	168.1	202.8	10.05	" "
1972	295.4	214.0	241.8	9.72	" "
1973	98.1	185.8	29.6	11.40	Imputation
1974	37.4	108.8	-71.6	16.44	System
1975	954.7	136.0	30.1	15.95	" "
1976	769.7	162.9	-11.7	15.15	" "

Source: Financial Statistics, 1965, 1968, 1974 and October 1978.

3.VI: Distributions of Profit

(I) Introduction

When a distribution is made by a company resident in the UK the recipient is liable to income tax under Sched. F,[108] If the distribution is a qualifying distribution the company must make a payment of advance corporation tax (ACT), at that time, to the Revenue at the appropriate rate.[109] Almost all distributions are qualifying distributions.[110]

Distributions are not deductible from profits in a corporation tax computation and are income in the hands of shareholders.

Since 6th April 1973 the UK has changed from the classical system to an imputation system whereby, whenever a company pays a dividend, or more precisely makes a qualifying distribution, it must pay ACT to the Revenue. This ACT is equal to income tax at the basic rate on the dividend, which is therefore available to the individual shareholder in the form of a tax credit or set off against his personal income tax liability and to the recipient company against its actual corporation tax (CT) liability on profits.

United Kingdom companies are now taxed at a rate of 35% on their profits (as against 40% corporation tax which previously applied under the classical system) so that with the imputation of a tax credit of 27% in respect of dividends, a company's Mainstream Corporation Tax (MCT) on a full distribution is therefore 8%. The advantage with the system is that it does not discriminate against distributions as did the system in UK between 1965 and 1972 so this provides incentives to the public to invest in companies.

In this section we shall discuss the definition of a distribution for the purposes of payment of advance corporation tax, franked investment income, qualifying and non-qualifying distributions, restriction of advance corporation tax set-off, and accounting for advance corporation tax.

(2) Meaning of distribution

In relation to company "distribution" means:[111]

(a) dividends paid including a capital dividend. A dividend is regarded as paid when it becomes due and payable, that is when it becomes an enforceable debt, not necessarily the date of the resolution;[112]

(b) any other distribution out of assets of the company (whether in cash or otherwise) in respect of shares in the company, except to the extent of any repayment of capital on the shares or of any "new consideration" received by the company when the distribution is made.[113] Consideration is new if it is external to the company, that is, it is not provided directly or indirectly by the company itself.[114] Thus amounts retained by the company by way of capitalising a distribution are clearly not new while money paid by the shareholder from his own savings is equally clearly new, even though it may have originally been earned in the employ of the company; so a bonus issue is not a distribution since there is no cost to the company; nor is a rights issue since the consideration is new. For example, company A has held shares in company B for many years and decides to distribute these to shareholders. The market value of each share in company B is £2.50 but company A offers them at £2. So, the distribution is 50p per share;

(c) bonus redeemable share capital and bonus securities issued by the company in respect of shares or securities of the company provided there are not issued for a new consideration.[115] Thus the issue of bonus redeemable preference shares or debentures and loan stock are all treated as company distributions;

(d) any interest or other distribution (such as premium on redemption) on the following securities of the company, which are bonus securities as indicated above; securities convertible into shares in the company other than securities quoted on a recognised stock exchange or those issued on reasonably comparable terms with securities so quoted; securities where the interest or other return is dependent on the result of the company's business or represents more than a reasonable commercial return on the use of the principal; securities issued by a company which is a 75% subsidiary to a non-resident parent company; and securities "connected with" shares of the company i.e. securities with rights, terms and conditions which make it necessary or indeed profitable for a corresponding amount of shares to be held by the same person. Also within the definition of distributions is any benefit received by a member from a transfer of assets by a company to its members or a transfer of liability by a member to the company.[116] The benefit is the excess in market value of the asset provided that the company does not receive full consideration for the transaction;

(e) also within the definition is any excess in the market value of an asset transferred by a company to its members or where a liability is considered to be new if it is external to the company, it is not to receive full consideration.[117] Special rules apply to transfers by subsidiary companies to parents.[118]

The term "distribution" does not apply to distributions in respect of share capital in a winding-up of a company,[119] but it includes a bonus issue of any redeemable share capital or any security (otherwise than wholly for new consideration):

(i) issued by the company in respect of shares in the company; or

(ii) issued by company after 5th April 1972 in respect of securities of the company.

Finally, in relation to a close company the meaning of "distribution", as it ordinarily applies for CT purposes, is extended to include:

(1) certain expenses incurred by such a company in providing benefits or facilitaties for participators and participators' associations, and

(2) certain interest paid to directors and directors' associates.

It should be borne in mind that while amounts treated as distributions cannot be deducted in computing the profits of a close company for CT purposes they are to be taken into account as distributions of the company for the purposes of apportioning any excess of the company's relevant income over its distributions.(120)

For the purposes of the "Imputation System" "distributions" are divided into "qualifying" and "non-qualifying" distributions.

(3) Qualifying and Non-qualifying Distributions

All distributions are qualifying distributions except:

(a) bonus redeemable shares and bonus securities; and

(b) any share capital or security which the company making the distribution has directly or indirectly received from another company in the form of bonus redeemable shares or securities.[121] In other words a qualifying distribution is any distribution other than an issue of bonus redeemable shares, bonus securities and a redeemable bonus share or debenture issue received by the company from another company and then distributed to the former company's shareholders[122]) Therefore all company distributions are qualifying distribution except the above two which are non-qualifying distributions.

The importance of this distinction lies in the fact that a company making a qualifying distribution is liable to pay ACT which confers a tax credit on the recipient. If the distribution is a non-qualifying distribution no ACT is payable and there is no tax credit. However there is a liability on the recipient to tax under Sched.F but only to the extent that he is liable to higher than basic rate;[123] he is taxable on the normal value of the distribution plus any premium on redemption. As far as the person who paid tax at the higher rate on the issue of the securities is concerned, he can use it to set off against any excess liability on redemption.

The total of a qualifying distribution and the relative

ACT is called a franked payment. For example :

qualifying distribution, July 1986 was	£205900
Advance corporation tax 29/71 x £205900	84100
Franked payment	290000

A franked payment corresponds to the amount included in a shareholder's income for income tax in the fiscal year in which the shareholder receives a dividend. If such payments are received by other UK companies they are referred to as "franked investment income".[124] A U.K resident who receives a dividend or other qualifying distribution from a U.K company is entitled to a tax credit. The amount of the credit is equal to the ACT paid by the company in respect of the dividend.

When such a dividend is received by a company, the total of the dividend and the tax credit is called franked investment income. It is called franked because the income out of which the dividend has been paid has been charged or "franked" with CT. A company receiving franked investment income is entitled to a tax credit, as is an individual, but the use to which it may be put by a company is peculiar to companies themselves. Thus the tax credit in franked investment income may be set off against the liability of the company to pay ACT on its own qualifying distribution; more precisely the ACT payable on distributions is calculated with reference to the excess of franked payments over franked investment income.[125] From the standpoint of companies, these two phrases represent the dual nature of the imputation system; namely that on one hand the payment of ACT represents a tax credit to the company making it, and on the other hand it represents a tax credit to the recipient company, not least to its shareholders. It is now proposed to consider how the tax credit can be used in each situation.

(4) Set-off ACT against Corporation Tax

The basic rules governing the set-off of ACT against liability to CT are:[126]

(i) When a company pays a dividend, it will at the same time become liable to pay an ACT except where that distribution is matched by franked investment or where the distribution constitutes group income. In the absence of these exceptions the ACT paid by the company in any accounting period can be set-off against its liability to CT on its income for that period.

(ii) The set-off of ACT is restricted to a company's liability to CT on its income charged to CT [127] for the particular accounting period. There is no set-off of ACT against CT on chargeable gains.

(iii) The amount paid by way of ACT in respect of an accounting period is deductable from the CT liability for the accounting period to arrive at the amount of the mainstream tax payable on the due date for payment.

The legislation provides for a restriction of the amount of ACT which may be deducted from the CT charge. The restriction is to that amount of ACT which when added to a qualifying distribution equals the income of the company for the accounting period chargeable to CT.[128] The reason for this restriction is that if a company makes excessive distributions, in relation to the taxable profits of a particular period, which arises for example out of profits of an earlier period or out of reduction for tax purposes by capital allowances of its commercial profits, it would be inappropriate to allow the company to use the whole of the payment of advance corporation tax (which must be paid) to escape liability to CT in any accounting period. Hence ACT where unpaid cannot be set off against the chargeable gains of the company. This is understandable as the chargeable gains of the company attract a lower rate of CT than its revenue income. It is therefore provided that the amount of the chargeable gains to be excluded is that amount before any deductions for charges on income, expenses of management or other amounts which can be deducted from or set against or treated as reducing profits of more than one description. This is to ensure that the company does not get any tax advantage via manipulation of chargeable gains.

The amount paid by way of ACT in respect of an accounting period is deductible from the CT liability for the accounting period to arrive at the amount of the mainstream tax payable on the due date for payment. A company does not have an unlimited right to set off the payments of ACT for an accounting period against its liability to CT on it (its income) of that accounting period. It is therefore provided that the maximum amount of ACT so creditable must not exceed the amount of ACT that would have been payable in respect of a distribution made at the end of that period which together with the ACT so payable in respect of it is equal to the company's income charged to CT for that period.[129] For example, the chargeable prfits of "A" Ltd., for the accounting period ended March 31st, 1987 are as follows:

	£
Schedule D., Case I	600,000
Unfranked investment income	53,000
	653,000
Charges on income	33,000
Profit chargeable	620,000

The payyments of ACT are as follows:

Franked investment income	5,000
Dividend paid Jan. 1987	650,000

Corporation tax rate is 35% and

advance corporation tax rate is 27%

The amount of ACT paid and the ACT amount deductible from CT are as follows:

ACT paid in respect of accounting period ended March 31st 87

		£
Dividend paid		650,000
ACT 27/73 x 650000		240,411
Franked payment		890,411
Franked investment income		5,000
Excess of franked payment		885,411
		=========
Advance corporation tax 885411 x 27%		239,061
		=========
Restriction of ACT deductible		
Profit chargeale to CT		620,000
LESS:		
Chargeble gains (as abated)		50,000
Income for restriction		570,000
		=========
Amount of restriction 570000 x 27%		153,900
		=========
Mainstream corporation tax payable		
Corporation tax liability		
	£	£
620000 at 35%		217,000
Less ACT paid	239,061	
Restricted to		153,900
		<u>63,100</u>

Surplus of advance corporation tax

	£
Advance corporation tax paid	239,061
Less advance corporation tax set-off	153,900
Excess of ACT paid over ACT relieved	85,161
	=======

From the above example the amount paid on advance corporation tax was in excess of the restricted amount of ACT which it was possible to set-off against the company's liability to CT for the accounting period. This excess is called a surplus of advance corporation tax. So the surplus of advance corporation tax arises whenever more advance corporation tax has been paid in an accounting period than it is possible to set off against CT for that accounting period by reason of the restriction as shown in the above example.

For an accounting period ending after 31 March 1984 a company can carry back surplus ACT and set it against MCT on income profits of the six accounting periods immediately preceding the period showing the surplus.(130) A refund of CT will only result if the permitted level of set-off has not been reached in those years.(131) If a surplus still remains it can then be carried forward without time limit and set-off against MCT on future income profits in the first year when the full quota of dividends has not been paid. The company can carry the surplus back six years to be offset against previously unrelieved CT and then in so far as any part of the surplus remains to carry it forward indefinitely.

To carry a surplus back the company must make a claim within two years of the end of the accounting period in which the surplus rises.[132]

If it cannot be relieved in the next accounting period it will be carried forward as a surplus to the next accounting period again and so on.

The advantage for a company with a surplus ACT is that it will help it to get off the ground when the business is in decline and when it is not making huge profits.

(5) <u>Franked Investment Income (FII)</u>

A resident who receives a dividend or other qualifying distribution from a U.K. company is entitled to a tax credit. The total of the dividend and the tax credit is referred to as "franked investment income". Thus the FII is income which has already been taxed and accordingly it is exempt from further CT.[133] For example, a dividend of £73 incurs ACT of £27, amounting to FII of £100 in the hands of a U.K. recipient company. Hence a U.K. company which has paid that dividend to another U.K. company would already have paid CT on the profits out of which the dividend has been paid. The latter company would have therefore received the dividend which forming part of its FII would not be subject to further CT. Where in any accounting period a company received FII the company shall not be liable to pay ACT in respect of qualifying distributions made by it in that period unless the amount of the franked payment made by it for the same period exceeds the amount of its FII.[134] The FII reduces the CT that has to be paid in advance. It can also happen that FII received in an accounting period exceeds the amount of franked payments. When this occurs we have what is called surplus of FII. A surplus of FII can be carried forward from one accounting period to the following accounting period and set-off against franked payments in that accounting period. If the surplus plus any FII received in the following accounting period again exceeds franked payments the new surplus is carried forward to extent and succeeding accounting periods until the surplus is absorbed by franked payments. In other words ACT is only payable on the amount of dividend that corresponds to the excess of the franked payments made by company for the period over the FII received by it. If therefore there is such an excess of franked payments over FII advance corporation tax is payable on an amount which is, when the ACT payable thereon is added to it, equal to the excess. Assume that the following facts refer to "B" Ltd. for the years stated:

	Accounting Period one	Accounting Period two
Sched. D, Case I	100,000	200,000
FII	20,000	30,000
Dividends paid	--	32,500

It is assumed that rate of ACT for all relevant years is 27/73 and CT rate is 35%.

Accounting period (1)

		£
FII		20,000
Franked payments		--
Surplus of FII carried forward		20000
CT payable 100,000 x 35%		35000

Accounting period (2)

		£
Surplus of FII brought forward		20,000
FII		30,000
		50,000
Franked payments:	£	
Dividends	32,500	
Add ACT 27/73 x 32,500	12,021	
		44521
Surplus of FII carried forward		5479
CT payable £200,000 x 35%		70,000

As we have observed from the above example FII for both years is accordingly the gross amount of such income. Franked payments are qualifying distributions (dividends) plus tax credit. The tax credit received when a qualifying distribution is received by a company affords no ultimate relief from CT. The franked investment income is not included in profits of a company for tax purposes. A company which has a surplus of FII for any accounting period, excluding any surplus brought forward, may, alternatively claim to have that surplus treated could be repaid by setting it off against the following reliefs and allowances which are usually deductible in computing general profits of the company.(135)

(6) Accounting for Advance Corporation Tax

For the CT purposes the accounting periods will usually be the successive periods for which the company makes up its accounts. An accounting period cannot exceed twelve months. A period of account is simply the period taken by the company in computing its accounts.(136) Where the period of account exceeds twelve months the accounting period will end after twelve months and a new one begin.

The scheme of tax is designed so that the period of account will usually coincide with the accounting period and is designed to interfere as little as possible with the freedom of the company to take whether period of account it takes.(137)

However the accounting period of a company is divided into a number of what are called "standard return periods". These periods end on March 31st, June 30th, September 30th and December 31st, quarter dates of a calendar year. If the end of the accounting period does not coincide with one of the quarter dates then the end of the accounting period is also the end of another standard period.

The return of dividends and ACT payable is made with respect to the same return periods. The returns are made in different parts of the same revenue for "CT 16". The return and payment of ACT are due within fourteen days from the end of the standard return period.

When a company has made a franked payment in a return period, it makes an ACT return in terms of Sched. 14 F.A.1972. If it has not paid dividends it does not require to make a return. However if the company receives some FII in a return period and in an earlier return period in the same accounting period it has paid a dividend and ACT, it will make a return of the FII even if in the return period in question it has paid no dividend. This is because by this means it will be repaid the ACT which has been paid earlier in the accounting period.[138]

Any FII received in a return period will be set-off first against franked payments made in the same return period. Any excess of FII over franked payments for that return period will be repaid if ACT has been paid earlier in the same accounting period or carried forward to the next return period or, as a surplus of FII be carried forward to the first return period.[139]

3.VII The three tax systems and economic double taxationn

The imposition of two taxes, the CT and income tax (IT), on corporation income creates the so-called phenomenon of double taxation. If corporate income remains in the country of origin it is taxed twice by the same domestic tax system. It is taxed first to CT in the hands of the corporation and, in turn, the distributed part of corporate income is taxed to income tax in the hands of the recipient shareholders. Therefore, the distributed part of corporate income is taxed twice. This phenomenon is called economic double taxation (EDT) and it differs from international double taxation which arises if the corporation and the recipient do not live in the same country.(140)

None of the three systems,however, provides for a complete avoidance of EDT on dividends. The 'classical system' results in the profits being taxed twice, first in the hands of the company paying its CT and again in the hands of the shareholders paying their IT on the dividends.

Under the "two-rate system", in order to reduce the EDT on dividends, a lower rate of CT exists for the distributed profits of share company than for its other profits. Then the dividend is taxed just as any other income, for the purposes of the individual income tax. The relief to mitigate EDT has therefore been performed at the company level.(141)

In order to reduce the EDT of dividends, under the "imputation system" part of the CT on distributed profits is credited against the individual income tax. The relief to mitigate EDT on dividends has been applied here at the shareholder level. However, the fact still remains that these systems all stem from the question whether or not the EDT should be mitigated. The classical system appears to adopt the position that the EDT should be rigidly maintained. Conversely, the other two tax systems attempt only to mitigate the EDT so, as mentioned above, none of the three systems prevents EDT.

Economic double taxation is entirely avoided if only one tax is finally imposed on the profit which is distributed to shareholders. This result can be achieved by the following suggested method;

One tax (IT)is finally imposed on the profit which is distributed to shareholdes, and CT is imposed on undistributed profit. Two examples are given below to demonstrate the treatment of this method for prevention of EDT, and to make comparison between this method and the imputation system.[142] It is assumed that the corporate profit is £780,000, charges on income are £80,000, the CT rate is 35%, the IT rate is 27% and the dividends are £400,000.

(1) Preventing EDT by using the suggested method

	£	£
Sched. D Case (i)	780,000	
Less charges on income	80,000	
Chargeable profit	700,000	

	£	
	700,000	
Less dividends	400,000	
		300,000
		=======
CT at a 35% X 300,000		105,000
Income chargeable to Income Tax	400,000	
Income Tax at 27% X 400,000	108,000	
Net dividends		292,000
		=======

Note:

(1) The profit chargeable to CT is equal to the chargeable profit less the gross dividend (7000,000-400,000=300,000);

(2) The distributed profit is subjected only, to one tax (Individual Income Tax) (400,000 X 27% = 108,000);

(3) The profit chargeable to CT, i.e. the chargeable profits less gross dividends, is subject to CT (700,000 - 400,000 X 35% = £105,000.

(2) <u>Comparison between the above method and the imputation system</u>

	Imputation System		Suggested Method	
	£	£	£	£
Sched. D Case (i)	780,000		780,000	
Less charge on income,	80,000		80,000	
Chargeable profits		700,000		700,000

Less dividends (gross)			400,000
Profit chargeable to CT		700,000	300,000
CT at 35%	245,000	105,000	
Less ACT 292000 X 27/73	108,000	---	
Mainstream Liability	137,000	105,000	
Individual Income Tax	108,000	108,000	
Less ACT	108,000	---	

The above examples illustrates that economic double taxation is prevented according to the suggested method and moderated according to imputaton and two-rate systems. Under the imputation system the distributed profit is subject to two taxes which are:

(i) one, income tax, on shareholders at rate 27% (108,000)

(ii) the other, CT, i.e. the difference between CT on the gross dividends and ACT (in the above example the gross dividends 400,000, so the CT on the gross dividends is 400,000 X 35% = 108,0000 (ACT) is £32,000. Therefore, the dividends are subjected to two taxes, income tax and CT. This phenomenon is so called economic double taxation.

Under the suggested method EDT is entirely avoided because the distributed profit is subjected only to one tax as shown in the above example.

3.VIII: Groups of companies and corporation tax

(A) Introduction

The changes in the corporation tax system which came into operation in April 1973 rendered it necessary to make some alterations to the classical system procedure concerning the treatment of group income, section 256 of T.A. 1970. Accordingly section 91 of the F.A. 1972 provided that for subsection (1) of S.256 there was substituted a new subsection (1) which was set out in part II of Sched.15 to the 1972 ACT and which had effect from 6 April 1973. Certain groups of companies, listed below, have been favourably treated by the British Tax System:

(1) A system was adopted whereby a company which had made some profit could make a subvention payment to another company within the group and this would be favourably regarded under the income tax law in the sense that payment would not be taxable in the hands of the recipient company.

(2) The system encouraged companies which consider it more profitable and useful to carry on a business with a different members of enterprise and structures . , the idea being that the tax system should not prevent good business being done in that way.

A group may be provisionally defined as an economic entity comprising of two or more companies, each of which has a separate legal existence, but which are connected either by reason of the power of control, which one of the companies, called the parent company, exercises over the others, or by reason of the fact that, although the companies are independent, they are under unified management.

In this chapter we shall consider how groups of companies have been treated under varying circumstances in the current British tax system. In this connection the subject will be examined under the broad subheadings, the definition of dependent companies and groups of companies, the nature of groups of company or why groups are formed?, the relationship between the companies and other companies in the same group, statutory rules applicable to holding companies and their subsidiaries; the form of group accounts, group relief-definition, items available for group relief (relief for trading losses, methods of group relief, group relief for special kinds of capital allowance, group relief for charges and other loss relief), groups of companies and capital gains, transfers of trading stock and surrender of advance corporation tax, summary and conclusions.

(B) Definition of groups of companies

Groups of companies are extremely diverse, and for this reason any attempt at a general definition encounters great difficulties. As said before, a group may be provisionally defined as an economic entity comprising two or more companies, each of which has a separate legal existence, but which are connected either by reason of the power of control, which one of the companies, called the parent company, exercises over the others, or by reason of the fact that, although the companies are independent, they are under unified management.

Although many states have passed legislation giving some recognition to the particular characteristics of groups of companies, in British Law, the Companies Acts 1948-85 do not contain any general definition of a group of companies. For the purpose of these Acts, one company is the holding company of another, if it controls it in any one of three ways, namely:(143) (1) by holding more than one half of its equity share capital, or (2) by controlling the composition of its board of directors; or (3) by being the holding company of an intermediate company which in itself is the holding company of the subsidiary.

The subsidiary's equity share capital means, for the purpose of the present definition, its issued share capital excluding any part thereof as respects either dividends or capital distribution, S.154(5) of Companies Act (C.A.)1948. The treatment of a company which holds more than one half of the equity share capital of another company as the latter's holding company appears somewhat unsatisfactory if control be regarded as the appropriate test because a majority holding of the equity does not necessarily confer voting control. A company is treated as being the holding company of another company if it is a member of it, and controls the composition of its board of directors, (S.154(1)C.A.1948). It has this power if, without the consent of any other person, it can appoint or remove the holders of all or a majority of the directorships of the other company. It is deemed to have power to appoint to such a directorship if its consent is required for the appointment, or if the appointment follows necessarily from the appointee being appointed a director of itself, or if it, or another of its subsidiaries holds the directorship S.154(7) of CT 1948.(144)

The holding company will be empowered to appoint or dismiss the holder of a majority of the subsidiary's directorships when it has sufficient voting at general meetings of the subsidiary to be able to procure the passing of resolutions for the appointment or removal of its director. The power to appoint or remove a director of the subsidiary may be conferred on the holding company under the memorandum and articles of the subsidiary company, or under a contract between the holding and the subsidiary companies.(145)

Therefore, it is necessary to define some terms that will be used in this section as follows:

(1) A 51 percent subsidiary is one more than 50 percent of whose ordinary share capital is held by another company.

(2) A 75 percent subsidiary is one not less than 75 percent of whose ordinary share capital is held by another company.

(3) A 90 percent subsidiary is one not less than 90 percent of whose ordinary share capital is held by another company.

(4) Groups of companies consist of a parent company and its subsidiaries; a subsidiary of the parent is a company more than 50 percent of whose ordinary share capital is owned by

the parent. However, a subsidiary may itself have a subsidiary or subsidiaries. In this case, level subsidiary may or may not join part of a group with the ultimate parent. This will depend upon the level of ownership both direct and indirect subgroups may also develop. For example, if company 'A' owns 60 percent of company 'D' 75 percent of company 'E', and 100 percent of company 'F'. 'D' owned 40 percent of company'T', and 30 percent of company 'U'. 'E' company owned 56 percent of company 'T', 20 percent of company 'U'. 'F' company owned 20 percent of company 'U' Therefore company 'A' owns 60 percent of company 'D', 75 percent of company 'E', 100 percent of company 'F', 66 percent of company 'T' (60 x 40 + 75 x 56) and 53 percent of company 'U' (60 x 30 + 75 x 20 + 100 x 20). So companies 'A', 'D', 'E' and 'F' form a 51 percent group, 'A', 'E' , 'F' and 'u' form a 75 percent group and only 'A' and 'F' satisfy the 90 percent group requirements.

The importance of the concept of a group for tax purposes is that companies within a group are eligible for certain concessions.[146] The particular concessions depend upon the precise level of ownership between the relevant companies. For CT purposes each member of the group is liable to CT separately. Thus the concept of a group only applies in the context of the specific concessions granted, and the purpose of the concessions is to treat a group of companies as nearly as possible as a single company.

The normal CT legislation applies to companies within a group structure, broadly this can be divided into two types:
(1) The "enabling and exempting" provisions which on the

whole are to the benefit of groups in that they allow special reliefs and privileges.

(2) The other type is the "anti-avoidance" legislation which restricts what groups can do in attempting to prevent their being used as instruments of tax avoidance.

The enabling and exempting provisions are:

(1) Group income concerned with sections 256 and 257 of T.A. 1970 as amended by section 91 and Sch.15 of F.A. 1972. Dividend S.256(1) and charges on income, S.256(2).

(2) Group relief, sections 258-264 of T.A. 1970.

(3) Surrender of surplus ACT, section 92 of F.A. 1972.

(4) The transfer of assets, section 273, T.A. 1970. and

(5) Replacement of business asets, section 276 of T.A.1970.

The anti-avoidance provisions are:

(i) Small companies rate and tapering relief, section 95, F.A. 1972.

(ii) Various anti-avoidance sections relating to companies leaving a group and inter-group transactions, SS.278-281, T.A.1970. These are closely related to the transfer of assets between group members and can be sub-divided into:

(a) Companies ceasing to be a member of a group, SS.278, 278(A)T.A. 1970.

(b) Disposal of shares in a subsidiary group member, S.279, T.A. 1970.

(c) Depreciatory transactions within a group, S.280, T.A. 1970, and

(d) Dividend stripping, S.281, TA. 1970.[147]

The effect of the British tax system, as providing group relief, is to save tax, thereby helping cash flow within the group. On the other hand it also attempts to protect the Revenue and to prevent tax evasion. The decision whether to run a business through one company or through a group of companies depends upon many factors, not all concerned with taxation. It appears that in practice, the activities of a single company will be regarded as one trade unless they are widely different. This has tax advantages, in that expenditure incurred from activities may be completely non-deductible unless they are regarded as one trade, and one may avoid the problem of the non-deductibility of pre-commencement and post-cessation expenses. Further, sales within the group will not accrue until the sale is made to an outsider. By concession the existence of separate companies is ignored for certain rules concerning directors.

(C.) <u>The nature of groups of companies</u>

It is not easy to generalise about either the nature of groups of companies or why groups are formed.[148] For instance, a group of companies may consist of a number of trading companies under the common control of a holding company or it may consist of some companies which are trading companies and of other companies which are investment companies. Some of these companies may be resident in the UK and others may not be so resident. A group may be made up of one subsidiary company controlled by a parent company, or it may be made up of a number of companies with a less clearly defined relationship between the individual companies.

Accordingly under the British tax system, a company carrying on trading activities is subject to CT. If those activities are divided up between different companies, the premise of UK tax law is that each company is a separate entity with separate profits and therefore separate CT liability. There is no simple charging of the group as a whole on its group profits. This premise is relaxed in a number of ways.[149]

(1) Dividends paid to a parent company may be paid without ACT, S.256 (1) T.A. 1970.

(2) Annual payments may be paid without deduction of income tax, S.256 (2).

(3) A Parent company may pass its credit for ACT to a subsidiary company, S.92, F.A. 1972.

(4) Certain assets may be transferred within the group without incurring liability to CT in respect of capital gains, S.272, T.A. 1970. Further all trades carried on by members of a group are treated as one trade for the purposes of roll-over relief, S.276, T.A. 1970.

(5) The transfer of an asset by a company to its members at an undervalue is generally treated as a distribution but not if within a group. S.233, T.A. 1970.[150]

(6) Trading losses and other deductions may be passed to another member of the group, S.258, T.A. 1970.

(7) Mention should be made of S.485 T.A. 1970 which can apply

whenever one person has control of another or both are under the common control of a third, this provision does not talk formally of groups.

(D) <u>The tax advantage of groups of companies</u>

There are some common kinds of advantages enjoyed by companies, as follows:

(1) The setting off the trading losses of one group member against the profits of another, S.258 T.A. 1970..

(2) The surrendering of ACT paid by one group member to another and treating the ACT surrendered as paid by the other, S.92 F.A. 1972.

(3) The payment of dividends by a subsidiary to a parent company without payment of ACT and payment of interest gross, i.e. without payment of income tax, by subsidiary to a parent company, S.256 of T.A. 190.

(4) The transfer of assets between members of the same group of companies without giving rise to capital gains chargeable to CT, S.272 of T.A. 1970.

(5) The tax system encouraged companies which consider it more profitable and useful to carry on a business with a different member of enterprise and structures to do so, i.e. the tax system did not wish to prevent good business being done in that way.

(6) The tax system attempted to protect the Revenue and to prevent tax evasion.

(E) The relationship between the company and other companies in the same group – Company Law

If a company has subsidiaries at the end of the financial year, these must be named, and the class and proportion of shares held in each must be stated, S.3 C.A. 1967. The same information must be given if the company and its nominees hold shares in another company, not being a subsidiary, more than one tenth of the issued equity shares of any class, or any shares exceeding in stated value one tenth of the holding company's assets, S.4 C.A. 1967. If the company is a subsidiary, it must state the name of its ultimate holding company, and if known, its country of incorporation. This information may be given in, or in a note on, or in a statement annexed to the accounts, S.5(1) of C.A. 1967.

Subsidiaries and their holding companies are treated as separate legal persons. However, for some purposes, a holding company and its subsidiaries are treated as if they were a single company under the Company Act 1948 to 1980 and for certain other purposes a holding company is treated as being a director of its subsidiary, although it has not been appointed to that office.(151)

A holding company may be appointed as director of a subsidiary company, except where the articles of the latter company provide otherwise. A holding company is frequently able to influence the manner in which its subsidiary affairs are conducted but this does not in itself make it a director of the subsidiary company. A holding company is treated as being the director of its subsidiary company where it has not been expressly appointed as such for the purpose of certain provisions of the Company Acts 1948 to 1976, but this is only the case where the board of the subsidiary is accustomed to act in accordance with the holding company's directions or instructions, S.124 of C.A. 1942.

(F.) Group relief

The setting off of trading losses of one group member against the profits of another, is a form of relief known as group relief, which is available between a parent and its 75 percent subsidiary and between two or more 75 percent subsidiary of the same parent.

This term is used to describe the amount of trading losses, excess charges on income, or surplus management expenses which one company in a group of companies may surrender, and another company in the same group may claim to be set against its corporation tax profits. The main provisions which deal with this form of relief were found in the T.A. 1970 SS. 258-264 and F.A. 1973 S.28.

For group relief purposes, companies will form a group when the holding company controls directly, or indirectly, at least 75 percent of the ordinary share capital of the subsidiary. In addition to meeting the definition of 75 percent subsidiary referred to above, group relief for trading losses is only available where the parent in relation to the subsidiary is entitled to not less then 75 percent of the profits available for distribution to equity holders, and to not less than 75 percent of the subsidiary's assets available to equity holders on a national winding up, S.28, F.A. 1973. An equity holder is defined in Sch.12 of F.A. 1973 as a person holding ordinary shares, or a loan creditor where the loan is not a normal commercial loan. The 1973 provisions are anti-avoidance legislation aimed at certain special share structures and arrangements which were developed in the years before 1973 to take advantage of features of the group structure for group relief purposes. In most straightforward commercial cases the parents of 75 percent subsidiaries as defined above, as companies whose ordinary share capital(152) is held at least to the extent of 75 percent by their parents, will also be entitled to 75 percent of profits available to equity holders and to 75 percent of assets available on a winding up to equity holders.

Group relief is available to a consortium of companies in the following circumstances:

(1) Where the company surrendering the loss is a trading or holding company owned by a consortium (not being a 75 percent subsidiary of any company) and the claimant company is a member of the consortium. For accounting periods ending after the 10th March 1981, a loss may be surrendered from a member of the consortium to a trading or holding company. Prior to that date it should be noted that loss relief was only transferable between the company and the consortium and

not the reverse.

(2) Where a trading company is the 90 percent subsidiary of a holding company, which itself is owned by a consortium.[153]

Group relief is available for:

(i) Trading losses,

(ii) Excess charges including non-trade charges,

(iii) Excess capital allowances given by discharge or repayment of tax; and

(iv) Excess management expenses.

More details for subheadings will be as follows:

(G) Group relief for trading losses

The trading losses incurred by the surrendering company for the accounting period may be set-off for the purposes of CT against the total profits of the claimant company for its corresponding accounting period, S.259(1) of TA. 1970. Since it is not provided that the amount of trading loss to be surrendered must be limited to the excess of the total profits over the surrendering company's profits from other sources, it must be assumed that the surrendering company is free to choose whether or not to set-of loss against total profits before surrendering it. If it decides to surrender the whole of its loss, then it will have to pay CT on any income from non-trading sources and on any chargeable gains. If the members of the group are close companies it will be available for the surrendering company to set-off its loss only against its revenue profits and surrender the remainder to the claimant company which should do likewise. In this way they will be able to reduce the groups distributed income, which for shortfall purposes does not include chargeble gains.

Losses which are caught by the provisions of T.A. 1970, S.180 at S.177 (4)(Trades not carried on a commercial basis) are not available for group relief.[154]

Group relief consists in being able to set-off the trading loss of a company not only against its own profits but also against the total profits of companies in the same 75 percent group. The group company with the loss is said to surrender the loss and is called the "surrendering company"; the company or companies against whose profits the loss is set are said to claim the loss and are described as the 'claimant companies'. The claim must be made within two years of the end of the surrendering company's accounting period.[155]

(H) Method of giving group relief

Within the group structure there are two basic types of companies. They are:

(1) The claimant company

The claimant company may set-off losses surrendered to it against total profits:

(i) against income, then

(ii) against chargeable gains.

Before the loss is set-off the claimant company must set-off:

(a) losses and charges brought forward under S.177(1);

(b) any losses of the same accounting period, S.177(2);[156]

(c) charges of the same accounting period.

There are no specific conditions attached to the surrendering company and in general it may:

(1) surrender as much loss as it wishes to a company up to the maximum of the claimant company's own eligible profits.

(2) Spread relief over a number of companies within the group.

In considering the amount of loss that can be surrendered to another group company, the surrendering company often considers the following factors:[157]

(I) maximisation of loss relief;

(II) effective utilisation of ACT

(III) timing of tax payments; and

(IV) potential loss of foreign tax credits.

In deciding where to allocate a group loss, then it will often be necessary to consider a combination of the above factors. In addition possible claims under S.177(2) carrying back and S.177(3A) should always be considered as a carry back claim and may result in earlier relief than that available under TA.1970,S.258. For example Company 'T' Ltd. is the wholly-owned subsidiary of Company 'A' Ltd. They provide the following information about their results for the year to 31st March 1986.

	'A' Ltd.	'T' Ltd.
	£	£
Schedule D case 1 profit (Loss)	50,000	(270,000)
Schedule A	7,500	
Chargeable gain	60,000	
Unfranked investment income	12,000	10,000

The amount of trading loss available for group relief is £270,000. The amount which may be relieved is limited to the profits available for relief as follows:

(1) <u>Total profit of 'A' Ltd.</u>

	£
Sch.D. Case 1	50,000
Sch.A	7,500
Unfranked investment income	12,000
Chargeable gains	60,000
Profits available for relief	129,500

The relief is applied in the CT Computation of Company 'A' Ltd. with the effect of reducing the profits chargeable in Company 'A' to nil.

Company 'A' Ltd.

(2) <u>Corporation tax computation</u>

	£
Accounting period ended March 31st 1986	
Sch.D Case 1	50,000
Sch.A	7,500
Unfranked investment income	12,000
Chargeable gains	60,000
Total profits and profits chargeable	129,500
Less Group relief	129,500

The above example stated that the amount of trading loss available for group relief is £270,000. In this example Company 'T' Ltd. might first set-off £10,000 of its trading loss against its own profits of £10,000 (Unfranked invest ment income) leaving £260,000 to be relieved by way of group relief. As stated above, we have seen only the total profits of the claimant company, 'A' Ltd. (£129,500) can be relieved; the balance of the trading loss in Company 'T' Ltd. will be carried forward and deducted from future trading income of Company 'T' Ltd. under S.177(1) T.A. 1970.

Company 'T'Ltd

Corporation tax computation

Accounting period ended March 31st 1986	£
Unfranked investment income	10,000
Less trading loss, S.177(2)	10,000
Trading loss available for relief	270,000
Less utilized, S.177(2)	10,000
Balance of trading loss for group relief	260,000
Less utilised Company 'T' Ltd.	129,500
Balance of trading loss for carry-forward	130,000

As stated above, the accounting period of both Company 'A' Ltd. and Company 'T' Ltd. were of twelve months ending March 31st 1986. Where accounting periods of surrendering and claimant companies coincide in this way, the trading loss of the surrendering company is deducted from the total profit of the claimant company, subject only to the limit of the amount of the profits or the amount of the loss, whichever is the less.

However, where a company joins or leaves a group, or in any situation where the accounting period of the claimant company does not fall wholly within the accounting period of the surrendering company, it becomes necessary to apportion profits and losses in order that relief is only given for the time during which the companies are members of the same group and only for the period common to the accounting periods of both the surrendering and claimant companies.[158]

(2) Relief for certain special kinds of capital allowances

The surrendering company's capital allowances, which are to be given by discharge or repayment of tax and which are available primarily against a class of income in excess of the surrendering company's income of that class (before deducting any loss of any other period or of any capital allowance) may be set-off against the total profits of the income.[159]

(3) Group relief charges and other loss reliefs

The total profits of the claimant which are available for relief are the total profits after reduction by any other relief from tax, except reliefs derived from a subsequent accounting period, e.g. carry-back loss relief from a subsequent accounting period under S.177(2) TA.1970. Other reliefs from tax include charges on income such as debenture interest, and loss reliefs such as trading losses being brough forward under S.177(1), TA.1970. Deduction of charges on income is usually the last relief to be given for tax and the deduction here before group relief is the exception which proves the rule.

Moreover, the surrendering company where it is an investment company may surrender its management expenses for the accounting period excluding any amount brought forward from a previous accounting period, and as reduced by its profits of that accounting period for the claimant company for its use.[160]

Finally, in any accounting period of an investment company where the expenses of management, together with any charges on income paid wholly and exclusively for the purposes of the company's business exceed the profits from which they are deductible, the excess may be carried forward to the succeeding accounting period and treated as part of the expenses of management for that accounting period, or, successively, of future accounting period (S.304 (2) TA.1970).[161] Alternatively, the company may claim relief for an excess of expenses of management against a surplus of franked investment income.

(I) <u>Groups of companies and capital gains</u>

The main effect of section 273 of the Income and Corporation Tax Act 1970 is to modify the consequence of transfers of assets between companies within the same group. Such a tansfer would be treated as a bargain made otherwise than at arm's length, so that for the purpose of computing the chargeable gains the consideration will be regarded as equivalent to open market value in pursuance of S.22(4) FA.1965.[162]

The disposal of any form of property contained in S.19 of Capital Gains Tax (CGT) 1979 could give rise to the no gain or loss treatment, but there are some exceptions which are contained in S.273 TA.1970:

(a) Where the disposal is of redeemable preference shares in a company, on the occurance of the disposal.

(b) Where the disposal is of a debt due from a member of a group, effected, by satisfying the debt or part of it.

(c) Where the disposal arises from a capital distribution on the liquidation of a company.

If the transfer is of an asset which the recipient company appropriates to trading stock, then that company is deemed to have received a capital asset and immediately transferred that asset to its trading stock. Thus, there would be no capital gain or loss arising on the inter company transfer, as it would fall within the provision of S.273.

Where the asset transferred to a group company is trading stock of the transfer company, then the latter is treated as having appropriated the asset as a capital asset immediately prior to the disposal. The value placed on the asset for trading purposes under S.122 CGT.Act 1979 would be the transfer value giving rise to a 'no gain or loss' situation. Under S.273(1) where a member of a group disposes of an asset to another member, both parties will be treated as if the asset had been transferred for a consideration such as would secure that neither gain nor loss had accrued to the transferer. Where it is assumed for any purpose that a member of a group has sold an asset or acquired an asset, it is to be assumed also that it was not a sale to, or an acquisition from another member of the group.

In connection with a disposal between members of a group, the consideration consists of compensation for any kind of damage or injury to assets, or for the distribution or dissipation of assets, or for anything which depreciates or might depreciate an asset and the disposal is treated as being to the person who ultimately bears the expense of furnishing that consideraton, S.273(3) TA.1970.

(J) Transfer of trading stock

Where there is a transfer of trading stock by one member of a group to another member, who receives it as trading stock on revenue account as respects both parties, no particular tax consequences ensue, unless the sale price is so low as to involve the transferer in a loss.(163) Trading stock may be transferred to another member who receives it as a fixed asset; or a fixed asset of the transferer may be received by another member in whose hands it is trading stock.(164)

Where a member of a group acquires an asset as trading stock from another member in whose hands it was a capital asset, the transferee will be treated as having acquired it otherwise than as trading stock and immediately appropriated it for the purpose of trading stock. The effect of this provision is to bring paragraph 1 of Sch.7 to the FA.1965 into operation, so that the appropriation to trading stock is treated as a disposal for a consideration equal to the market value of the asset. Under paragraph 1(3) of Sch.,7 there is an option to bring the item of stock into 'purchases' at its original cost price. Since S.274 applies to the whole of paragraph 1 it would seem that a transferee within the same group as the transferer could bring the asset into trading stock at its cost to the transferer company.

Where a member of a group disposes of an asset to another group member, and the asset forms parts of the trading stock of a trade carried on by the transferer is treated, for the purposes of paragraph 1 of Sch.7, as having immediately prior to the disposal, appropriated the asset to a purpose other than that of trading stock. This means that the transferer is regarded as having transferred it for a consideraton equal to the amount brought into his accounts in respect thereof, and in view of the decision in Sharkey v. Wernher,[165] it is to be expected that the amount would be its market value. This in turn entitles the transferee company to regard that asset as having been acquired at its open market value.

(K) Surrender of Advance Corporation Tax

A United Kingdom resident holding company may surrender ACT paid, in respect of dividend only to a company which has been its subsidiary company throughout its accounting period. A company will be a subsidiary company where the holding company is entitled to more than 50 percent of:

(a) the ordinary share capital;

(b) the profit available for distribution to the equity shareholders; and

(c) the assets available for distribution on a winding up.

A company which has paid advance corporation tax in respect of dividends paid by it, is able to surrender the ACT to its 51 percent subsidiary, S.92, F.A. 1972. As we have said, a 51 percent subsidiary is one in which more than 50 percent of the ordinary share capital is held by its parent. As in group relief structures, the parent company must, in addition, be beneficially entitled to more than 50 percent of profits available to equity holders and more than 50 percent of assets of the subsidiary must be available for distribution to equity holders were the subsidiary to be wound up, S.92(9), F.A. These and other anti-avoidance provisions in sub secton 9 of S.92 will not usually be of relevance to normal commercial groups of companies.

Advance corporation tax which is surrendered by a parent to its 51 percent subsidiary is treated by the subsidiary as having been paid by it in respect of a distribution made by it on the date when the actual dividend was paid by the parent company. If more than one dividend was paid by the parent company, proportionate amounts of the ACT surrendered are treated as having been paid with respect to distributed profits paid when the actual dividends were paid.[166]

Surrendered ACT, treated as if it had been paid by the subsidiary, is available for set off against the corporation tax charged on the subsidiary. As with any ACT paid by the subsidiary itself any surrendered ACT which the subsidiary cannot use in the current accounting period, i.e. any surplus ACT in the subsidiary, may be carried forward and set-off against the CT charge in future accounting periods. However, no surplus ACT which arises from surrendered ACt may be carried back. In determining what surplus of ACT there is in a subsidiary for an accounting period, a surrendered amount of ACT will be set off against the subsidiary's liability to CT for the current accounting period before ACT paid on a distribution is actually made by the subsidiary itself.(167)

Surrender of ACT is only possible between U.K. companies and only from a parent to a subsidiary (not vice versa). It must be made by means of a claim within six years from the end of the accounting period to which the claim relates, and the claimant company must assent to the claim.(168)

Where the majority shareholder in the parent company holds shares directly in the subsidiary, he may receive a share of the benefit accruing to the subsidiary disproportionate to his share in the parent company (unless the parent company is fully compensated for the surrender). This would not be the case if it were to carry back or forward surplus ACT under S.85 of the F.A. 1972 to reduce its own CT liability. To allay the fears of the minority shareholder a payment for the surrender is necessary. For this reason a payment made by a subsidiary to the parent company in respect of the surrendered ACT is not to be taken into account in computing profits or losses of either company for CT purposes and is not to be regarded as a distribution or a charge on income.[169]

It can be seen that a U.K. resident parent company can surrender its ACT for the benefit of its U.K. subsidiaries. The advantage of this is that it helps cash flow within the group by saving taxes which the subsidiaries may have had to pay. It may be more advantageous for a group of companies to opt for group relief for losses which is a more comprehensive relief than that of the surrender of suprlus ACT. There are detailed rules covering the treatment of the surrendered ACT and it is not to be taken into account in computing profits or losses of either the surrendering company or the receiving company for CT purposes, nor is it to be regarded as a distribution or a charge on income. Very broadly, these rules enable a group of companies to be treated as one company for the purposes of setting off ACT against CT on income.[170]

Chapter Three: Reference

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163. See case Petrolium Securities Ltd. v. Ayres, 41 T.C. 389.
164. S.274 T.A. 1970.
165. Sharkey v. Wenher, 36 T.C. 275.
166. S.92(2) and (3) F.A. 1972.
167. Ibid, S.97(3A) F.A. 1972.
168. Beardon D, op.cit, P.307.
169. S.92(7) T.a. 1970.
170. Op cit, M. Lewis, British Tax system, p.415.

CHAPTER FOUR

INCOME MEASUREMENT FOR TAX PURPOSES

Chapter Four

Income measurement for tax purposes

4.1 Introduction

In the second and third chapters we discussed the various systems of company tax systems, also we attempt to evaluate the United Kingdom corporation tax system in its various stages.

This chapter examines the theoretical and general aspect of business profit for corporation tax purposes. The chapter begins with a brief discussion of the accounting concept of profit, economic concept of income, capital and its importance, accounting principles and CT, profit for tax purposes, main rules for computing profits, allowed and disallowed expenditure, trading stock, methods of valuing trading stock, trading losses and capital allowances.

Before dealing with the computation profit of the company, we attempt to define what is meant by income profit and the distinction between income and capital. The central focus of this chapter is the concept of trading profit for tax purposes and the inter-relationship between profit for financial accounting purposes and profit for tax purposes. We shall be considering the computation of income with particular emphasis on the trading profits of companies. Thus we shall be concerned mainly with general principles as they apply to company revenue and expenditure. As we have seen earlier since 1973 the UK has changed from a "classical" system of CT to an "imputation" system,[1] companies resident in the UK are liable to CT on all their world-wide profits[2] (The corporation tax rate is now 35%)[3] whilst non-resident companies carrying on business here through a branch or agency are taxed on their UK income.[4]

4.2 Concepts of income

(A) The accountant's concept of income

The concept of profit for accounting purposes is one of net income. The Oxford English Dictionary defines the term profit, generally, as advantage or benefit. The American accounting profession defines, profit or net income in more details as follows:[5]

> "Net income (net loss) the excess (deficit) or revenue over expenses (net decrease) in owners' equity (assets minus liabilities) of an enterprise for an accounting period from profit directed activities that is recognised and measured in conformity with generally accepted accounting principles."

Also, the Canadian Institute of Chartered Accountants considers profit to be synonymous with income, which it defines as the excess of revenues over expenses for a period, usually referred to as net income.

The term "profit" or "income" implies the existence of appropriate principles in accordance with which profit or income can be measured and the consistent application of the measurement principles.

The Institute of Chartered Accountants in England and

Wales stated that: "The general aim of a profit and loss account should be to show a true and fair view of the profit or loss over the year, before and after taxation, based on the consistent application of recognised accounting principles. The account should be presented in a form which affords as clearly and readily as circumstances permit a comparison with the results of previous years."[6]

For the dominance of economic objective in business, a major concern of accounting is to measure the income (profit or loss) which results from business activity over a period of time. A business is an economic organisation whose purpose is to acquire factories or production and to combine and utilize them in such a way that wealth is increased. The change in wealth which results from the activity of a business is called income.

Although the preceding definition of business income may seem quite clear and plausible, there is disagreement among economists, accountants and businessmen as to its exact meaning. The precise definition of business income depends, to a large extent upon the purpose for which it is being measured. Therefore, the owners need to know from time to time what the progress of the business has been toward its objective of earning a profit, as well as what its financial standing is at a given time.

Under the traditional concept[7] of profit for accounting purposes, capital is assumed to be owner's equity plus retained earnings, but this concept of profit has been subject to criticism because it does not take into account the changing value of money. Accordingly, in a period of inflation, an amount that represents the preservation of the capital of the business may be reflected as profit. Also it has been suggested that the capital of a business is the productive capacity of its assets and not the owner's interest in the business.[8] From this viewpoint, no profit is recognised until provision has been made to maintain the productive capacity of the assets of the business.

Accounting definition of income takes into consideration many user needs, e.g. management, creditors and others for information about income as an indication of the progress of the enterprise, in addition the problems which arise in measuring income.

The realised net income of an enterprise measures its effectiveness as an operating unit and in the change in its net assets arising out of (i) the excess of deficiency of revenue compared with related expired cost and (ii) other gains or losses to the enterprise from sales, exchange or other conversions of asset.[9]

Income can be either positive or negative. If business operations are successful, revenue and gains will exceed expenses and losses and there will be a positive net income and corresponding increase in the net assets and owner's equity of the business.[10] If expenses and losses exceed revenues and gains, the result is a negative income and a corresponding decrease in net assets and owner's equity. Negative income is called net loss, which should not be confused with some of the negative components of income, such as losses from uncollectable accounts from the sale of property at less than cost, and from natural disasters such as fires or floods.

Net assets refers to the amount by which total assets exceed total liabilities, thus: Assets - Liabilities = Net Assets. If the net assets of a business increase as a result of operations, the business has earned a net income. If they decrease, it has incurred a net loss. Income does not include the effect of any transactions with the owners of the business, such as the payment of dividends or the investment or withdrawal of assets. Profit and earnings are widely used synonymously for income.

The accountant has defined income as a surplus arising from business activity resulting from the cash to the cash cycle of business operations and derived from a periodic matching of revenue from sales with related costs. The matching process is an integral part of the accounting income determination function and causes an aggregation of unallocated costs carried forward at the end of each defined accounting period, these costs represent the non-monetary assets of the entity, such as buildings, plant, and inventories, such as measurements of entity's monetary resources and after deduction of its various liabilities and give rise to its residual equity or accounting capital.[11]

There are many different ways of measuring the income or profit of a business for a particular period. Each of these different methods may result in a fair and accurate statement of the profit of the business for the period. However, some methods of measurement may be more useful than others from the point of view of the particular user of the financial statements. For example, unrealised gains and losses are not generally taken into account in computing profit, but to a lender or an investor, they may be extremely important. There are other fundamental propositions concerning the measurement of profit for accounting purposes and it must be noted that the unit of measurement is invariably money. The use of money as the unit of measurement has some important effects upon financial statements. The most important of these effects is that the impact of inflation or deflation in the value of money is not disclosed in the financial accounts, and a unit of measurement that has a constant value should be used.[12]

Accounting income is therefore a measure which results in a corresponding measure of capital. Indeed, it can be identified with the periodic movement in such capital, i.e.

$Y = R_t - R_{t-1}$. Where Y is accounting income;

R_t is the residual equity at the end of the period, and

R_{t-1} is the residual equity at the beginning of the period.

Assuming no new capital or loan receipts or payment, no dividends, and a constant price-level. If a dividend had been paid to the owners of entity, Y would then identify with:

$D_t(R_t - R_{t-1})$ Where D represents the dividend.

In other words R_t would be computed after payment of the dividend and $R_t - R_{t-1}$ would be the understood portion of Y for the dividend period.

Accounting income is a residual measure and is conceived as a comparison between business completed and business not completed in a certain period. It is also a temporal measure normally computed in terms of matching revenue and expenditure transactions; furthermore it can be analysed as a temporal change in capital.(13)

Finally, the concept of profit depends upon the use to which the measurement will be put. Investors are primarily concerned with the profitability of a business from the point of view of predicting, comparing, and evaluating the business's earning power. Management is more concerned with the cash flow generated by the business, therefore, its concept of profit is often based upon cash flow.(14) The concept of profit or income for tax purposes is likely to be different from both of these concepts, it appears that the starting point in the definition of income or profit from a business for income tax purposes is definition of income or profit for financial accounting purposes.

(B) Economic concept of income

The word "income" denotes broadly 'that which come in'. In current business and economic usage, the term is commonly used in different contexts to denote several different things. Thus, a perfect definition of "income" is yet to be evolved. There is no dearth of definitions but none of them is entirely satisfactory. The literature of economics contains a great deal of discussion on this topic. The most common definition of income is that given by (Robert M.) Haig. He defined income as the money value of the net accretion to one's economic power between two points of time.[15] However, this definition limits income to money income alone, (H.C.) Simons [16] another American economist, elaborated on Haigs definition in 1938.

He said:

> "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption, and (2) the change in the value of the store of property rights between the beginning and end of the period in question".

The problem of the income concept lies in its exact relationship to capital, for capital in its broadest sense generates income. According to (J.R.) Hick [17] a man's income is the amount which he can consume in a given period of time without impairing the productive ability of his capital. However, in Hick's definition, he perhaps does not

take into account the factor of saving for it is not necessary that all income should be consumed. In Hick's approach, capital appears only as the capitalised value of a certain future prospect, and income as the standard stream equivalent of the prospect. Fisher and Kaldor[18] have defined income as the value of a given flow of services. This flow which is taken into account is the net flow emanating from all one's property. Thus it follows that saving and appreciation in capital value are always capital, not income. They are saved from being invested.
Fisher's income is a series of events that constitute income however, they are not in the first place financial ones but physical ones. Financial transactions are mere preliminaries to the final human enjoyment. Fisher concludes that: [19]

> "It is only what we carry out of the market place into our homes and private lives which really counts. Money is of no use until it is spent. The ultimate wages are not paid in terms of money but in the enjoyment it buys. The dividend cheque becomes income in the ultimate sense only when we eat the food, wear the clothes or ride in the automobile which are bought with the cheque".

Fisher's concept of income is equivalent to consumption of services as measured in monetary terms. The measure of income in any period is therefore totally dependent on the individual's personal decision as to whether or not to save.

In general terms such a measure can only be of very limited use, and as Kaldor says:[20]

> "If we reserved the term income for consumption we should still need another term for what would otherwise be called income; and we should still be left with the problem of how to define the latter."

Moreover, Fisher's discussion centres around the individual, not around the business entity. In terms of the corporation Fisher would argue that there can be no income since there can be no physical enjoyment, unless it be through the shareholders whose income it then is. However, even if the idea of consumption were stretched to cover the corporation context, it would still be of no use. With a corporation, consumption might be equated to distribution, but it has already been noted that central to company law is the doctrine of capital maintenance. Therefore a notion of income that permits any amount to be paid out by way of dividend, regardless of whether there is saving or overspending (that is payment out of contributed capital) is clearly out of context.

Fisher values capital on the basis of the future values of the future services discounted back. Whilst he sees income, in the sense of consumable services, as being derived from the physical attributes of capital goods, by contrast he regards the monetary equivalent of the capital goods as being derived from the monetary equivalent from the services to be rendered in the future. Given this and his concept of income as consumption Fisher is adamant that any capital gain, presumably an increase in the monetary equivalent, is not income. It is merely capitalisation of future income and as such must be seen simply as a growth in capital. It is only when the growth in capital, whether it be a change in monetary equivalent owing to new physical attributes or just a price change, is consumed that such growth is recorded as income. He treats increases in personal capital (saving) as potential rather than actual consumption, in other words, that saving should not be treated as income until it is consumed and enjoyed, e.g. A. purchases 1000 ordinary shares in B. limited company at T0. £15,000. He receives, at annual intervals, the following dividends at T1 £2000, at T2 £4500, at T3 £5700, i.e. the notion T0,T1,T2...Tn will be taken to mean point T = 0,1,2,3...n. A sells the shares at T4 for £10,500. Assume A spent his dividends and sale proceeds on consumer non-durables, then his economic income, according to Fisher and Hick, would be, in period T0 - T1 £2000, in T1 - T2 £4500, in T2 - T3 £5700 and in T3 - T4 £10,500; a total of £22,700 which effectively include returns of capital amounting to original investment of £15,000. No account is therefore taken of change in the value of capital during cash period.

In the above example, no account is taken of capital consumption which should have been reinvested in order to maintain A's future income and well being (of the total receipt of £22,700, £15,000 should have been reinvested in order to maintain the flow of future dividends.)

From the definitions given above, we may attempt to summerise the characteristics of income as follows:

(1) Income is a flow which can be measured only as between two points of time, and it is distinct from capital, which is the reservoir, at stock, at any given moment.

(2) Although there are problems in defining both income and capital with precision, many people have a fairly clear general understanding of what is meant by each of the terms.[21]

(3) Income is flow which takes place without hurt to the capital.

(4) Neither term income nor capital, is defined in the Taxes Acts, in both countries, Great Britain and Egypt, therefore we have recourse to the Courts to see how they have tackled the problem.

(5) As far as a business or a corporation is concerned, the income or profit is the residue from the gross income after deducting every expenditure item incurred, to achieve the gross earning without impairing the value of the capital stock, plus the accretion in the value of the capital.

(6) Sometimes capital may rise in value, thus leaving a gap between the present value and the past value; it becomes necessary therefore, while computing income, to take also into account the invisible gains in the value of capital; and finally

(7) Income tax is a tax on income and not on capital.

(c) Capital and its importance

Capital may be defined as that portion of goods, physical assets or equipment created in the past but not consumed and available for use. As individuals, and as a community, we have the choice of spending all of our current money income on goods and services for immediate consumption or reserving some of it for subsequent use (savings). The portion saved for future use may be referred to as capital. This money does not immediately become capital in the sense that we use the word in economics. The financially intermediate institutions with whom savings are deposited provide money for business enterprises to buy productive assets, such as plant and machinery to facilitate production.

Accounting capital is normally described in terms of residual equity of a business entity, and is identified with its various assets, net of any corresponding liabilities.[22] These assets can be divided into monetary and non-monetary categories, and accounting capital is therefore traditionally conceived as a collection of available physical or tangible goods and services expressed in aggregate money terms. Capital is, in this sense, simply an expression of the entity's property rights in net assets.

Therefore, the accounting capital is mainly transactions-based, derived from the process of determining income from recorded transactions - consequently, it is a measure depending entirely on the nature of the transactions recorded. In many respects, it is far removed from the economist's conception of capital.

As a factor of production, capital is in the form of a stock of producers' goods which are available for use in production. These include machinery of all kinds, and with buildings represent the main investment of firms, stocks of raw materials and components or finished product and also forms part of the firm's capital, which is known as circulating or working capital as the firm hopes that money spent on the items mentioned will be recovered rapidly from the sale of finished products.

Finally, it is illuminating to imagine what would happen if for the next ten years the whole of the national product of any country, e.g. U.K. or Egypt, were spent on consumer goods, and none of it on buying or maintaining capital assets. For the first year or so, almost everyone would be able to join in the bonanza and increase his consumption of goods and services, and his standard of living. But it would not be very long before fewer goods came on to the market as machinery failed, and road-rail services had breakdowns causing interruptions to the flow of production. In time, few factories would remain in working order and the community would revert to direct methods of production, as the decaying machinery became unusable. Output and living standards would fall, and the benefits of thrift would become starkly apparent through their absence.

(D) Distinction between income and capital

As has already been seen, there are problems in defining the terms "income" and capital, with precision. Although not specifically emphasized the fundamental relationship between capital and income has been touched upon. In accounting, capital and income are regarded widely as a stock and flow, with the stock resulting from a transacted flow which is accounted for when measuring accounting income. In economics, the stock-flow concept also exists, though the generally accepted relationship appears to be the valuation of capital as a discounted future stream of income, and the measurement of income as an expired portion of such capital.(23)

A rigorous examination of the relationship between income and capital was first made by Fisher. He regarded interest as the bridge between the two terms, i.e. as the price of hiring money today in order to obtain a certain amount of money tomorrow.

Although there are problems in defining both income and capital, both terms are used by lawyers, accountants, economists and others and many people have a fairly clear general understanding of what is meant by each of these terms.

It is an important point that the definition of income or profit for tax purposes is mainly based on the accounting practice. As far as the corporation is concerned, the problem is the presentation of the net profits, which as we mentioned before, is the gross earning minus the costs plus the capital gains.[24] Also the income for tax purposes, must be money or something capable of being turned into money by the recipient, so that the possession of a mere right or other benefit is not treated as income for tax purposes. Conversely certain receipts which would not be regarded as income by economists are treated as income for tax purposes. In the words of Professor Meade on the Structureand Reform of Direct Taxation [25]

> "The distinction between income and capital gains has become more and more important, more and more sophisticated ways have been devised by tax payers to turn highly taxable income into less highly taxable capital gains."

For the reason given above the distinction is important and legally required.

It is necessary to distinguish capital from income therefore, some of the cases make a distinction between fixed capital and circulating capital. There is some value in this distinction, but it must be borne in mind that an item which would be fixed capital in one person's hands may be circulating capital in another person's. For example A owned a factory which is a part of fixed capital, if A sells the factory at a profit, then the profit is of a capital nature and is not chargeable to income tax. When B who makes his living by the buying and selling of factories, sells that factory, then the receipt is treated as trading income and is an item included in his taxable profit.

Indeed the function of an asset in any particular trade may determine its character so that the character of the asset may change if and when there is a change in the business.(26)

It will be conceded that the function of an asset plays an important role in the categorisation of the proceeds of realisation of the asset as either capital or trading receipt; one cannot subscribe to the hypothesis that the function of the asset is only test of chargeability of profits gained as a capital or business revenue.(27) On the contrary, there are many situations in which the nature of the asset - and not strictly its function decides whether or not it is a capital or trading receipt. For example, where a lump sum payment is made to acquire the right to occupy premises for a period, say, of 20 years, it is treated as a capital receipt(28) but in a case where on the other hand, by contract a right is acquired to occupy premises for 20 years with an obligation to make periodic payments for such rights to occupy, this will be treated as trading or revenue receipt on the ground that no payment of capital nature has been made even though the function of assets in the two cases is similar.

It can be seen that the distinction between income and capital involves two main considerations namely (1) the physical nature of the asset and (2) its function. In some cases the physical nature of the asset may be decisive of the question whether it is a capital or trading receipt while in others the function of the asset may be conclusive of the question. Other cases may overlap.

It is necessary to distinguish between income and capital for the purposes, not only because the law requires such a distinction but also for the following reasons:[29]

(a) the rates of tax under the respective headings may not be the same, particularly as income tax rates are more liable to adjustment from time to time than capital gains tax rates;

(b) the respective rules for computing income for income tax purposes and capital gains for capital gains tax purposes are not the same;

(c) the various exemptions and reliefs from tax under the respective headings are not the same;

(d) capital gains accruing on the disposal of assets after 5th April 1965 which were held on or before that date are chargeable to tax only on that part of the gain accruing after 1965;

(e) the chargeable, i.e. capital, gains of a company are not chargeable to capital gains tax but to C.T. as part of the profits of company, (but these gains are computed in accordance with capital gains tax principles) but the amount to be included in respect of chargeable gains in a company's total profits for an accounting period is to be reduced by a specified fraction. Thus, in effect, the rate at which a company pays tax on its chargeable gains may be different from the rate at which it pays tax on its income; and

(f) capital allowances, which are in the nature of depreciation allowances, are available in respect of certain classes of capital expenditure, e.g., capital expenditure on machinery and plants or on industrial buildings, Sched., 8 F.A. 1971. Relief from income tax, or C.T., in the main against trading income, is given for such qualifying expenditure.

4.3: Accounting Principles and Corporation Tax

I: Introduction

As has been said earlier, without accountancy principles it would be very difficult to ascertain the taxable profits of companies.

It is clearly established that profit for tax purposes is to be determined according to generally accepted principles of commercial and industrial practice,provided that is no statutory prohibition.

In this section profits will be considered as a form of income, i.e., as an annual income on capital employed in industry and trade as providing a taxable base for CT purposes. It is impossible to draw a firm line between business profit and other forms of income from property. For example, profits are fluctuating returns in contrast to the fixed income of interest received by the holder of bonds, but the net profits of a bank are the interest received from bonds and bills which it buys less expenses.

So, the profits of a company depend on how much money it has borrowed at a fixed interest. Two companies may have exactly the same amount of business on the same terms, but one will show a smaller profit than the other because it has to pay interest on debentures or bank loans, whereas the other works entirely on its own capital and therefore has no interest charge to deduct. Such profits as these differ from wages which are the price paid for certain amounts of work, or the interest, which is the price paid for a loan.

This section demonstrates accounting principles which are relevant for tax purposes; the concept of accounting profit; reasons for profit measurement, profit and taxation, trading receipts, trading expenditure, capital and revenue; expenditure incurred wholly and exclusively for tax purpose; trading stock, methods of valuing trading stock, and disallowed expenditure.

II: Accounting Principles and Taxation

An examination of the records which survive for ancient civilisations show the existence of an accounting closely allied to the state's administrative machinery. In Ancient Egypt, for example, a sophisticated system of accounting, employing various counterchecks, ensured that royal revenue reached the Treasury. In some cases, the records of the old scribes survive. These documents show exactly how much was received. This minute care is not only taken in the case of large amounts but even the smallest quantities are conscientiously entered.[30]

When income tax was introduced, however, there was no systematic accounting so that income tax was a tax imposed on the balance of the annual revenue receipts over revenue payment. This was considered inequitable in the sense that it did not reveal the true economic profit. It therefore become essential to develop a system that could ensure the looked increasingly to accounting theory and practice to facilitate the measurement of taxable profit.[31]

(a) Treatment of Taxation in Accounting

The treatment of taxation in accounts is regulated in Britain not only by the Companies Acts but also by statements of Standard Accounting Practice(SSAP);for instance,SSAP 5 'Accounting for VAT' (April 1974); SSAP 8, 'The treatment of taxation under the imputation system in the accounts of companies' (amended version December 1977);and SSAP 15,'accounting for deferred taxation' (October 1978).[32]

The statement of Standered Accounting Practice (SSAP5) requires that the following items should be included in the taxation charge in the profit and loss account and where material, separately disclosed. [33]

(1) The amount of UK corporation tax specifying:

(i) the charge for CT on the income of the year (where such CT includes transfers between the deferred taxation account, these should also be separately disclosed where material);

(ii) tax attributable to franked investment income;

(iii) irrecoverable ACT; and

(iv) the relief for overseas taxation.

(2) The total overseas taxation, relieved and unrelieved, specifying that part of the unrelieved overseas taxation which arises from the payment of proposed payment of dividends.

(b) Accounting principles and British Courts

The courts in the absence of statutory guidelines for the measurement of taxable profit were quick to recognise accountancy principles once they became established. Lord President Clyde said;[34]

> "In computing the balance of profits and gains for the purposes of income tax... two general and fundamental common places have always to be kept in mind. In the first places the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business during such year or accounting period and the expenditure laid out to earn these receipts. In the second place the account of profit and loss to be made up for the purposes of ascertaining that difference must be formed consistently with the ordinary principles if commercial accounting so far the income tax act".

The phrase "the ordinary principles of commercial accounting" has been used countless times by courts to determine the taxable profit of trade.

Therefore, companies as certified by the Auditor should represent a "true and fair view" of the company's profit or loss. The test for tax purposes however is the full amount of the profit or gains.[35] In the case of Southern Railway of Peru Ltd v. Owen Lord Radcleffe said:[36]

> "I think that one is bound to say that references to an auditor's duty under the Companies Act take us into a field that is not exactly the same as that in which the annual profits trade should be ascertained for the purposes of income tax".

So, it can be seen that the annual profits shown by the financial accounts of British companies are inappropriate for tax purposes and require adjustment.

In the light of the above consideration, there is no doubting the fact that the British courts have done the best they can with the scanty rules relating to the measurement of taxable profit: however, it is desirable that the State should provide general guidlines so that courts as well as accountants will follow them in measuring taxable profit of companies. However, if the accountants want to be taken seriously by the court then they should develop and clarify their own ideas on techniques of profit determination. In less developed countries, such as Egypt, an accountant has a greater role to play than has his counterpart in Britain. In the area of taxation he should see his role as entailing a positive contribution to the economic life of the country through his appreciation of the use of taxation as an instrument of fiscal policy that is an important part of the economic and social life of the community.

As can be seen from the above, it is necessary to clear up numerous topics, before arriving at the taxable profit, i.e.. what is taxable profit ? What is the profit; capital; the distinction between revenue and capital expenditures; etc..? So , while an attempt has been made to cover comprehensively every aspect of the computation of trading profits as it applies to companies, this does not mean that all the issues relating to the subject have been covered. Those areas which have not been considered particularly relevant to the needs of developing countries, like Egypt have been left out.

IV The Reasons for Profit Measurement

Prior to the late 1920s, in financial reporting the main emphasise was on the balance sheet as a statement of the financial soundness and solvency of a business entity. The reason for this may well have been due to the position of bankers, lenders and creditors as the major external contributors of financial resources to business entities, and hence the main users of any published financial statements. These persons and institutions, being concerned with the immediate and short term future liquidty of entities, naturally tended to be more interested in the balance sheet than the income statement.(37)

In recent times accountants have concentrated primerily on income in financial accounting theory and practice. The gradual development of a sophisticated investment community and markets and the consequent need for accounting information relevant for investor protection and decision making resulted in the income statement eventually superseding the balance sheet as the primary reporting statement. This has now caused the measurement of accounting income to appear to predominant over the corresponding measurement of assets, liabilities and residual equity.

Income is a measurement of actual business achievement which can be compared with previous hopes and expectations of performance. It can also be regarded as an indicator of past business activity and behaviour which can be used as a guide to future activity and behaviour. It is an operational concept of practical significance: useful and relevant in the field of investment decision making when past and potential business performances are being evaluated.

The economist's main interest in the micro-economic concept of income is due to its usefulness as a theoretical tool for analysing the economic behaviour of the individual, i.e., in terms of maximizing his present consumption without imparing his future consumption by eroding his economic capital.

One further reason for the economist's interest in income is because of its use as a basis for tax capacity. It is a useful measure which can be taxed to redistribute wealth and economic resources between individuals. Thus business entities are taxed on profit derived from their operational activities, and the basic rules for computing these profits are prescribed by government by means of fiscal legislation.

The economist therefore has significant reasons for recognizing and analysing micro-economic income, but they are far less varied than those of the accountant, who measures it for reporting and decision-making purposes. The following indicate some of these major decision areas to which measured accounting income information is applied in practice.[38]

(1) Income as a guide to dividend and retention policy i. e., when management has to determine how much of an entity's periodic wealth increase can be distributed to its owners, and how much should be retained to maintain or expand its

activities.

(2) Income as a measure of the effectiveness of an entity's management i.e., when investors attempt to measure the quality of its policy-making, decision-making and controlling activities.

(3) Income as means of predicting the future income of an entity for purposes of evaluating the worth of an existing or potential investment in it, i.e., when making investment decisions.

(4) Income as a measure of management's stewardship of an entity's resources, i.e., when reporting income as the operational consequence of utilizing these resources on behalf of ownership.

(5) Income as a means of evaluating the worth of decisions and of impairing future decisions, this can apply to all decision makers connected with an entity; i.e., to business managers as well as to investors, lenders, creditors... etc.

(6) Income as a managerial aid in a variety of decision areas within and without the entity, for example, when reviewing pricing policy, in collective bargaining procedures, when determining legal rights and obligations, when determining the credit worthiness of an entity, and in governmental social and economic regulation(as with retail prices in monopoly situation).

These are just a few areas in which accounting income can have a part to play in the planning decision making and controlling functions related to business entity.

4.4: Profit Measurement

A brief glance at accounting literature shows that the difference between sales revenue and the cost of trading stock sold is typically labelled as the gross profit. Managers, investors, and tax collectors are intensely interested in this profit and how it is computed. For instance, managers are concerned that the budgeted gross profit percentage be attained.

The detailed gross profit of an income statement is a splendid learning device, e.g., the known amounts can be included in the gross profit, and unknown amounts can be computed after inspecting the interrelationships of all items. The basic relationship can be stated algebraically as follows:

[Net Sales _ Cost of Goods Sold (CGS) = Gross Profit]

and [Beginning inventory + Net Purchases _ Ending Inventory

= CGS].

The closing stock is measured at the end of each reporting period. However, when the actual amount of the closing stock is not known because it is not feasible to obtain a physical count for monthly and quarterly financial statments, the gross profit relationship is often used to estimate the closing stock figure. For example, assume that past sales have usually resulted in a gross profit percentage of 30%, then the accountant would estimate gross profit to be [30% x 10000(as net sales) =£3000]. By using the above equations, the closing stock could have been estimated:

[£10000 (Net Sales) _ 7000 (CGS) =£3000 (Gross Profit)]

Also [CGS = B1 + P _ E1], then(CGS)7000 = 1000 + 8000_ 2000

and [E1 = B1 + p _ CGS] then (E1)2000 = 1000 + 8000_ 7000

Where B1 is opening stock, P is net purchases and E1 is the closing stock. Auditors, tax inspectors , use the gross profit percentage as a way of satisfying themselves about the accuracy of records, for example, the Inland Revenue compiles gross profit percentages by types of retail establishment.Black H.A(39) Thus if a company shows an unusually low percentage, tax inspectors may suspect that the taxpayer has failed to record all cash sales. Similarly, managers watch gross profit percentages, not only to judge operating profitability but also to monitor how well employee theft and shoplifting are being controlled.

In the above example, suppose a manager or an outside auditor had gathered the following data for a certain company for the past three years:

	19X3	19X2	19X1
NET SALES	10000	10000	9000
COST OF GOODS SOLD	7000	5000	4500
	-----	-----	-----
GROSS PROFIT	3000	5000	4500
	=====	=====	=====
GROSS PROFIT PER_CENTAGE	30%	50%	50%
	=====	=====	=====

The example above illustrates the gross profit test whereby the percentages are compared to detect any phenomenon worth investigating. Obviously, the decline in the percentage might be attributable to many factors, possible explanations include:

(1) Competition has intensified, resulting in reduced selling prices.

(2) The mix of goods sold has shifted so that, for instance, the £10000 of sales in 19x3 is composed of relatively more products bearing lower gross profit e.g., more toothpaste bearing low profit and less perfume bearing high profits.

(3) Shoplifting or embezzling has soared out of control., for example, a manager may be pocketing and not recording cash of £2000. After all, sales in 19x3 would have been £12000 if the 50% profit had been maintained.

Briefly, there are two main ways of measuring the profit of a business as follows:

(1) The value of the business may be compared at two different dates using the same valuation methods. After adjusting for additons or subtractions from the business by its owners, the difference between the values at the two dates is the profit for the period. Clearly, the validity of measuring profit in this way depends upon the validity of the methods used to measure profitability. Hicks[40] was certainly thinking of a present value method of valuation. Since we have already noted that this may not be a practicable method for accountants, in this way one problem in trying to measure profit can be happen particularly when prices are changing, the comparison of the valuations of business at two different dates can lead to several plausible

results, for instance, does one measure any increase in value in money terms, real worth term or physical terms?

(2) Accountants traditionally measured profit, whereby taking the difference between the revenue and expenses which relate to the business for the period in question. However, there are some problems which will arise, e.g., in defining a relevant revenue, according to this method. In order to maintain objectivity and prudence, increases in value of stocks due to the operations of a business are not included in profit, until there is a sale. On the other hand, when sales are made unless some adjustment is performed, gains due to inflation or to increases in value during previous years are ncluded in this year's profit.

Despite these problems, accountants continue to measure profit by comparing revenues with expenses. The accounting statement which deals with this is called the profit and loss account. Several adjustments to correct the profit and loss account for those problems have been proposed as part of current value accounting systems.

4.5: Profit for Tax Purposes

Corporation tax is chargeable on the full amount of profits or gains of the company in respect of its trading activities.[41] But this is not to say that the income of a company is treated as a gross receipt, rather it is treated as the balance of receipts over the cost of obtaining their receipt. There are three main aspects which must be considered:

(1) trading receipts;

(2) trading expenditure allowed by tax law; and

(3) an adjustment of trading stock, debtors and creditors as at the beginning and the end of the accounting period, where necessary.

However, there is no general principle stating precisely how the above items are to be treated in the ascertainment of taxable profit. This is where the ordinary principles of commercial accounting come in to provide the criteria by which to judge whether, and when an item should not be taken into account in determining profit.

Therefore, the vital steps between the profit shown in an ordinary commercial profit and loss account and the figure treated as income for tax purposes should be watched closely by the taxpayer. Normally, in both United Kingdom and Egypt the professional accountant will prepare a statement showing the adjustment of profit for tax purposes, and will submit this to the Tax Inspector with a copy of the accounts.[42]

The Tax Inspector may query any items which are not quite clear, and ask for a detailed analysis of omnibus classes of expense such as sundry business expenses accounts which are commonly used for keeping together the items which do not fit into one of the standard classifications. When the Tax Inspector is satisfied with the explanations, or has made such changes as he thinks necessary, he raises the tax assessment according to the adjusted profit figure.[43]

The taxpayer, or the managing director of the limited company taxpayer, should go through the statement of profit adjustment before it is posted to the Tax Inspector. In this way the taxpayer will understand exactly which expenses are not being allowed for CT.

In addition, the same rules are laid down for the computation of taxable profit. They are found under five heading:

(1) amounts included in computing profit (income);

(2) amounts not included in computing profit;

(3) deductions allowed in computing profit;

(4) deductions not allowed in computing profit; and

(5) miscellaneous rules for computing profit.

Therefore, the Tax Inspector will find occasionally, that the account has not been given a clear description of some unusual kind of expense, and that it is being disallowed. There may be some unnecssary confusion inherent in the distinction between capital and income, or with some other costs and the taxpayer may have to satisfy himself and the tax inspector as to the purpose of the expenditure. For example, where a lump sum payment is made to acquire the right to occupy premises for a period of 21 years, it is treated as a capital but, as mentioned before in the research, in the other case where a lump sum is made by contract, a right is acquired to occupy premises for the same period (21) with an obligation to make periodic payments for such rights of occupation, then this will be treated as trading or revenue expenditure on the grounds that payment of a rental nature has been made even though the function of the asset in the two above cases is the same, except in the first case the payment is made to acquire the right to occupy premises, while in the other case the payment is made by contract to occupy premises with an obligation to make periodic payment . In the case of Strick v. Regent Oil Co. Ltd. Lord Morris of Borth-Y-Gerst said.[44]

> "On the fact as found in the stated case I consider that lump sum payments which were made by the appellents were of a capital and not of a revenue. I am of this opinion for two reasons. The first is that each payment was made as the price of acquiring an interest in land which was an asset of capital nature. The leases were granted to and accepted by the Appellants on the basis that there would be subleases to the lessors and that in the subleases there would be covenants which obliged the lessors to obtain all their supplies of petrol from the Appellants.

> There were other covenants, such as those which compelled the lessors to carry on business or to bring it about that an assignee would likewise be compelled to and would obtain all his supplies from the appellants".

So, it can be(seen that the distinction between "income" and "capital" involves two main considerations namely (i) the physical nature of the asset and (ii) its function. In some cases the physical nature of the asset may be decisive of the question whether it is a capital or trading receipt while in other the function of the asset may conclusive of that question. This does not mean that the two factors are mutually exclusive.

Some cases follow concerning capital and trading receipts and the first is where damages were compensation received which were held to trading receipts.

It has been said by Lord Macmillan in the case of <u>Van den Berghs, Ltd v. Clark</u>:[45]

> "The question whether a particular receipt should be dealt with as an income receipt or as a capital receipt cannot be solved by reference to any provisions of Income Tax Act, and that no infallible criterion emerges from a consideration of the case law".

For instance, in <u>Kelsall Parsons and Company v. IRC</u>[46] Counsel maintained that a payment for loss of a "profit-making apparatus" was necessarily a capital payment in the hands of the recipient who received it as compensation for such loss. The question whether a sum received by a trade as compensation, or the cancelling of one of his trading contracts is to be regarded as a capital or a revenue sum must in each case depend upon the particular circumstances under which the payment has been made. For example, A is a manufacturer at 1st Jan. 198 he buys a car for his salesman to use on his journeys to customers. So that, the car is a capital expenditure. C is a motor trader and he also buys a car to re-sell to one of his customers. The car, in this case, is a trading transaction, the selling price being income and the cost being allowable expenditure, the whole being "revenue". But A has sold the car, after his salesman quits his job, at a good price, at a profit, in fact. Because the car was capital expenditure the profit on the sale is a capital profit. In other examples, the damages received for the deprivation of the use of a company's trading stock or non-performance of a business contract or indeed for any other similar commercial injury stand on the same footing as the profits of the company's business for the loss of which the damages are paid. In other words, the damages received in such circumstances are treated as trading receipts. Thus in the following cases the damages or compensation received were held to be trading receipts, compensation for the requisition of the property of a colliery company,(47) or for the late or delayed completion of a ship under repair,(48) or for cancellation of contracts for future deliveries,(49) or compensation for trading stock destroyed by fire.(50) In all these cases the receipts have been treated as trading receipts on the ground that the damages were paid as reimbursement for the trading.

4.6: Profit and Corporation Tax

Taxes other than taxes on profits (such as CT) may be included in the costs of the business. A property tax, such as local rates, is a fixed cost, it does not vary with output. It is therefore a heavier burden when times are bad and output is low. But it can be included as a business cost.

In both countries, United Kingdom and Egypt, a company's tax is based on its accounting profit, although numerous adjustments might have to be made when computing the profit subject to taxation.

Up to 1965, the profits of UK companies were liable to two kinds of tax: the first was profits tax, paid by the company on the whole of its profit "after deduction of depreciation allowances", the second was income tax, also paid by the company on the whole of its profits, but recovered from shareholders on the part of the profit paid out in dividends. Thus the company itself paid income tax only on that part of its profit which was placed to reserve[(51)]

In 1965 the above system was abolished and was replaced by a corporation tax "at 40% in 1966". In addition, companies had to deduct income tax from dividends and pay it over to the government.

In 1973 the classical system was replaced by the imputation system. This system greatly reduced the bias against distribution. So, any distributions were liable to basic rate, while taxpayers were not further affected.[52]

As mentioned above the pre_1965 system did not encourage the company to distribute or undistribute its profits while the classical system encouraged it to retain the profit. But the imputation system greatly reduces the bias against distribution and in fact encourages it. Moreover the imputation system has two significant aspects:

(1) the corporation tax rate (35%in 1987) is lower than both company tax systems;

(2) any distributions subject to income tax at basic rate. The distributions are to be treated by their recipient as though tax had been paid at the basic rate. So a basic rate taxpayer is not required to pay any additional tax.

Finally, the profit shown in ordinary commercial profit and loss accounts require adjustment for tax purposes. The starting point for the statement of adjustment of profit is the net profit shown in the profit and loss account. It may seem superfluous to suggest that special care should be taken in preparing the annual accounts which lead up to the net profit but there are a number of pitfalls. For example;[53]

(i) Have any expenses which might fairly be treated as revenue been pushed into fixed asset accounts in error, even major expenses which are revenue and should be distinguished from complete replacement of the asset.

(ii) Have any expenses been pushed into the profit and loss account which are really related to the purchase of a fixed asset? Formerly it was a habit amongst some businessmen to "write off" all the incidental costs of acquiring an asset, on the grounds that they had added nothing to the asset's value. They would then be disallowed from the revenue items for tax purposes but at the same time might be missed from the capital allowances claim being made on the asset itself.

The taxpayers should be sent the statement together with a copy of the full annual account to the Tax Inspector at the same time as the completed annual return of income in April of each year. If this proves impracticable _ for example, it would be impossible if the accounts had been made up to 31 st March leaving only April itself in which to complete them, or if they have been held up through staff shortages_ they should forward the return as soon as possible.

It is necessary to understand that the Tax Inspector is not forced to accept the statement as correct, but uses it as a starting point for his queries. But when the Inspector is satisfied with the explanations, or has made such changes as he thinks necessary, he raises the tax assessment according to the adjusted profit figure shown below.

Figure (4.1)

Statement of Adjustment of Profit

for Tax Purposes

		£
Start with net profit shown in the the profit and loss account.		xxx
Add back the expenses not allowable for Tax Purposes,		
For example:		
Legal expenses of a capital nature,	x	
Loss on sale of machine,	x	
Depreciation,	x	
Entertainment of UK Customer,	x	
General reserve for bad debts.	x	
		xx
		xxx
Deduct income which is either not taxable or taxable under a different headings		
For example:		
Investment income	x	
Profit on sale of land,	x	
		xx
Adjusted profit for tax purposes.		xxx

Figure (4.1) contd.,

Less Capital Allowances.	xx
Balance of trading income liable to CT(Taxable profit).	xxx

Notes:

Capital allowances are shown as a separate entry at the foot of the statement and not included with the other figure. This treatment of the capital allowance according to Egyptian Tax System differs from British Tax System. The depreciation is deducted from the the gross profit, there is no need to add it and deduct again from statement of adjustement of profit for tax purposes.

4.4 Main Rules for Computing Profit

In both business and tax accounting, the basis of an asset is usually in the first instance its cost, though the definition of cost may differ for the two purposes. Even when there is complete agreement on the cost of assets, the basis may differ for tax and business purposes because, in certain circumstances, there are business reasons for carrying assets at other than cost and there are tax requirements whereby assets must sometimes be carried at other than original cost.

The tax treatment of this basis is very important for two reasons: first, to indicate its bearing on such crucial matters as the determination of profit, gain and expenditure, loss, and of deductions for capital allowance; second, to illustrate the types of technicality that are peculiar to tax accounting and to give some of the reason for these technicalities.

Corporation tax is charged on all the amounts of the balance of the profits or gain, in the case of Coltness Iron Company v. Black.(54)

> "Something very different from the amount of the net profits of the year which would appear in the ordinary annual balance sheet of the trading company."

The net income shall be computed upon the basis of the taxpayer's annual accounting period ... in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the commissioner does clearly reflect the income. In this sub-heading we shall lay down the following main points:

1. <u>The wholly and exclusively roles</u>

For expenses to be allowable for tax purposes, expenses will be deductible in arriving at the taxpayer's profit under Cases I and II of Sch. D only if:

(1) It is an income and not a capital expenditure.

(2) It is incurred wholly and exclusively for the purpose of the trade, profession or vocation.

(3) Its deduction is not prohibited by statute.(55)

Countless battles have been fought between taxpayers and the Tax Inspector about the application of these rules above to particular circumstances. Their meaning looks obvious at first sight in general terms, but a surprising number of queries arise as soon as they are applied to a set of actual accounts.

These rules were stated by Lord Sumner in the case of <u>Usher's Wiltshire Brewery Ltd. v. Bruce</u>.(56)

> "The effect of this structure, I think, is this, that the direction to compute the full amount of the balance of profits must be real as subject to certain allowance and to certain prohibitions of deductions, but that a deduction, if there be such, which is neither

> within the term of prohibition nor such that the expressed allowance must be taken as the exclusive definition of its areas, is to be made or not to be made according as it is or is not, on the facts of the case, a proper debit item to be charged against incomings of the trade when computing the balance of profits of it."

It is very important to notice the distinction between expenses incurred in earning the profits (which may be deductible) and expenses incurred after the profits have been earned, (which are not deductible). For example, the payment of income tax is an application of profit which has been earned and is not deductible Ashton Gas Co. v. IRC.[57] Other taxes, however, such as rates and stamp duty may be paid in the course of earning the profits, and so may be deductible. The professional costs involved in drawing up the trader's accounts and fees paid for advice are, in practice, deductible, but expenses involved in contesting a tax assessment are not. In the case of Smith's Potato Estates Ltd. v. Bolland, Viscount Simonds stated that: [58]

> "His [the trader's] profit is no more affected by the eligibility to tax than a man's temperature altered by purchase of a thermometer, even though he starts by haggling about the price of it."

2. Expenses must be income not capital

For the difficulty of determining whether payments are income receipts, taxable under Cases I or II or Sch. D, or capital receipts, the liability is to capital gains (CGT), a number of tests have been suggested: the classical test which is the distinction between a sale of the fixed capial of the business and of its circulating capital. Sale of the circulating capital produces income receipts. Other tests are but variations on the original theme and contain the same defect of classical tests.[59]

There are some texts applied in classifying expenditure as income or capital as in deciding whether a receipt is income or capital. Therefore a distinction is drawn between the fixed and circulating capital of business. A payment is therefore capital if it is made to bring into existence an asset for the enduring advantage of the trade.[73] Considerable difficulty is quite often experienced in determining whether an expense is of a revenue nature, which is allowable, or of a capital nature which is not. There is no statutory definition, as mentioned before, of the two terms. In the case of Odeon Associated Theatres Ltd. v. Jones, Salmon L.J. stated.[60]

> "But no help can be derived from the statute in deciding the question of what is capital expenditure [or revenue expenditure]. The statute does not give even the faintest hint as to how this question should be answered."

A once and for all payment, even though it brings no enduring asset into existence, is more likely to be of a capital nature than a recurring expense. If the payment is to enhance the company's good will then the payment is a capital expenditure.

4.8: Capital and revenue expenditures

No invariable rules have been established for distingushing revenue expenditure (current expenses) from capital expenditures. A perfectionist would insist that outlay which would be of benefit for more than a year should be set up as an asset to be charged off over the entire period of usefulness. For example, the cost of a biennial, paint job should properly be divided between the two years, as should the cost of regularly recurring repairs or replacements on equipment, if they benefit more than the period in which they are made.

Many of the accounting manuals, prepared by trade associations, detail rules for treating different types of expenditure on capital assets. Consistency, rather than absolute accuracy, seems to be the chief objective.[61]

In general, a rule of reason is applied for both tax and business purposes in distinguishing between expense charges and capital expenditures; neverthless, differences in judgement incentives are imposed by the differing objectives of tax and business accounting. In general, if a repair or replacement is so large that it would distort income to treat it as an expense in a single year, e.g., in the case of new boilers and engines in a ship, the outlay must be treated as an additional capital expenditure. It would be preferable to treat the power plant and the hull of the ship as separate assets with distinct service lives. Any replacement in the nature of a betterment should also be treated as a capital expenditure. But ordinary maintenance, repairs, and replacements are usually considered as expenses of the period in which the work is done. From the following case we attempt to derive some different criteria for deciding what these two terms mean and the distinction between them. Yet it is still not possible to provide an all embracing definition of capital and revenue expenditure which brings out their distinctive features. In the case of Regent Oil Co., Ltd v. Strick, Lord Morris of Borth-Y-Gest has stated:(62)

> "The decided cases, carefully marshalled in argument, show that in the diverse and varying sets of circumstances in which decision has been called for as to whether payments have been of capital or of revenue nature no all embracing formula has been evolved. No touchstone has been devised".

The problem is that the two terms cover such a multifarious area that it is extremely difficult to provide a single definition that will take care of all the dimensions of the subject which is becoming more sophisticated and complicated.(63) Others even think it naive to attempt to do that. The problem has been clearly illuminated in the passage of Lord Denning in the case of Heather v. P-E Consulting Group Ltd.(64)

> "The question-revenue expenditure or capital expenditure- is a question which is being repeatedly asked by men of business, by

accountants and by lawyers. In many cases the answer is easy; but in others it is difficulty. The difficulty arises because of the nature of the question. It assumes that all expenditure can be put correctly into one category or the other; but this is not simply possible. Some cases lie on the border between the two; and this border is not a line clearly marked out; it is a blurred and undefined area in which any one can get lost. Different minds may come to different conclusions with equal property. It is like the border between day and night or between red and orange. everyone can tell the difference except in the marginal cases; and then everyone is in doubt. Each can come down either way. When these marginal cases arise then the practitioners- be they accountants or lawyers- must of necessity put them into are category or the other".

The same view is given in a passage by Peter Whitman.(65)

"One of the most difficult and fundamental problems in income tax is to distinguish between revenue and capital payment. Certain expenditure can quite easily be designated as either of a revenue or capital nature, but there is a twilight area in between which it is impossible to prodict with any confinedence whether the judiciary would attribute such payments to revenue or capital account."

In the light of the above cases and others, a number of different criteria have been propounded, to help in deciding what these two terms mean and the distinction between them;

(1) Capital expenditure is a thing that is going to be spent once and for all. While revenue expenditure is a thing that is going to recur every year.(66)

(2) Capital expenditure creates new or actual capital assets. Revenue expenditure is a lump sum spent to keep the prosperity of the company,and to enable it to continue to carry on as it has done in the past.(67)

(3) Capital expenditure which could be incurred on an existing capital asset to enhance substantially its value. An expenditure on obtaining a new charter to give a company an improved administrative will be revenue expenditure. In the case of <u>CIR v. Carron</u> it was held that expenditure on obtaining a new charter to give a company an improved administration structure was not capital expenditure because no new or actual asset was created.(68)

(4) There are three-fold tests, as Mesgravy J stated them, for distinguishing between capital and revenue expenditures. He asked the following questions:(69)

(a) What is the nature of the payment ?

(b) What is to be obtained by payment ?

(c) In what manner is what is obtained to be used, relied on or enjoyed ?

It can be seen that various tests have been applied by the courts for the purposes of distinguishing trading expenditure from capital expenditure.[70]

4..9: Bad Debts

The treatment of bad debts in ordinary business accounting differs from the corresponding tax treatment in several respects. In ordinary business usage the term "bad debts" refers primarily to losses arising from transaction made on credit in the normal course of business, that is, to losses on trade accounts and notes receivable. For tax purposes, bad debts are defined much more broadly. The tax concept was especially broad, embracing such items as losses on bonds and other debt obligations held as investments as well as losses on loans to officers and employees.

For both tax and bookkeeping purposes bad debts may be accounted for in two ways, as follows:

(i) They may be deducted as direct charges against income at the time they have been definitely ascertained to be uncollectable. or

(ii) A reserve for probable losses may be established, ordinarily at the close of the period for which the accounts are made up.

Before considering the consequences of these differences in scope and accounting treatment, the rationale of the customary provisions for bad debts is briefly presented. In commercial enterprises, the most commonly used and ordinarily the most justifiable basis for determining charges or credits to income is the completed transaction. Income is generally deemed to arise when a sale is made. Except for accruals of items such as interest or rent, no credit is taken for profits except when and to the extent they are received or at least reasonably assured.

Therefore, sales are commonly recognised as producing income at the time of sale on the assuption that the receivables taken in exchange for goods or services are the equivalent of cash, collection of which will be made in due course. But an element of risk is inherent in most sales on credit. The taking up of income at the moment of sale therefore constitutes a departure from the strict theory of recognising profits when realised.(71)

Such recognition will prove to have been in error to the extent that receivables are not collected. The provision for loss on bad debts is thus essentially a correction of income estimates previously or currently made. From the viewpoint of the balance sheet, it is intended to reduce the receivables due from customers to the net amount estimated to be realizable.

Rigid adherence to the completed transaction as the basis of income recognition might be considered to imply that no provision for failure to collect the proceeds of a sale should be made until the loss is definitely ascertained. When two accounting periods are involved, however, as may often be the case, to take up income in one period and to cancel it in another would hardly be satisfactory. It would obviously distort the comparability of results of operations as between the periods. The charge-off method doubtless has this effect in direct ratio to the rigidity of instance upon the date of ascertainment as the time for taking the deduction. In contrast, the reserve method, by far the more common accounting practice, has the merit of allocating the approximate loss to the year in which the sale was made, the proceeds of which were never realized.

The receipts arising from a sale of goods or services may be regarded as containing two parts: that which represents a cost and that which represents a gain. A case could be made in principle, although probably not in practice, for treating these parts separately. As far as the cost element is concerned, the sale may be regarded as a conversion of an asset from one form to another. To the extent that the value of the asset created exceeds its cost, there is a present or prospective accretion to assets and a gain.

In the ordinary case of a corporation making its return of income on an accrual basis, a gain will be taken up unless there is a high degree of uncertainty concerning the collectibility of the debt arising from it. In accounting as well as in tax practice, the measure of the gain is the excess of the cash equivalent of the receivable over the cost of the goods or services sold. In measuring the cash equivalent it is necessary to consider the interest element arising from delay in payment, the cost of collection, and the credit risk. The credit risk is more generally recognized as significant and provision is made for it. In some cases it is covered by insurance and the premium is, of course, charged against income in the period in which the debt is created.

More commonly, the debt is reduced to its assumed cash equivalent by a bad debt reserve. It then becomes apparent that the provision is properly a charge against the period in which the receipts are created. From another viewpoint, the bad debt reserve may be regarded as a self-insurance premium, the amount of which should equal the premium necessary to cover the risk of loss.

Finally, bad debts fall into three groups: firstly, outright bad debts of named customers,. These are written -off as hopeless cases, having vanished, gone abroad, or gone bankrupt. At the end the total may be transferred to the profit and loss account, and will be wholly allowable for tax purposes according to the tax system of both counries, Great Britain and Egypt. If one customer should unexpectedly come up with a part-payment at a later date (for example, a distribution from the receiver in bankruptcy) this must be brought in as taxable income of the year it is received, so that in the end only the net amount lost has been allowed for tax. Secondly, probable specific bad debts. There is reasonable certainty that named customers will not pay their accounts, but it is not yet time to write then off completely because they are still being pursued hopefully. The need here is to create an account for specific provision for bad debts of named customers by making a credit entry on this account and a corresponding debit entry on the profit and loss account. This will be alloweable for tax purposes (according to the British tax system, and non_allowable according to the Egyptian tax system because the tax law did not permit the deduction of a bad debts loss until the loss had been definitely ascertained). At the end of the year a fresh list is made and a balancing adjustment to bring the amount of the provision into line with the new total. It follows that if the adjustment is a reduction of the previous provision, will add to the taxable income insted of reducing it ; and fristly general provision. Every year some customers fail to pay, but at any one moment the management does not know precisely which ones nor how much will be involved. For prudent accounting a general provision for bad debts can be made in the form of a per-centage of the total value of all debtors. The per-centage is selected according to past experience. This general provision is not allowable for tax ,in both countries, when it is created or increased. (72)

4.10: Trading stock

All manufacturing and trading companies must take specific account of changes in the size and value of their trading stock in order to present their net income adequately. Trading stocks are usually taken into account in the course of calculating the cost of goods sold. When prices fluctuate substantially, different methods of accounting for trading stocks may cause big variations in income because the same trading stock will have markedly different values.

The American Institute of Accountants defines the term inventory "trading stock" as the aggregate of those terms of tangible property which (i) are held for sale in the ordinary course of business, (ii) are in process of production for such sale or (iii) are to be currently consumed in the production of goods or services to be available for sale.

In the UK trading stock "inventory" is usually referred to as stock-in-trade or work in progress.

Trading stock may consist of the following types:

(1) Raw materials and supplies to be consumed in production;

(2) Work-in-progress, of partly manufactured goods;

(3) Finished stock or goods ready for sale.The cost of trading stock is (i) direct expenditure on goods bought for re-sale, materials and components used in manufacturing finished goods, may be added to this, (ii) direct expenditure incurred in bringing stock to its existing location or condition, e.g., direct labour, transport, etc..,

III. indirect or overhead expenditure incidental to the class of stock concerned.

However, the value of unsold trading stock is a matter of personal opinion. This fact has been largely ignored by the accounting profession, who have been content to leave valuation to the directors of the business when satisfied that recognised principles of valuation were being applied. The Revenue have been more persistent in applying rules to ensure the accuracy of stock valuations, their concern being with the understatement of profit which comes with an understatement of stock.

The main rules of checklist of trading stock are:

(1) The stock should be checked as at the end of each accounting period, and the directors or sole trader or partners must certify that this has been done.

(2) Whatever methods of valuing stock may be used, they are to be used consistently. Different firms may adopt slightly different methods from one another, but any one firm should keep to the same method every year. Where an alteration is really necessary, as, for example, following a complete change of the board of directors where newcomers intend to adopt different accounting methods, the facts should be given to the Inspector who may request an adjustment in the tax computation in the year of the change.

(3) The basic principle of cost price or market value, whichever is the lower, must always be followed. The snag is to know either the cost or the market value accurately'

(4) Market value is net realisable value at which the goods

could be sold at the stock-taking date.

(5) Where there is a running stock of one commodity, with frequent additions and withdrawals but no single unit distinguishable from any other unit, for example, a base stock of raw material of a type which does not deteriorate, the principle of "first in first out(FIFO)' must be used to determine the cost price. and

(6) The Revenue may ask to see the stock figures and details of valuation.(73)

According to Egyptian tax law the trading stock"inventory" should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or will physically become a part of merchandise intended for sale. The taxpayer must be carrying on business before he can inventory merchandise; a mere holder of goods cannot use inventory accounting methods.(74)

The regulations specify with some care the meaning of cost and market value for trading stock purposes. In general, the cost of merchandise purchased is the invoice price minus trade or other discounts, except strictly cash discounts approximating a fair interest rate which may be deducted or not at the option of the taxpayer, plus transportation or other charges incurred in acquiring possession of the goods. The cost of merchandise produced, the cost is the cost of raw materials and supplies entering into or consumed in connection with it plus expenditure for direct labour plus indirect expense incident to production; a reasonable proportion of management expenses may be included, but selling costs and return on capital, whether by way of interest or profit, cannot be. In general, market price means the current bid price at the date of the inventory for the merchandise in the volume in which it is usually purchased by the taxpayer.

<u>Method of valuing trading stock</u>

As far as the quantitive effect on income is concerned, the method of valuing trading stock is ordinarily much more significant than is the precise line of demarcation between goods that can, or cannot, be inventoried. Therefore the following is a list of the more usual method of pricing:

(1) The average cost method;

(2) The base stock method;

(3) The first-in first-out method;

(4) The last-in first-out method;

(5) Standard price method; and

(6) Work-in-progress cost.

Unfortunately, the law does not lay down how trading stock is to be valued in computing profit for tax purposes. Problems arise as to the proper method of valuing this trading stock for tax purpose. For these purposes we shall discuss only the first four methods because they are more applicable than others. However, this does not rule out the possibility that the latter methods may be employed by some companies. Also we shall not go into detail because these are not strictly legal or judicial methods. They are the assumptions by accountants as convenient methods of valuing trading stock and all that the judges do is to examine the practical effects of these assumptions to ascertain if they comply with the tax principles. Thus in the word of the Lord President in the case of <u>CIR v. Marshall</u>.[75]

> "It is not for this court to fix principles of valuation, for a principle of valuation is not a part of the law universal at all, but, of course, it is necessary sometimes to ask this court whether a particular principle of valuation if adopted, would or would not accord with the description of the Income Tax Acts which requires the balance of profits and gains to be duly ascertained".

(1) <u>Average cost</u>

The cost of an item is determined from the weighted average of the cost of similar items at the beginning of the period. The average may be calculated on an annual, monthly, or other periodic basis, or as each additional shipment is received, depending upon the circumstances of the business.

This method does not assume any specific flow of goods, nor does it necessarily reflect a matching of current costs with current revenues. It is, however, a relatively easy method to apply in situations where an item is part of a homogenous group.

This method is used frequently for material being processed or used in manufacture, but it is sometimes applied to finished goods also. The goods concerned, as sold or consumed, are charged out at short intervals on the basis of the average cost of opening stocks plus additional purchases during the intervals, as demonstrated in the example below. Therefore the average cost is to be determined by taking into account the items on hand at the beginning of the period and those acquired during the period, apparently without regard to the sale of units during the period. Consequently, in a period of rising prices, the average cost determined under this method would be lower than the cost of the most recent purchases, while the number of units on hand might be no greater than the number represented by the most recent purchases. In industries where large numbers of small items of stock are purchased at fluctuating prices, an average price may be used for pricing issues.(76) A simple example will illustrate this statement.

			Cost	
		No.	Each	Total
Units on hands at beginning		1000	1.00	1000
Purchases during period				
Month	1	2000	1.50	3000
	2	500	2.00	1000
	8	1200	2.25	2700
	12	900	1.75	1575

continued from previous page

	5600		9275
Average cost per unit		1.66	
Unit on hand	900	1.66	1494

The effect of the average cost calculation, applied in the manner illustrated, is to reduce the trading stock value as a result of the lower prices in the earlier part of the period, even though the items on hand might be those purchased in the last month of the period. The converse of this situation is also true: in a period of decreasing prices, the average cost method will result in a higher stock value than the cost of the most recent purchase.

(2) <u>The base stock method</u>

This method involves taking a fixed amount of stock to represent the basic minimum holding of the company which is then valued year after year at a fixed total amount which would probably be determined from the cost or market value of the similar stock held many years earlier when the prices and quantities might have been very different.[77]

In the UK, the Judicial Committee of the Privy council in considering the LIFO method, was obliged to make use of comments on the base stock method.[78]

> "In the United Kingdom an attempt has been vainly made to uphold the base stock method for income tax purposes. In the recent case of Patrick v. Broadstone Mills Ltd Singleton L J., in words that are equally apt if applied to the life method, declined to accept the base stock method as conformable to income tax law though it might be approved by accountancy practice."

It can be understood that the English Courts have rejected the "base stock" method on the grounds that it violates the income Tax Acts.

(3) First-in first-out (FIFO)

For the purpose of income determination, the cost of the first goods purchased or acquired is the cost assigned to the first goods sold. Therefore, the cost allocated to the trading stock items on hand at the end of the period is the cost of those items most recently acquired.

It will be noted that the FIFO method is an application of a flow of costs theory that results in the stock being determined as a residue of cost.

The FIFO method is based on 'historical cost' and , in general, it may be stated that the FIFO method of determining cost is acceptable for tax purposes. This is probably the case because for most businesses, the physical flow of goods may approximate to a first-in, first-out flow, since goods purchased earliest will normally be sold first to avoid loss through deterioration. This method will lead, in times of rising prices, to higher profit figures and more realistic balance sheet values than the average cost or the last in first out method. It assumes that the stock bought first is used first, it also leads to a more precise ascertainment of the true profit in an accounting period. Thus its effect is to impose a relatively higher tax charge at a time of rising prices and a relatively lower charge when prices fall. The problem with this method is that, although there is an approximate matching of specific cost against specific revenue, there is not matching of current cost against specific revenues, this will be considered further when we consider adjustments necessary to allow for inflation.

Although the FIFO method is judicially acceptable for tax purposes, it may create difficulties for companies, i.e., where prices rise there is a tendency to repress business activities.

(4) <u>Last-In First-Out (LIFO)</u>

Under this method, for the purposes of income determination, the cost of the goods most recently purchased or acquired is the cost assigned to the first goods sold. As a result the stock on hand at the end of any period, provided the quantities on hand at the end of the period are the same as they were at the beginning of the period, is valued at cost attributed to the stock at the beginning of the period. Increases in quantities during a period are valued at the cost prevailing during the time the accumulations are deemed to have occurred. Decreases in quantities are considered to have first reduced the most recent accumulation.

This method is the reverse of FIFO as it assumes that issues are made from the latest items received into the business. This method is rarely used in the UK and it was rejected for tax purposes by the Privy Council in Minister of National Revenue v. Anaconda American Brass Ltd.[79] In this case the respondent company carried on the business of purchasing materials, manufacturing them into sheets, rods tubes and selling the manufactured goods. The company claimed to value its stock on the LIFO method for 1947, a year in which there had been large increase in the price of materials. Thus by attributing the highest cost to the metals processed and the lowest cost to those retained in stock the company was able to show for lower profit, (but not the real profit, which in fact was much higher) than if it had followed the accustomed or traditional method of return,FIFO.

In the argument against the LIFO method,Sutherland L.S and J.R Hicks said:[80]

> "For whatever safeguards are introduced the net effect of the LIFO option must in these circumstances, be a postponement of the payment of taxes. But neither in a time of internal inflation, nor at a time when the prices of imported materials are rising

sharply (these being precisely the times when the LIFO alternative will be most generally attractive) is it desirable to give a general licence to such postponement. The effect of postponement is to put more spending power into the hands of business, for the time being. There is nothing to stop them from exercising that spending power, but as they do so they contribute in the one case to inflationary pressure, in the order to the strain on the balance of payments. The right course is to keep business short of funds during the time of pressure and to let them off more easily later. This is what FIFO does while LIFO works in the other, the wrong direction"

The LIFO and the basic stock methods have been rejected by British Courts as being inconsistent with the income tax law. The Egyptian tax system accepted all the above methods where the company can choose any method but cannot change that method without any justifiable reason.[81]

(5) Standard Price Method

In manufacturing or processing industries where several operation are involved or goods are producted on mass production lines, stock is valued on a predetermined or budgeted basis. Stock may be valued at the same prices, provided standards are kept up to date.

(6) Work-In-Progress Cost

The cost of work-in-progress is difficult to determine, but may be defined as prime cost actually incurred plus a fair cost of overhead incurred, i.e., it is usually valued by adding to direct costs (such as labour) a proportion of indirect overhead expenses.[82] The taxpayer is allowed to value work-in-progress at direct cost only. In the case of Duple Motorbodies v. Ostime[83] the company made motor bodies and since 1924 used the "direct cost" of ascertaining the cost of the work in progress, meaning that only the cost of materials used and labour directly employed in the manufacture were inclued. [84]

4.11: Relief for Trading losses

In general, a person carrying on an activity such as a trade, which normally generates income in the form of profits, may suffer a trading loss in a particular accounting period because expenditure has exceeded income for that period.[85] In such a case there will clearly be no income for assessment purposes and it would be inequitable if no relief from income tax could be claimed on the loss.

There are one or two preliminary points to be made about trading losses arising in companies.[86]

(1) If a company has a trading loss for an accounting period there is no Sched. D, Case 1 amount to be included in profits liable to CT for that period.[87]

(2) In many cases in theory and practice there will be other kinds of profit, including abated chargeable gains, in the same accounting period in which a trading loss arises. These other profits will be liable to CT and it is quite possible in certain circumstances for CT to be payable for an accounting period in which a trading loss arises.

(3) Relief for losses for taxation purposes consists in being able to reduce current, past or future profits so that less tax is paid on these profits than would otherwise be the case. The CT assessment is usually based on the results of a twelve months period. Losses for earlier or later twelve month periods are not automatically deducted as happens in a company's financial accounts. To deduct losses for tax purposes there has to be specific legislation for relief in

each case.

(4) In a general way if trading losses are being carried forward they can only be deducted from future trading income in that trade. If trading losses are being deducted from the profit of the current or a prior period all profits, trading and other profits of the period, can be reduced by the loss.

Relief for trading losses

There are a number of alternative ways in which relief may be given on trading losses for CT purposes:[88]

(i) The loss may be carried forward and set-off against future trading profits, no part of the loss being set-off against other profits of the accounting period in which the trading loss arises; or

(ii) Set-off against other profits of the accounting period, any balance of loss then remaining being carried forward and set-off against future trading profit as in (i) above; or

(iii) Set off against other profits of the accounting period and then against total profits of the preceding accounting period , any balance of loss then remaining being carried forward .

It is perhaps worth recalling that Schedule D Case I trading loss is arrived at after deducting capital allowances. These may in fact turn a profit, into a loss, for tax purposes. Also, charges on income are deducted from total corporation tax profit.

A loss incurred by a Company in the carrying on of trade is to be computed in the same way as a corporation tax profit. According to the UK Tax system, there are various statutory provisions which give loss relief against income for tax purposes, and, in the main they apply where a loss has been sustained by a person carrying on a trade, profession or vocation. Therefore, a trading loss can be relieved in the following ways:

(1) <u>Carry forward</u>

The tax law [89] gives taxpayers (e.g. trading company) the right to carry forward and set-off against the first available profits of the same trade so long as the company continues to carry it in succeeding accounting periods without limit of time. Where the trading loss has been carried forward but the amount of the trading income against which it will be set off is insufficient, any interest or dividends on investment which would fail to be taken into account as trading receipts but for the fact that they have been subjected to tax under the other provisions shall be treated as if they were trading income of the trade.[90] Moreover, in any accounting period where the charge on income paid by a company exceed the total CT profits, and include payments made wholly and exclusively for the purpose of trade carried on by the company the excess may create or augment a loss which will be available to be carried forward.[91] A company may also require a surplus of FII to be taken into account for relief under section 177(1)[92] In an accounting period, a company may incur a trading loss and after all available loss reliefs have been claimed still find that some proportion of the loss is unrelieved. If at the same time it has a surplus of FII, then the company may elect to have the surplus treated as if it were corporation tax income.

Sections 254 and 255 of TA 1970 enable this surplus to be used in claim for loss relief which provide the company with a cash payment of tax credit attached to the surplus of franked investment income.

The main points concerning loss relief according to surplus of FII are:

(1) If a company has a surplus of FII for any accounting period and makes a claim, then the surplus is regarded as an equivalent amount of corporation tax profits for the purposes of making a claim for loss relief under sections 177(2) and 248.

(2) The surplus of FII available for relief excludes any FII brought forward.

(3) In the first accounting period following the one which relates to the claim, in which there is an excess of franked payments over FII, then any loss used in a section 254 claim can be used in the normal way. Until that occasion arises any loss carried forward under S.177(1) is restricted accordingly. A formal claim for loss relief under section 177(1) must be made within six years of the end of the year of assessment for which relief is claimed.[93]

Some restrictions are placed upon the right to carry forward losses. The relief is available only to the company that has incurred the loss, and such a company must be carrying on the same trade as that in which the loss arose. If it ceases to trade with unused losses then any purchaser of the trade cannot make use of them. The right to carry forward losses is not altogether advantageous. It is bound to raise the difficult question of whether or not an expanded or contracted company is carrying on the same trade as before the changes took place.

(2) <u>Set off against profit of whether description of current past accounting periods</u>

Under this method trading losses may be set off against any income in the year in which the losses are incurred, whether revenue or capital profit.(94) If the trading losses are still unrelieved, they may be carried backwards and set off against any profits of the preceding accounting period, if the company was then carrying on the trade.(95) The period to which trading losses may be carried back must not exceed the length of the accounting period for which the losses have been incurred.(96) Thus the right to set off a trading loss against profits of any description applies only to profits of the same or the preceding accounting period. This can cause difficulties in the case where a trading company has lapsed in a period of inactivity as illustrated by the decision in the case of <u>Ingram (J.G) And Son ltd. v. Callagham,</u>(97) and the case of <u>Golf v. Osborne and Co.</u>

(Sheffield) Ltd.[98]

However, for relief to be available under this method it must be shown that either in the same accounting period or in an immeditely preceding period, the trade was carried on a commercial basis, and with a view to the realisation of gains.[99] The fact that a trade was being carried on at any time so as to afford a reasonable expectation of gain should be conclusive evidence that it was then being carried on with a view to the realisation of gains.[100]

Finally, where a company ceases trading and another company takes over the same trade then unrelieved losses can be carried forward to the successor company providing that certain conditions are met:

(a) On or at any time within two years after the succession and within a one year period thereto, at least 75% of the interest in the trade is held by the same persons. This means that 3/4 of the ordinary share capital in both companies must be held by the same persons throughout the three year period. Throughout the same period the same trade must be carried on by a company with respect to CT.

(b) It follows from this provision that the transfer of trade from an individual to a company precludes the transfer of trading losses between these entities. However, in that case under Section 172 of T.A 1970 some relief for an individual is available whereby part of a business loss may be set off against income which he received from the company.

Where there is a transfer of trade then the following circumstances apply:[101]

(1) The trade is not treated as if it had been discontinued and a new one started.

(2) Terminal loss relief is not available to the company ceasing to trade. If the second company ceases to trade within four years of the succession, then terminal loss relief can be carried back, where appropriate, to the first company.

(3) Relief under S.177(1) for the carrying forward of losses is available subject to any claim by the company ceasing to trade, under S.177(2) i.e. set off against corporation tax profits.

(4) No balancing adjustments are raised on the transfer.

(5) Unused capital allowances or stock relief can also be carried forward.

(6) Losses can not be carried forward where at any time before the change in ownership, the scale of activity becomes small or negligible and the change takes place before any considerable revival has occurred.

(7) Schedule D case Vi losses or capital gains tax losses cannot be transferred.[102]

(3) Terminal Loss relief

When a company ceases to carry on trade and in its final accounting period incurs a trading loss, the loss cannot be carried forward since there is no more trade, and hence no profit against which the loss can be set-off. Terminal loss relief may be carried back against trading profits of previous years which are limited to three years only.[103]

The main features of terminal loss relief are as follows:[104]

(1) The period of the loss available is the twelve months prior to the date of cessation.

(2) Relief is available in respect of the three years prior to the beginning of the twelve months period ending with the date of the cessation.

(3) All other forms of loss relief must be claimed in respect of the period of the loss, before making a claim under Section 178.

(4) Loss relief is only available if it arose from trading in the last twelve months, and it must not include any loss brought forward under Section 177(1).

(5) A claim for terminal loss relief must be made within six years of the date in which the trade ceases.[105]

(6) If there is an excess of charges on income in the final period, then any trade charges may be used as a trading loss under this section.

(7) Any charges on income paid in the three year period of the claim must be set-off against non-trading income and chargeable gains first, and then against any trading income, before any deduction for terminal relief is made.

(4) <u>Calculation of Terminal Loss</u>

A terminal loss normally consists of the following main elements:

(a) the loss arising in the last fiscal year;

(b) the capital allowances of the last fiscal year;

(c) the balance of the loss (if any) arising in the remainder of the twelve months preceding discontinuance; and

(d) the lower of:

(i) a proportion of the capital allowances of the fiscal year preceding discontinuance, or

(ii) the amount of the capital allowances for that year unrelieved.[106]

However, in addition to the restrictions of loss relief mentioned as prescribed by Sections 177 and 178, there are further restrictions by section 483 of the Income and Corporation Tax Act 1970. It provides that no loss relief will be given under subsection (1) or (2) of S.177 if within any period of three years there was both a change in the ownership of a company and before or after a major change in the nature or conduct of a trade carried on by the company or if there was a change of ownership at any time after the scale of the trading activities had become small or negligible and before any considerable revival of the trade.[107]

According to the Egyptian Tax System, if any accounting period results in a loss, such a loss shall be deducted from the profits of the following year and in case such profits are insufficient to cover whole losses the remainder shall be carried forward to the following year. If there is still any remainder it shall be carried forward to the following year and so on up to the fifth following year but no remainder shall be carried further.[108]

It seems to me that the treatment of trading losses under the Egyptian Tax System falls short of that of the British Tax System. In Egypt, there is a time limit on the carrying forward of the loss whereas under the British system, allowances are made for losses to be absorbed throughout the company's life.

It is known, the real profit or loss cannot be ascertained until a company ceases to trade or at the end of the life of the company (which always has a limited life). At that point a company will bear all real taxes which are the total of CT which is imposed on the net profit minus trading losses sustained every year during the company's life, i.e for tax purposes, a company's life is divided into periods, which called accounting periods, for which Tax Returns must be made.

Another reason I think that the British Tax System is more beneficial to companies sustaining losses than the Egyptian system is because a company in UK has a better chance of returning to profitable trading, whereas in Egypt, the time-limit imposed by the tax system puts pressure on companies in such situations to falsify Tax Returns to avoid tax, in order to cover their losses.

4.12: Capital Allowances

For accounting purposes, the cost of capital assets must be spread over the accounting periods in which those particular assets will produce benefits for the business. Providing for the allocation of the cost of a capital asset over the period of its useful life on a systematic and rational basis for financial accounting purposes is known as depreciation. Depreciation applies only to the cost of fixed tangible assets that deteriorate over time or are consumed through use. Land, for example, is not subject to depreciation.

The word "depreciation" means different things to different people. To the man in the street, it may mean declining value. To the businessman, it means provisions for replacement. But for tax purposes it means an arbitrary allocation of part of the original cost of an asset to a particular year.

The treatment of depreciation raises two problems:

(i) What cost is to be eligible for depreciation; historic cost, current cost, replacement or some other?

(ii) How is this cost to be allocated, over how long a period is it to be separated, and what are the patterns of spreading to be followed over this period?

From the business viewpoint, the purpose of depreciation, for an ongoing corporation, is generally felt to be the provision of sufficient assets from the current revenue to replace assets as they wear out. So far, for depreciation to perform its function in the computation of income, at the end of the useful life of the assets, the total accumulated depreciation of that asset should be enough to replace it with a new one. If an asset costs £35,000 in 1975, but the replacement cost in 1987 would be £50,000, due to charge in price over the years, the depreciation should be based on the replacement cost (£50,000).

Accounting during the last century recognized that there must be a systematic way to allocate the cost of fixed assets over accounting periods beginning from the aquisition of these assets. At the beginning of this century, accounting books recommended several equations to determine the costs for each year; one such method now follows:[109]

$$\text{Depreciation} = \frac{\text{Cost to be allocated}}{\text{Estimated Life}}$$

This method is what is known today as the straight line method.

The accounting profession has considerably refined its view of depreciation allowances. At one time depreciation was regarded as an amount set aside for further asset replacement. Secondly, it came to represent the decline in values of asset (balance sheet) and thirdly, it came to be seen as a cost allocation against the revenue attributable to these costs (income statement).

In the early development of accounting practice, depreciation was originally conceived of as a means of providing for the replacement of fixed assets. Depreciation accounting is a method of allocating the cost of fixed assets to various accounting periods in order to arrive at the appropriate matching of revenue and costs for the purposes of computing profit for particular accounting periods.

According to the Egyptian Tax System, depreciation allowed is based only on the original cost rather than replacement value or any other value. The Egyptian Cessation Court, in the case of <u>Egyptian Tax Office v. Egyptian Railway</u> [110], refused the replacement value and accepted the historical cost as a base for depreciation allowed. So, in my opinion, if depreciation allowed for tax purposes is based on the historical cost, the tax is actually taxing capital and impairing the ability of a company to continue in its business. In particular during a period of inflation the amount is not adequate to replace plant and equipment when it must be retained. Therefore, it seems to me, for encouraging capital reformation, and for other reasons, the depreciation rate is better decided on the basis of replacement value instead of historical cost.

Depreciation is the gradual and permanent decrease in the value of an asset from any cause. The reason for charging depreciation is that although the purchase of an asset occurs once only, the use of the asset goes on into future periods. Therefore, the asset's cost must be allocated to the periods that receive benefit from the expenditure so that the net income, in the year of purchase, is not distorted, as it would be if the total cost was charged to expense in that one period. The distribution should be equitable so that each period bears its fair share during the lifetime of the asset. Further unless assets are depreciated, it is obvious that, on the Balance Sheet, their value will be overstated; and the Balance Sheet will not be a correct representation of the state of the business. Moreover, assets such as plant and machinery are held for the purpose of earning income, and the loss arising on those assets through wear and tear is undoubtedly a loss incurred in the earning of such income, and should equitably be charged or set off against it. Lastly, if depreciation were not provided for by charges against profits additional capital would have to be raised whenever the necessity for replacing the asset arose.

The life of an asset is the number of years that it will continue to be usable or productive. At the end of their life some assets have no value at all e.g. a Lease, or Patents; other assets have a residual or break-up value, that is, the value of the material as old or scrap iron e.g. Plant and machinery.

The allocation should be based on some rational mathematical system which is determined at the beginning of use. To determine what use might be had from an asset, we shall attempt to examine those factors which would make the asset less useful. These factors fall into two classes, physical and functional. Physical factors include:[111]

(i) Wear and tear: the lessening in utility that comes from normal use of the asset.

(ii) Decay: the lessening in utility by the effect of nature.

(iii) Destruction: the lessening of utility due to the asset's physical destruction.

Function factors include:

(i) Obsolescence: the reduction of utility that results from the development of a better machine or process.

(ii) Inadequacy: the reduction in utility that comes about because more production is needed than this asset or combination of assets can give (such a situation may force an earlier retirement of this asset or combination of assets than was originally contemplated.)

The amount of depreciation claimed in any particular year for accounting purposes is dependent upon two factors: the estimated life of the asset and rate or method of depreciation. The useful life of an asset is determined primarily by reference to the asset's physical life span.

The cost of an asset is allocated over its estimated useful life usually in accordance with one of the following methods:

(1) "Straight Line" Method.

(2) "Reducing Balance" Method.

(3) "Hourly" Method.

(4) "Units of Production" Method.

(5) "Sum of the Year Digits" Method.

(6) "Depletion Unit" Method.

The straight line and reducing balance methods are applicable according to the Egyptian Tax System. Also the two methods are adopted by UK Tax System. Details for the two methods are as follows:

(1) Straight Line method (S/L). Under this method, the cost

of an asset is allocated rateably over its useful life; therefore, the amount of depreciation claimed in the last year of the asset's life will be the same as the depreciation claimed in its first year.

The method can be used and is commonly applied in the case of leases having a comparatively short life, industrial and commercial buildings, hotels, and agricultural buildings and works... It must not be overlooked that, although there depreciation charged for any asset will be constant from year to year, there is really a reducing burden when it is considered that the funds retained thereby will themselves earn income.

In order to calculate the depreciation charge under this system it is necessary to classify the asset under effective life periods, separate accounts being utilised from each group having the same expectation of time of utility.

(2) Reducing balance method (R.B). Under this method, a fixed rate percent, on the diminishing value of the asset is written off each year, so as to reduce the asset to break-up value at the end of its life, repairs and small renewals being charged to revenue. This method is commonly used for plant, fixtures, furniture,... Among the advantages claimed for this method are the following:

(i) the early years are charged with the largest amounts for depreciation, thus reducing the asset in the same ratio as its loss in value for resale accrues, it being recognised that normally a new asset loses its saleable value most rapidly when first put into use;

(ii) the asset loses efficiency as it gets older and the charge for depreciation should decrease accordingly;[112]

(iii) it is very simple in operation and the total charge to revenue in respect of depreciation and repairs is more equal each year than under the S.L method.

Rate of Depreciation Adopted

The following are the rates of depreciation generally adopted, according to the Egyptian Tax System (for guidance only), though it is quite possible that special circumstances may make them higher or lower -

Freehold Land and Buildings; are	2%
Plant and Machinery	15%
Motor Lorries, Vans, etc.	30%
Furniture, Fixtures, and fittings	6%
Cars	25%

The Egyptian Tax Office allows taxpayers maximum freedom in selecting the rate of depreciation, or estimated life. Therefore, the deductions are allowed as long as the taxpayers use the rate systematically and the deductions were clear and reasonable. However, the taxpayer has to carry on with the method and can only change to the other method with good reason. In addition, according to Egyptian Tax System depreciation must be calculated by reference to historical cost. For encouraging the taxpayer to dispose of the old assets (machine and equipment) and replace them with the Egyptian Tax System allows a deduction of twenty five percent (as accelerated depreciation) of the costs of the new machines and equipment purchased by the company to be used for production in addition to the real depreciation effected as customary according to tradition and the nature of each industry, commerce or activity. The accelerated depreciation shall be calculated as from the date the machine and equipment shall be used in production and for only one time.[113]

Legislative Background according to UK System

It is necessary to trace briefly the historical development of capital allowances in order that basic objective underlying the scheme for granting allowances for capital expenditure may be made clear. Because there was no systematic accounting when income tax was introduced and because the tax itself initially was regarded as a temporary phenomenon, it took some considerable time before a meaningful scheme of capital allowances was introduced for wastage of capital assets. In the words of the Tucker Committee.[114]

> "For more than a generation after the imposition of the present income tax no relief whatever was given for the using up, in the course of carrying on a business, of any kind of fixed asset."

In the light of this, income was simply regarded as the surplus of receipts over the expenditure necessary to earn them so that income was assessed and taxed without capital allowances for the capital assets that helped to produce it.[115]

The first statutory allowance was granted in 1878 as representing the diminished value by reason of wear and tear during the year in which plant and machinery were used in trade. Accordingly in 1878 capital allowances were first introduced by a statutory allowance as representing the diminished value by reason of wear and tear during the year of plant and machinery used for the purposes of trade. This allowance did not extend to obsolescence and so in 1897 a concession was made to include obsolescence, although this was not made statutory until 1918. In 1918 special depreciation allowances, made to mills, factories and other similar premises regarded as being very susceptible to depreciation owing to the vibration caused by plant and machinery, were brought within the scope of the depreciation allowances.[116] The Royal Commission of 1920 considered but rejected any general scheme of capital allowances, although some were permitted. The Royal Commission of 1955 has stated that:[117]

> "So far the origin of these various allowances are somewhat haphazard. Indeed it seems that up to 1920 there was little attempt to explain them in terms of a comprehensive taxation theory or to relate them to the tax system as a whole."

It was not until 1944 that there was a significant development in respect of capital allowances. In 1944 the Chancellor of Exchequer, Sir John Anderson announced a system of allowances which was carried into legislation by the Income Tax Act 1945. Thus he said that taxable profits of industry should be:[118]

> "Real profits in the sense that these profits should be struck only after making all proper deductions and allowances, especially adequate allowances such as might be made on a commercial basis for the amortisation of money expended on assets which are used up in the making of the profits".

Thus the importance of giving comprehensive capital allowances to mitigate expenditure on capital assets was for the first time officially underlined.

The legislation is now consolidated in the Capital Allowances act 1968 supplemented by the Taxes Act 1970 and the Finance Act 1971. Capital expenditure is allowable in respect of:

(1) Industrial Buildings (C.A.A 1968 SS1-17).

(2) Machinery and Plant, C.A.A 1968:SS. 18-50 "old system" F.A 1971: SS.40-50 "new system.

(3) Mines, Oil wells and Mineral Deposits of a Wasting Nature (CAA 1968 SS.51-66).

(4) Dredging (CAA 1968 S 67).

(5) Agricultural Land and Buildings (CAA 1968 SS.68,69).

(6) Scientific Research (CAA 1968 SS.90-95).

(7) Patents (TA 1970: SS.378,379, 385, 387, 388).

(8) Know-how (TA 1970 SS.386,387).

(9) Cemeteries (TA 1970, S141).

Many types of capital expenditure qualifying for allowances are confined to income taxed under Sched. D, Case I and do not extend to Sched. D case II or Sched. E.

This system defined certain types of capital expenditure as qualifying for allowances. For certain of the classes of expenditure the title to allowances extends to a person who incurs capital expenditure on a qualifying asset which he then allows some other person to use for the purposes of that person's trade. For instance, a lessor of an industrial buliding might qualify for allowances on capital expenditure incurred by him on an industrial building used for the purposes of his lessee's trade. The rules providing for capital allowances take account of the technical differences between income tax and corporation tax as regards the assessment to tax of profits or gains.(119)

A capital allowance differs from a deductible expense in the following ways:

(1) it must be an item of capital expenditure as distinct from revenue;

(2) a revenue expense is deductible unless prohibited by statute;

(3) capital expenditure qualifying for a capital allowance cannot be allowed as revenue expenditure;

(4) a revenue expense is deductible at once and in full whereas allowances are made only at specified rates and often over several years; and

(5) whereas an excess of expenses over receipts creates a trading loss, excess allowances are different, and for the

most part special provision is to be made so that they are treated like excess expenses. In relation to the person incurring the expenditure, " capital expenditure" excludes:[120] (1) any expenditure allowed as a deduction in computing the profits or gains, for tax purposes, of a trade carried on by him, and

(2) any sums which are payable under deduction of income tax by virtue of SS.52 or 53 of T.A. 1970.

A capital sum is similarly defined and, as regards sums received, excludes:[121]

(i) any sums which are to be included as receipts in computing the profits or gains, for tax purposes, of a trade carried on by the person receiving the sum, and

(ii) any sums which are payable under deduction of income tax by virtue of SS.52 or 53, TA 1970.

Capital expenditure is treated as incurred on the date on which it becomes payable except where the rules expressly otherwise.[122]

Main features of capital allowances

The main features of capital allowances according to the UK Tax System, are summarised in the following points:

(1) Depreciation of fixed assets is not an allowable deduction for tax purposes. It is replaced by capital allowances which are a standardised system of depreciation for tax purposes.

(2) Capital allowances are available in respect of qualifying expenditure incurred in an accounting period, which is the basis period.

(3) Capital allowances are deemed expenses in arriving at the Schedule D Case I trading income of a company. A balancing charge is treated as trading income.

(4) The writing down allowance for plant and machinery can be disclaimed by a company in respect of accounting periods ending after the 13th March 1984.[123]

(5) If capital allowances effectively create a trading loss then they are not carried forward separately but as an integral part of the company's trading.

(6) The historic cost basis is generally applied ,as a cost of capital assets, for capital allowance.

(7) The renewals basis, where it is applied, is generally confined to fairly small items.[124]

Relief for capital allowances can be given in two ways:

(i) Relief given in taxing the trade:[125] The allowances are given as a deduction against the Sched. D Case I assessment. If they exceed the assessable income they can used in a loss claim or carried forward and added to the allowance available in taxing the trade for the successive year without time limit and set-off against future assessable profits of the same trade.

(ii) Relief given by discharge or repayment of tax:[126] Capital allowances which are available to a person or company for any accounting period, by way of discharge, or repayment of tax primarily against a specified class of income, are to be deducted from, or set-off against his income of that class for that year, or the company's income of the specified class for that accounting period. Any balance of allowances for a particular accounting period which cannot be allowed because of an insufficiency of income of the specified class for that accounting period, may either:[127]

(a) be carried forward to the next accounting period and treated for relief purposes as an allowance available by way of discharge or repayment of tax against income of the specified class for that period; or

(b) be allowed against profits generally (income and chargeable gains) for the first accounting period, subject to claim being made by the company within two years of the end of that period. The amount to be allowed against profits generally for that first accounting period must not include an amount brought forward from an earlier period. There is provision for an excess of disallowed allowances for the first accounting period, exclusive of any amount brought forward, to be carried back against profits generally of the preceding period equal in length to that first accounting period. Relief by way of carry-back against profits generally of the preceding period is given after any relief for earlier allowances or for losses.

The capital allowances are calculated by reference to the current accounting periods of the company which are referred to as "chargeable periods". In computing a company's profits for CT purposes for any accounting period, capital allowances in the case of trade are treated as trading expenses of the period to which they relate, and balancing charges due are treated as trading receipts of the period.[128] Relief can be obtained in respect of capital allowances in excess of profits, for example, under losses or can be set-off against a surplus of FII.[129]

Capital Allowance for Plant and Machinary

A new system of capital allowances, introduced by the F.A 1971, applies in respect of capital expenditure incurred by a person on or after 27th October 1970 on providing machinery or plant for a qualifying purpose. Such capital expenditure may be incurred on either new or second-hand machinery or plant except that in certain special circumstances capital expenditure incurred on or after 27th October 1970 on second-hand machinery or plant is dealt with under the "old" system,[130] which applies normally to capital expenditure on machinery or plant incurred before that date.[131]

For determining the meaning of plant and machinery we have to return to British Courts because there is no difinition of plant and machinery in the Tax Act. The first definition was given in 1887 by Lindley L.J in the case of Yarmouthv. France he said:[132]

> '... in its ordinary sense (plant) includes whatever apparatus is used by a business man for carrying on his business-not his stock in trade... but all goods and chattels, fixed or

movable, live or dead which he keeps for permanent employment in his business".

This definition is wide and a number of cases have excluded specific items from relief. In general, if the item is of a durable nature, it may be plant, so in the case of Caledonian Railway Co. v. Banks,[133] railway engines and carriages were held to be plant also in the case of Hinton v. Maden and Ireland Ltd,[134] Knives and lasts which had an average life of three years, and which were used on shoe machinery, were held to be plant. The definition of plant is not restricted to items used physically. In the case of Ben Odeco Ltd v, Powlson,[135] interest payments made to finance expenditure on an oil rig were held not to be plant. Also in Benson v. The Yard Arm Club ltd,[136] the purchase and conversion of an old ferry boat into a floating restaurant was held not to be plant. So the Revenue generally refuses to allow wiring as plant whilst light fittings will not be plant unless they are of specialised nature.[137]

From the above cases the definition of plant and machinery embraces not only the most obvious items of plant and machinery such as railway- locomotives and carriages but also knives and lasts used in the manufacture of shoes etc. Unless the plant comes within one of certain special cases, expenditure on plant acquired after 27th October 1970 is pooled.

The new system of capital allowances for plant and machinery provides the following steps:

(1) first year allowance of a substantial percentage of the

capital expenditure; this allowance is abolished since April 1st 1986;

(2) a writing down allowance during the life of the asset, an allowance that obviously does not apply if there is a 100% first-year allowance;

(3) balancing charge; this will arise where the total allowances given are greater than the adjusted net cost;

(4) balancing allowance which arises where the adjusted net cost is greater than the total allowances given.[138]

Writing down allowance now applies where the person incurs capital expenditure on the provision of machinery and plant wholly and exclusively[139] for the purpose of trade. The consequence of this expenditure is that the asset belongs to him:[140] it is no longer necessary that the asset should be brought into use in trade.

Where an asset is acquired partly for business purposes and partly for other purposes the allowance is reduced to such extent as is just and reasonable in the circumstances; particular attention is directed to the use to which the asset is put.

In general, all plant and machinery used in the trade is placed in one pool and the writing down allowance is applied to the value of the pool.[141] However, the following items must be pooled separately:[142]

(1) assets used partly for non-business purposes,[143]

(2) assets for leasing outside the UK,[144]

(3) Certain road vehicles,[145]

(4) ships,[146]

(5) also certain items are pooled separately if the taxpayer so elects.[147]

The writing down allowance is given at 25% of the balance of the pool each year on a reducing balance basis. However, no writing down allowance may be claimed for the period during which permanent discontinuance takes place, only a balancing allowance is made.[148]

Finally when the allowance is deductible in taxing a trade, the usual method is to set the allowance against the taxable profits of the trade profession or employment, as the case may be, when making the annual return.[149] Excess allowances may be brought forward to be set against future profits.[150] Therefore the allowances are calculated by reference to the pool of expenditure which consists of the following:

Balance of expenditure brought forward from previous year	xxx
New expenditure	xxx
	xxx
Less disposal value of plant sold or ceasing to be used permanently in the business	(xx)
	xxx
Less writing down allowance(25%)	(xx)
Balance of expenditure carried forward	xxx

Furthermore the general rules of capital allowances of plant and machinery are summarised as follows:

(i) Where a company carrying on a trade incurs capital expenditure on the provision of machinery or plant for the purposes of the trade and owns these assets, it shall be entitled to a first year allowance "FYA" which will be of an amount equal to the whole of the expenditure in respect of which it is made.[151] The FYA has now been abolished.

(ii) The company is also entitled to writing down allowance on the machinery or plant where the above basic qualifying conditions are fulfilled and a lower initial allowance has been claimed. The balance will accordingly be depreciated at an annual rate of 25% The writing down allowance will therefore be proportionately reduced for accounting periods of less than twelve months.[152]

(iii) Where there has been a permanent discontinuance of trade, the company is entitled to a balancing allowance[153] or balancing charge[154] as the case may be in the following circumstances:

(a) Where the allowance already given is less than the cost of the asset less amount realised on disposal an extra or balancing allowance is given.

(b) Where the allowances exceed the expenditure on the asset less amount realised on disposal then there is a balancing charge in the form of a sum to recapture the excess.

(iv) No FYA is available to a company in respect of capital expenditure incurred on road vehicles other than those:[155]

(i) primarily suited for the conveyance of goods or burden, or

(ii) of a type not commonly used as private vehicles and unsuitable to be so used (e.g. works buses) or

(iii) provided wholly or mainly for hire to, or for the carriage of, members of the public in the ordinry course of a trade (namely, taxis and drive-hire cars etc.).

The advantage of this provision is that it encourages the use of capital sums that would otherwise be paid for motor cars in other more profitable ways. Writing down allowances may be claimed for all vehicles. However, there are some special rules for this type of asset. For private cars costing more than £8,000 the following conditions apply:

(1) They must not be pooled with any other items of plant, and separate record of each purchase should be kept.

(2) The writing down allowance is restricted to £2,000 per annum until 25% of the written down value is less than that amount. Where the accounting period is less than 12 months then a proportion of the maximum is allowed.

(3) When a vehicle in this category is sold then a separate "balancing charge or allowance is computed."

For private cars costing £8,000 or less purchased on or after the 1st June 1980, a separate pool must be kept, and they must not be grouped with pooled plant as previously.[156]

Where more items come into the pool, the writing down allowance is 25% of the excess of sums spent over sums so far allowed whether under a first year allowance or a writing down allowance plus disposal value. Disposal value becomes relevant when:

(a) the asset ceases to belong to the claimant[157]

(b) if he loses possession of it in circumstances in which it is reasonable to assume the loss is permanent

(c) the asset ceases to exist as such as a result of destruction, dismantling or otherwise

(d) the asset begins to be used wholly or partly[158] for purposes other than those of the trade, or

(e) the trade is permanently discontinued. If the qualifying expenditure exceeds the disposal value, the writing down allowance of 25% of the excess may be claimed.

For expenditure after 31st March 1986 the allowances are set out in the table (4.1) [exception of a minor and transitional nature e.g. under pre 14th march 1984 contracts or regional schemes are ignored].[159]

Table (4.1)

Capital Allowances and Depreciation Methods

according to British Tax System

Types of assets	FYA	IA	WDA	Depreciation Method used
Industrial Building	___	___	4%	Straight line #
Hotels	___	___	4%	,, ,, ,,
Assured tenancies	___	___	4%	,, ,, ,,
Industrial and commercial buildings in enterprise Zones	___	100%	25%	Straight line
Machinery and plant	___	___	25%	Reducing balance *
Mines/oil wells	___	___	25% or 10%	,, ,, ,,
Dredging	___	___	4%	Straight line
Agriculture and forestry building and works	___	___	4%	Straight line
Scientific research	100%	___	___	___
Patents	___	___	25%	Reducing balance
Know-how	___	___	25%	,, ,, ,,
Ships				Free depreciation **

Under the straight line method the cost of an asset is allocated rateably over its useful life. The amount of

depreciation claimed in the last year is the same amount of depreciation in the first year. The criticism of the method is that the asset loses efficiency as it gets older as the charge for depreciation should decrease accordingly. Therefore the straight line method is not equal each year. However, this method is simple in operation.

* Under reducing balance reduction of percentage of previous balance. The method is commonly used for plant, fixtures, furniture, etc. It results in higher depreciation deductions at the beginning of the use of the asset and smaller amounts at the end than would be allowed in the straight line method. Although the method avoided the deficit of straight line method but still not the accurate methods. It is very simple in operation, and the total charge to revenue in respect of depreciation and repairs is more equal. Under the method the asset is never completely written off.

** extended to old ships as from 1st April 1985 (FA 1985 S.58).

Industrial Buildings and Structures

Capital allowances are given to persons who have incurred capital expenditure on construction or purchase of buildings used as industrial buildings in qualifying trade or undertakings. capital allowances which are available in respect of expenditure on buildings may be considered under the following headings:

(1) Industrial buildings and structures.

(2) Hotels.

(3) Small workshops.

(4) Enterprise zone expenditure.

Industrial buildings and structures have a statutory definition which means[160] "an industrial building is a building or structure used for one or more of a number of qualifying purposes such as:[161]

(i) A trade carried on in a mill, factory or similar premises.

(ii) A trade concerned with the manufacture or processing of goods or materials.

(iii) A trade consisting of the warehousing and storage of goods or materials which are to be used in the manufacture of other goods.

(iv) A qualifying trade engaged in the repair or maintenance of any goods or materials, not being part of any retail trade.[162]

Allowances are given to companies which incur capital expenditure on the construction or purchase of industrial buildings. Companiesare entitled to the following allowances:

(1) An initial allowance wich has now been abolished.

(2) Writing down allowances are

2% of expenditure incurred from 6th April 1946 to 5th November 1962.

4% of expenditure incurred from 6th November 1962 onwards.

(3) Balancing charge, this will arise where the total allowances given are greater than the adjusted net cost.

(4) Balancing allowance, this will arise where the adjusted net cost is greater than the total allowances given.

Thus, the allowances are given only if the building is an industrial building or structure. So where only a part of a building is used for a qualifying activity then only that part will rank as an industrial building. The expression building or structure is not defined, and in general, an extension or addition to a building is treated as if it were a separate building. A structure embraces such things as: walls, bridges, culverts, tunnels, roads, aircraft run ways, and factory car parks. Costs of site preparation are included in the cost of a building.[163]

Chapter 4: Reference

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"B Ltd has the following results for the accounting periods of twelve months ended on the dates indicated".

	March 31th 1985 £	March 31th 1986 £	March 31th 1987 £
Trading profit/(loss):			
Sched,D Case I	300,000	(480,000)	270,000
Sched,D CaseIII	3,000	4,800	1,200
Unfranked investment income	45,000	45,000	45,000
Chargeable gains (as abated)	---	6,000	1,500
	48,000	55,800	47,700
Total profit before loss relief	348,000	55,800	317,700

Computation of CT according to alternative methods:

Method (1)

	1985 £	1986 £	1987 £
Sched.D Case I	300,000	-----	270,000
Less Loss brought forward			480,000
Loss carried forward			210,000
Sched. D Case III	3,000	4,800	1,200
Unfranked Investment income	45,000	45,000	45,000
Chargeable gains	---	6,000	1,500
Total profit after loss relief, and profits chargeable	248,000	55,800	47,700

Method (2)

	1985 £	1986 £	1987 £
Sched. D Case I	300,000	----	270,000
Less Loss brought forward			424,200
Loss carried forward			154,200
Sched. D Case III	3,000	4,800	1,200
Unfranked investment income	45,000	45,000	45,000

Chargeable gains	---	6,000	1,500
		55,800	
Less Trading Loss set-off agaimst other profit of aaccounting period		480,000	
Balance of loss carried forward		424,200	
total profits, after loss relief, and profits chargeable	348,000	---	47,700

Method (3)

	1985 £	1986 £	1987 £
Sched. D CaseI	300,000	---	270,000
Less Loss brought forward			76,200
			193,800
Sched. D Case III	3,000	4,800	
Unfranked investment income	45,000	45,000	45,000
Chargeable gains	---	6,000	1,500
	348,000	55,800	
Less Trading loss set-off against other profit of accounting period		480,000	
Balanc of loss set-off total profits of preceding pepiod	424,200	424,200	
Balance of loss carried forward	76,200		
Total profit after loss relief, and profit chargeable			241,500

88. Rankin H.C.D., op.cit, P.48.
89. Lewis M., op.cit P.256.
90. S.177 (7) T.A.1970.
91. Ibid, S. 177(8).
92. Ibid, S.255.
93. Ibid, S.177(10).
94. Ibid, S.177(2).
95. Rankin op.cit, P.63.

96. S.177(3), T.A. 1970.
97. The case of Ingram (J.G) and Son Ltd. v. Callagham, (1969) 45 T.C. 151.
98. The case of Golf v. Osborne and Co. (Sheffield) Ltd., (1953) 45 T.c. 441.
99. S. 177 (4) TA1970.
100. Ibid, S.177(5).
101. See SS.252 and 253.
102. Rowes p. op cit, P.189.
103. S.178 of TA1970.
104. Rowes P. op cit, P.187.
105. S. 178(5), TA 1970.
106. Woolf E. and others, op cit, P.129.
107. S.483(b)

> "No relief shall be given under section 177 of this act (relief for trading losses against future trading profits or total profits) by setting a loss incurred by the company in an accounting period beginning befor the charge of ownership against any income or other profits of an accounting period ending after the change of ownership."

108. S.115 of Egyptian Tax Law No.157 of 1981. (in Arabic).
109. Simini J.P., and Grant A.J., Accounting Made Simple, Allen W.H., and Company Ltd, London, 1978, pp.83-87.
110 The case of Egyptian Tax Office v Egyptian Railway, Cases of Egyptian Cessation Courts, Vol.11, p.328. (In Arabic)
111. Helmy A.I., Accounting Problems, Dar Al-Nahdda Al Arabia Cairo, 1963, p.36. (In Arabic). See also, Al Gazzar M.M., Accounting Cost, Maktaba Ain Shams, Cairo, 1973, p. 165. (In Arabic)
112. Bigg W.W., and Langton A.E., Spincer and Pegler's Book-Keeping and Accounts, H.F.L (Publishers) Ltd., London, 1952, pp.64-66.
113. SS.24(3) and 114(3) Law 157, op cit.
114. Cmnd 8189, Para. 192.
115. Leake D.P., Depreciation of Wasting Assets, 4th ed., 1923, p.146.
116. Ayua I.A., The Company Taxation With Particular Reference to Nigeria, Thesis for Ph.D degree Birmingham University, Birmingham, 1979/80, p.145.
117. Cmnd 9474. Tiley J., (1978), op cit, pp.375-381.
118. Parlimenary Debate House of Commons, Vol. 409 col 257-258.
119. Lewis M., (1977) op cit, pp.310-211. See also, S.82(1) C.A.A 1968.
120. Ibid, p.210.
121. S.82(1), C.A.A 1968.
122. Ibid, S.82(3).
123. Rowes P., (1984), op cit, p.91.
124. Lewis M., op cit, p.198.

125. S. 71, CAA 1968.
126. Ibid, S.71.
127. Lewis M., OP CIT, PP.212-214.
128. S. 73 CAA 1968; S. 48(4) FA.1971.
129. S. 254(2) T.A.1970.
130. Old system contained in CAA 1968 Pt. 1 Ch.II.
131. Lewis M, op cip, P.233.
132. The case of *Yarmouth v. France*, (18870 19 QBD, 647.
133. The case of *Caledonian Railway Co. v. Banks*, (1880) 1 TC at P.487.
134. The case of *Hinton v. Maden and Ireland Ltd.*, (1859) All ER 356.
135. The case of *Ben Odeco Ltd. v. Powlson*,(1978) C.D.S TC
136. The case of *Benson v. The Yard Arm Club Ltd.*,(1978) C.D.S. T.C. 408.
137. Beardon D., and others, op cit, P.67.
138. See Table(4.1).
139. S.55 FA 1985.
140. S.45 FA 1971.
141. Ibid. S.44.
142. Tiley J., *Butterworths UK Tax Guide 1986/87*, Butterworths Co. (Publishers) Ltd. London, 1986,P.325.
143. Sch. 8 Para.5 F.A. 1971.
144. S.65(2)(b), F.A 1980.
145. Sch. 8 Para.10, F.A 1971.
146. Sch. 8 paras. 8 and 8B, and 8c wich added bu F.A 1985.
147. S.57 F.A. 1985.
148. Tiley J., (1986) op.cit, P.325.
149. S.44(2)(1) F.A.1971.
150. Op.cit Tiley J., (1986) , pp.325-327.
151. SS.41(1)(a)(b), 42 F.A.1971. Also F.A.1972 S.67(2)(a) and Sch. 28. Pt X II in relation to expenditure incurred after 21 March 1972.
152. S.44(2)(a)(1), F.A.1971.
153. Ibid, S.44(2)(a)(b).
154. Ibid, S44(5).
155. F.A.1970 Sch. 8 Para. 10 as amended by F.A.1976 S.43.
156. Whitehouse C., and Stuart-Buttle E., *Revenue Law Principles and Practice*, 4th Ed., Butterworth and Co. (publishers) Ltd., London, 1986, pp.112-114.
157. F.A.1971 S.45 as amended by F.A 1985, S.55, Sch.14 para.3.
158. F.A.1971, S.49, Sch.8, para.5 as amended by F.A.1985, S.55, Sch.14, para.6.
159. Tiley J., (1986), op.cit P.306.
160. Lewis M. (1977) op.cit, P.222.
161. C.A.A. 1968, S.7(1)(3).
162. The case of *Vibroplant Ltd. v. Holland*, (1982) Stc 164. See also S.75 of F.A. 1982.
163. Lewis M. (1977), op.cit, P.224.

CHAPTER FIVE

TAXATION OF OVERSEAS PROFITS

Chpter Five

Taxation of Overseas Profits

5.1 Introduction

As mentioned earlier a company which is resident in the UK is liable to CT on all its profits wherever arising.[1] A non-resident company is liable to CT only if it trades in the UK through a branch or agency and liability will then be restricted to the chargeable profits from that branch or agency.[2] The words "wherever arising" used in Section 246(1) of Income and Corporation Tax Act 1970 bring into charge overseas profits made by branch or agency trading within the UK. Even if the non-resident company carries on trade in the UK but not through a branch or agency it will nevertheless be liable to tax. Apparently it will be liable to income tax .[3]

In this chapter we shall be discussing the UK tax treatment of overseas profits, the definition of resident and non-resident companies, trading overseas through a branch or subsidiary, considering particularly how double taxation has been mitigated and whether the UK approach can encourage and indeed facilitate economic development in a developing country like Egypt. Also we shall try to examine the taxation of overseas profits provisions.

It is very important to ascertain the residence of a company which lies in the fact that it helps in determining the liability, not only, of domestic profit but also more importantly as far as this chapter is concerned of foreign profits.

5.2 Company Residence

Since income tax originally applied both to individuals and to companies it was perhaps inevitable that residence would be taken as the basis of taxation of companies.

Residence in its normal sense, is the status which establishes the scope of the charge to UK corporation tax. Thus, if a company is resident in the UK in this sense, it will be liable to tax in the UK, under the UK tax system, on its world wide profits. In such circumstance the company cannot be a controlled foreign company (CFC) because it is not resident outside the UK. [4]

The concept of residence of companies seems to establish the following principles:

(1) A company resides "where its central management and control actually abides". In the case of De Beers Consolidated Mines, Ltd. v. Howe Lord Loreburn said: [5]

> "A company resides, for the purpose of income tax, where its real business is carried on... and the real business is carried on where central management and control actually resides".

Also in the case of Unit Construction Co. Ltd. v. Bullock Lord Radcliffe has remarked: [6]

> "this judgement must be treated today as if the test which it laid down was as precise and unequivocal as a positive statutory injunction".

Thus, a company is resident where its controlling board meets and not simply where its directors are resident.[7] So for a company to be non-resident its central control and management of its business must be abide outside the UK. This can be done, for example, by having the directors meetings held abroad, which meetings must be genuine occasions when real business decisions are reached. Conversely, a foreign company whose board of directors meet in the UK and exercise control at such meetings would be resident here even though all of its trading operations were abroad. This test assumes that it is always possible to identify a single country in which the central management and control of a company are exercised.

Secondly, a company may be resident in more than one place. Central management and control of major matters may be divided among two or more countries coupled with some substantial business operations in these other areas so that there is no single central control. The major difficulty lies in reconciling the case of <u>Egyptian Delta Land and Investment Co. Ltd. v todd</u>.[8] The company was incorporated in 1904 in England for the purpose of dealing in and developing land in Egypt. In 1907 the company by special resolution altered its articles of association so that the company should thenceforth be managed and directed entirely from Egypt. The London directors retired and all the subsequent directors were resident in Egypt; all meetings of directors and of the company had been in Egypt; the seal minute books, account book register of transfer and the company bank account were all kept in Egypt. All that remainded in London as required by the Companies Act—were a registered office (which meant simply an address rather than a specific amount of floor area) a register of members and a register of bearer warrants. The case of Swedish Central Rail. Co. Ltd. v. Thompson[9] was distinguishable, as the Special Commissioners decided, and that the mere satisfaction of the requirement of the Companies' Acts could not constitute residence. On the other hand the Revenue contended that if management and control were not the sole test of residence there were carried on in the UK acts of sufficient importance to justify a finding of residence. Rowlatt, J. reversing the Commissioners held that the duties which the law imposed on the company fulfilled the idea of residence, arguing not least from the premise that a company must have a residence in the UK.[10] The Court of Appeal decided unanimously for the Crown, holding inter alia that there was no sufficient authority for holding that the seat and control of the business afforded the only test of residence. Thirdly, or the placed incorporation registration though not of itself a test of residence, may be a factor which if taken into consideration with other factors could lead to a conclusion that the company is a UK resident company,[11] i.e. all English companies would be resident here while foreign companies might also be held to be resident.

In addition , a company can be registered in the UK with a registered office here complying with the other statutory obligations as the position of Egyptian case. The test of residence to be applied in the case of foreign company cannot be different from that applied in the case of a British company. Finally a subsidiary, even the wholly owned subsidiary of a company resident here, is not itself a UK resident company if its board of directors take their own decisions at meetings held overseas as to management and control.[12]

Thus, there are three propositions, which are:

(1) the test of residence laid down in the De Beers case applies to all corporations regardless of the place of registration or incorporation;

(2) a company may be resident in two places; and

(3) a finding of dual residence is not to be made unless the control of the general affairs of the company is not centrally placed in one country but is divided among two or more. It is also clear that residence may be in one country and the company's sole trade carried on in another,[13] and conversely that the mere carrying on of trade in the UK is not sufficiant to establish residence here.[14]

The non-resident company is to be regarded as resident in that territory in which it is liable to tax by reason of domicile, residence or place of management, which means "place of effective management".[15] However, if a non-resident company carries on business in the UK through a branch or agency then it will be liable to UK corporation tax on:

(i) trading profits derived from the branch or agency;

(ii) income from property owned by the branch or agency;

(iii) chargeable gains on assets situated in the UK used for the purposes of the branch or agency.[16]

The tax advantages of being a non-resident company are substantial. Such a company may be a subsidiary of a company incorporated outside the UK and also not resident within the UK. If this is so then there is neverthless a possiblity that the UK company could be deemed by the UK Revenue to be a "dependent agent" of its parent company. If this could be established then the profits of the UK company would be subject to UK corporation tax and the UK Revenue might also seek to subject the profits of the parent to UK corporation tax under section 79 of TMA 1970.

5.3 Overseas income and gain

Foreign income is assessed under four categories which are:

(1) Schedule C for interest received through paying agents.

(2) Profit of a trade carried on partly overseas and controlled from UK by a British company.

(3) Case V of Schedule D if the profits of trade carried on wholly overseas and controlled from abroad. It is immaterial whether the taxpayer is a sleeping or an active partner in the firm. In the case of Sulley v A-G[17] the taxpayer bought goods in the UK for export to America where they were resold by his partner;/the trade was carried on wholly overseas, and so it was within Case V, not Case I. In the case of Ogilvie v Kitton[18] the taxpayer who was resident in Aberdeen was the sole owner of a business of woollen warhousemen carried on by his employees in Toronto. He had the sole right to manage and control his business and although that right was not exercised, it could have been. Therefore, the trade was not wholly overseas.[19]

(4) Case IV of Schedule D covers all interest received on loans made abroad or from sources which are secured on the assets of the person to whom the loan was made, e.g. interest on mortgages or debentures. In all cases the amount to be assessed before IV and V on income chargeable as in (1)& (2) above which would be assessed under those cases if the companies were resident in the UK but excluding income specifically exempt in the hands of non residents.[20]

Where a company wishes to carry on its trade overseas, it may do so by establishing a branch in the foreign country or by establishing a foreign subsidiary company or by other ways such as direct exporting... In these cases the profits will flow back to the UK in the form of dividends, interest which is generally deductible in computing profits, royality payments and in other forms such as payments for services. Where the resident company sets up a wholly owned subsidiary in the foreign country to carry on a trade there, it is a question of fact whether that subsidiary is carrying on its own trade or is simply acting as agent for its parent's trade, case of Apthorpe v Peter Schoenhofen Brewing Co. Ltd.(21) The question depends on who manages the trade and not on who owns the shares, case Kodak Ltd v Clark.(22) As demonstrated below a company is resident where its central management and control abides. The House of Lords held in the case of Mitchell v Egyptian Hotels Ltd(23), and Ferguson v Donovan,(24) that a company resident in the UK could be trading wholly abroad.

Income tax borne by a non-resident company on income which is liable to CT is set off against the CT chargeable.

A non-resident company in the UK is not within the scope of CT S.238(2) T.A.1970.(25) It is liable to UK income tax on income from other sources in the UK excluding income specifically exempt in the hands of a non-resident. The central management and control of its trade or business is or is not exercised in the UK.(26)

5.4 Non-resident companies

A company not resident in the U.K. but carrying on a trade in the U.K. through a branch or agency is liable to corporation tax on:

(1) trading income arising through or from the branch or agency;

(2) income from property or rights used by or held by the branch or agency excluding distribution from U.K. resident companies; and

(3) chargeable gains from assets used for the branch or agency.

Such companies are assessable under Sch.D cases. The basic rule for determining the residence of companies for the purpose of corporation tax is, where its real business is carried on, where the central management and control actually abides. In the case of De Beers Consolidated Mines Ltd. v. Howe Lord Loreburn L.C. said:[27]

> "In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A Company cannot eat or sleep, but it can keep house and do business. We ought to see where it really keeps house and does business."

This rule is embodied for the purposes of that section in TA.1970, S.482(7). A body corporate shall be deemed to be resident or not according to whether the central management and control of its trade or business is or is not exercised in the UK.

5.5 Double Taxation

Double taxation arises whenever any transaction, investment or busines activity involves more than one country. Double taxation is normally caused by the fact that most governments levy tax on income which has its source within their boundaries, and also tax their residents on foreign source income, on either an arising or remittance basis. For example, a person who is resident in Egypt, is subject to tax on his worldwide income wherever it arises. Another cause of double taxation is that various countries differ in their definition of residence and have different rules to determine where income has its source.

The problem affects companies as well as individuals: An example of this would be a company resident for tax purposes, not only in the U.K., but also in another country where the whole of the profits of the company would be subject to tax in both countries.

This section will be devoted to U.K. double taxation relief. Egyptian double taxation relief and tax treaties between developed and developing countries.

Economic and international double taxation

The corporation tax and the personal income tax which are imposed on corporate income creates the so-called phenomenon of double taxation. If corporate income remains in the country of origin, it is taxed twice by the same domestic tax system. It is taxed first under the corporation tax law in the hands of the corporation and, in turn, the distributed part of corporate income is taxed under the personal income tax law in the hands of recipient shareholders. Therefore, the distributed part of corporate income is taxed twice. This phenomenon is called economic double taxation to distinguish it from international double taxation. The latter arises if the corporation and the recipient shareholder do not live in the same country. In that case the corporate income is taxed under the system both of the country of origin, and of destination.

The existence of double taxation may have undesirable effects upon equity and efficiency from both the domestic and international points of view. However, as far as the economic double taxation is concerned, the government takes into account other considerations as well, and chooses a tax system which in the end, may or may not affect, alleviate or eliminate economic double taxation. The subject of international double taxation is dealt either by unilateral provisions by each government separately, or by bilateral provisions between two governments.

5.6 Double Taxation Treaty

Overseas income may be taxed in its country of origin and if UK tax is also chargeable on the same income, the taxpayer is entitled to relief in one of three ways:
Firstly, the UK has a number of double taxation agreements with foreign countries. They differ in details, but generally provide that certain categories of income will be taxed in only one of the countries concerned (usually where the taxpayer is resident). Other income will be taxable in both countries, but with a credit for one amount of tax against the other.[28]
Secondly, if there is no treaty in force, unilateral relief is given from UK under Section 498 of T.A 1970. This takes the form of a credit against the UK tax equal to the foreign tax paid. Thirdly, if neither of the above applies, unilateral relief may be given under section 516 of T.A 1970 by way of deduction of the amount of foreign tax paid from the foreign income which is assessable to UK tax. relief by deduction is less advantageous to the taxpayer than relief by credit.

As far as a company is concerned it needs relief to mitigate the effect of double taxation it suffers, for two types of foreign taxation namely the tax which is charged directly in respect of profits arising abroad, and the tax on dividend income, particularly from its own subsidiaries. The UK has tackled this problem by one of the methods mentioned above.

The objectives of a tax treaty may be classified under various headings:

(1) A treaty aims to achieve capital-export neutrality and international equity. The former aim may be achieved by eliminating international double taxation by creating neutral conditions to facilitate the flow of capital between two or more countries. The withholding tax is used as a device for achieving this purpose. The aim of international equity is achieved by defining the tax base as a means of avoiding discriminatory practices between the contracting countries.

(2) A treaty may enhance the fight against tax evasion and avoidance by the contracting countries. The co-operation of these countries would restrict actions such as, for example, transfer prices which lead to tax evasion and avoidance; and where there is no UK income tax or corporation tax payable against which to claim a credit.

(3) By credit method, income is taxed on a worldwide basis but a credit is granted for taxes paid abroad. The rationale of this method is derived from the public finance principle of horizontal equity. In this way full relief for foreign tax is given as the amount of foreign tax paid is deducted from the similar amount of UK tax payable, so that the total tax burden on income flowing to the U.K. is the greater of the U.K. tax or the foreign tax on the assessable income. This is the normal way by which the UK grants relief for foreign tax levied on the income of UK residents.[29]

Taxes are levied on that income, namely, the corporation tax and the withholding tax of the origin country and personal income tax of the destination country. It is obvious that this method does not fully alleviate international double taxation since the withholding tax levied by the source country is a final tax.

This method is used by a number of continental European countries but the UK only in specific circumstances, for example the remittance basis of taxation.

(4) By taxing the net income after deduction of foreign tax. This is only a partial relief and does not fully remove the burden of double taxation. This method is used in the UK only when granting relief for taxes which do not correspond to income tax or corporation tax such as taxes levied on the basis of payroll or net worth, or to the extent there is provision for

a) relief from income tax or corporation tax in respect of income; or

b) charging the income arising from sources in the UK to persons not resident in the UK; or

c) determining the income to be attributed to persons not resident in the UK and their agencies, branches or establishments in the UK; or

d) granting persons not resident in the UK the right to a tax credit in respect of dividends paid to them by UK companies.

5.7 The needs for tax treaties

In general it is very likely that foreign income will be liable to tax in two countries. Many technical complexities make the problem of international double taxation very complicated.

John Tiley says that it is quite unreal to regard the negotiation of double taxation treaties as an academic search for the ideal system[30] he sees it as a haggle over revenue sharing between sovereign states. Certainly one cannot see the treaty as a search for the ideal system i.e. a system which brings about complete tax neutrality between conflicting or competing tax jurisdictions, but rather as a means of limiting the effects of double taxation.

In the absence of relief against international double taxation the following factors will arise :

(1) The unco-ordinated taxation of the same income impairs economic efficiency and equity among persons and among countries;

(2) Income that arises in one country and then flows to another country, say, business profits, dividends, interest, royalities and so on, is generally taxed by both countries according to their respective laws. If the taxation of such international income by each country is not co-ordinated, a heavier burden may be imposed on that income than on domestic income. The consequences of this are many and generally adverse. At prevailing income tax rates, cumulative taxation of the same income by two countries may be

prohibitive, with a consequent decrease in foreign investment. Alternatively, lack of co-ordination may grant income from foreign investments unintended tax benefits. In either event, the result is a tax-induced distortion of allocation of capital among countries, with a probable loss of efficiency in the world-wide use of capital.

(3) Where a wholly-owned subsidiary corporation organized under the laws of the host country is formed to carry on the business, even the least important business activity undertaken by the subsidiary is subject to tax in the host country. But where the business activity is carried on through a branch a certain minimal amount of business activity, say, a mere warehousing of goods in transit, may fall outside the scope of income-tax of the host country. Where the branch falls under the definition of a permanent establishment, the full income is subject to tax in the host country. In the absence of agreement on the concept or definition of a permanent establishment, a good deal of confusion and misunderstanding can arise between the foreign enterprise and host country as to the tax liabilities in the host country.

(4) Another significant factor is outright evasion of tax which is induced by the fact that a company's books and records are commonly not available from one country to another country in which the company also operates; effective control is only possible if the two countries agree to exchange information, another delicate problem that requires fuller understanding between two governments. Successful tax

evasion in only one of the two countries would also distort capital flow and impair inter-firm efficiency, to say nothing of the loss of revenue to the country concerned, and

(5) Tax-incentive measures adopted by a developing country to attract capital may require tax co-ordination between the countries. For example, an enterprise of a capital- exporting country operating in a developing country through a branch in that country may gain nothing by a tax holiday granted to the branch by the developing country. The income tax law of the capital exporting country (where a tax credit system is used) may unilaterally allow the corporation to diminish its domestic income tax by the account of income-tax paid to the foreign country. Consequently if the foreign country decreases its income-tax to zero, as in a tax holiday, the domestic tax thereupon increases automatically by a corresponding amount. To the extent that the tax incentive measures of a developing country may increase world efficiency in use capital or mitigate an undesirable world-wide distribution of income, economic efficiency or equity may be impaired by the absence of bilateral tax co-ordination that would allow credit for the spared tax or would in some other way allow the tax incentive of the developing country to be effective.

In addition, the main purposes of the double taxation treaty will be revealed as follows:

(1) To reduce or eliminate the effect of double taxation on income or gains. It can also be seen as implying a principle of neutrality, in that one purpose of the relief is

to avoid discrimination as between domestic and foreign investment.

(2) Among the major impediments to free capital and technology flows are the rules of a national tax system which are in conflict with other systems. Tax treaties seek to eliminate, or at least to mitigate the impact of these impediments by bringing about harmonisation and can therefore be seen as instruments of high policy.

(3) Tax treaties also serve other policy objectives, i.e. the prevention of tax avoidance and tax evasion, and the fostering of international co-operation. A feature of the treaties is provision for consultation and administrative assistance between the tax authorities of the contracting state [31] and

(4) To meet the needs of less developed countries in relation to developed countries in their need for revenue and for foreign exchange. The danger is that the less developed countries, in their need for revenue, impose statutory rules (taxes and exchange rules) which are so burdensome that they inhibit foreign investment. Developed countries consciously seek, by treaty, to limit the level and scope of such penal taxes. Needs of underdeveloped countries can therefore be met by agreeing to witholding tax rates which do not result in outflow of revenue from the underdeveloped to the developed countries.

The effect of a tax treaty in alleviating international double taxation

In general, irrespective of what principles are followed by the sourceand residence country, it is likely that overseas income will bear tax in two countries. All these technical complexities make the problem of international double taxation too complicated. In the absence of relief against international double taxation four charges arise in a subsidiary-parent relationship as follows:

(1) The subsidiary is liable to corportion tax in the state of origin of its trading profits;

(2) When the subsidiary pays dividend to its parent those dividends are liable to tax in the country of origin;

(3) The parent is liable to corporation tax in the destination country on the dividend received by its subsidiary; and

(4) The dividend paid by the parent out of this income is subject to the destination countries pesonal income tax in the hands of the recipient shareholders.

The amount of foreign tax to be included in the overseas assessment varies in the withholding tax which will be included where the UK company can claim credit for the underlying tax.[32] When UK recipients received dividends from overseas company they can be entitled to relief for the underlying tax either under the specific terms of double taxation agreement with the overseas county or to unilateral relief. Where relief is available under a double tax agreement it is necessary to look at precise wording of the article in the agreement to see the basis on whch it is available. However, in practice it will normally be found that the unilateral provisions are as generous as any of the relief available under the agreements. For instance, it may be found in an agreement that the required levelof ownership needed by the UK company in the foreign company in order to obtain relief for underlying taxes may be as high as 25%. In such circumstances it will always be open to the UK company to rely on the unilateral provisions which only require a 10% ownership.(33) Thus unilateral relief for underlying tax is claimable where a dividend is paid to a UK company which either controls directly or indirectly, or is a subsidiary of a company which controls not less than 10% of the voting power in the company paying the dividends.(34)

To ascertain the underlying tax period for which dividends have been paid by the overseas company must be determined. Therefore, it is provided that dividend is paid for a specified period the underlying tax for the purposes of computing the credit is the tax on profits of that particular period.(35) If the dividend is not paid for a specified period but it is paid out of specified profits the underlying tax for the same purpose is the tax on those proffits. Where the dividend is paid neither for a specified period nor out of specified profits, such dividend is deemed to have been paid out of the profits of the last accounting period for which the accounts of the compamy were made up prior to the date when the dividend become payable. If the total of dividend exceeds the profits which available for distribution in any of the aforementioned period, the excess is deemed to have been paid out of the immediately preceding accounting period, and so on. It is necessary to declare that if any investment in foreign company of less than 10% of the voting power the relief for the underlying tax is not granted. For example, A UK company receives a dividend from an Egyptian company. The Egyptian Profit, suppose, LE100, Egyptian tax rate is 40%, Egyptian withholding tax is 15%, and UK corporation tax rate is 35%. Column A (in the next page) shows the position if the UK company qualifies for underlying tax relief and column B the position if it does not qualify.

	A	B
Egyptian Profits	100	100
Egyptian CT (40%)	40	40
Dividend paid to UK company	60	60
Egyptian withholding tax (15%)	9	9
Received by UK company	51	51
Gross up for foreign taxes to arrive at UK taxable income	49	9
UK taxable income	100	60
UK corporation tax (35%)	35	21.0
Less relief for foreign taxes	35	9.0
UK tax payable	--	12.0
Net income to UK company	51	39.0

5.8 Types of Double Taxation Treaty

There are three ways used to alleviate international double taxation:

(1) Each country by itself through unilateral provision irrespective of whether any reciprocal provisions are granted by any other country, attempts to reach this goal.

(2) Two countries come into agreement to follow the same policy regarding this problem and

(3) International organizations like O.E.C.D. and E.E.C. through multilateral tax treaties attempt to relieve international double taxation.

The relief is provided in two forms, either in the way which the destination country treats income earned abroad, namely, it adopts the exemption, credit or deduction method, or the origin country levies a low rate of withholding tax. It is worth mentioning that all international double taxation treaties reduce the rate of withholding tax rather than the rate of C.T.

Under the exemption method, income earned abroad is exempt from corporation tax at home. However, there are three taxes levied on that income, namely, the C.T. and the withholding tax of the origin country and personal income tax of the destination country. It is obvious that this method does not fully alleviate international double taxation since the withholding tax levied by the source country is a final tax. This method violates the ability to pay principle since it is based on a territorial basis and it is consistent neither with international nor national equity.

Under the credit method, income is taxed on a world wide basis but a credit is granted for taxes paid abroad. The rationale of this method is derived from the public finance principle of horizontal equity. Contrary to the previous method it is consistent with the ability to pay approach and treats individuals equally under the circumstances on an international basis, namely it achieves international equity. In addition to that the provision of the credit method secures equal treatment between investment at home and abroad.

Finally under the deduction method, income is taxed on a worldwide basis but taxes paid abroad are considered as expenses and are deducted from the tax bases as such. This method involves equal treatment of individuals in a domestic level, namely it achieves national equity.

(I) <u>Credit V. Deduction</u>

The legislation does provide in fact for the taxpayer to take double tax relief by way of deducting the foreign tax from the income to be taxed rather than by crediting the foreign tax against the U.K. tax liability on the income.
In normal circumstances, relief by deduction in this matter is likely to be less beneficial than relief by credit, but there are circumstances, particularly where substantial foreign tax will go unrelieved, where it may be more beneficial to take relief by deduction. It is not permitted to take part of the relief by way of deduction and part by

credit in relation to the same source of income. The following two examples are shown. Where the first gives a situation where relief by credit is more beneficial the other takes relief by deduction favouring the taxpayers.[36]

Example (1):

A United Kingdom company operates through an overseas branch which generates profits of £20,000. Foreign tax amounts to £6,000 and there is a foreign branch profit remittance tax of £500.

	DTR by deduction	DTR by credit
Trading income	£20,000	£20,000
Deduct foreign taxes	6,500	-
Taxable income	13,500	20,000
Corporation tax at 40%	5,400	8,000
Less double taxation relief	-	6,500
	£ 5,400	£ 1,500

Example (2)

The same facts are assumed as in Example (1) but this time the total tax paid is £12,000 and the company has a U.K. trading loss of £9,000

	DTR by deduction	DTR by credit
Trading income (£20000-£9000)	£11,000	£ 11,000
Deduct foreign tax	12,000	-
	--------	--------
	(1000)	11,000
	========	========
Corporation tax at 40%	-	4,400
Less double taxation relief (restricted)		4,400
	---------	--------

Limitation on the amount of credit for income and corporation taxes

The legislation provides a limit on the foreign tax credit available for income and corporation taxes as follows:

(1) Limitation on the amount of credit for income tax

The amount of the credit allowed to any person in the year of assessment is not to exceed the difference between the income tax which will be borne by him for the year (a) if he was charged a tax on his total income for the year and (b) if he was similarly liable to tax on the same income but excluding the foreign income on which credit is to be allowed, e.g. if a UK resident has taxable income in the UK of £20,000 per annum and receives £5,000 from a foreign employment which is liable to foreign tax, the credit for any foreign tax does not exceed the amount of UK tax on £25,000 less UK tax on £20,000 as following (assuming the effective UK tax rate is 30%, he has to pay tax at 20%)

Foreign income	£ 5,000
Less 20%	1,000

Foreign income assessable in UK	4,000
UK income	20,000

UK assessable income	£24,000
	========
UK income tax at 30%	£7,200

Less double taxation relief (maximum 30% x £4000 = £ 1200)	1,000
UK tax payable	6,200

If foreign tax rate is 40% instead of 20% the credit for double taxation relief will be:

Foreign income	£ 5,000
Less 40%	2,000
Foreign income assessable in UK	3,000
UK income	20,000
UK assessable income	£23,000
UK income tax at 30%	6,900
Less double taxation relief(maximum 30% x £3000 = £900)	
Actual suffered £2000 - Unrelieved foreign taxes £1100	900
UK tax payable	£ 6,000

This example demonstrates that the foreign tax credit available to taxpayers in the U.K. is equal to the full amount of the foreign tax suffered provided that it does not exceed the U.K. tax payable on the same income. The maximum credit therefore, wil always be the lesser amount of the actual foreign tax suffered, and the equivalent U.K. tax liability.

(2) Limitation on the amount of credit for corporation tax

The credit limitation that applies for income tax purposes is extended to corporation tax, and it is provided that the amount of the credit on tax to be allowed against UK corporation tax in respect of any income does not exceed the UK corporation tax attributable to that income. Following the introduction of the imputation system of corporation tax, an additional limitation was introduced on 1st April 1973. For example, a UK company carries on trade in the UK and also through a branch in Egypt. The UK business realises a profit during the year of £50000 whilst the Egyptian branch generates £20000 profit but suffers Egyptian tax rate 30%

UK assessable income - made up of		£70,000
UK £50,000 + Egyptian £20,000		
		=======
UK tax rate at 40%		28,000
Less Double tax relief - Egyptian tax 32% x £20000		
	= 6400	
restricted to 40% x 20000	8000	6,400

UK tax payable		21,600
		========

Assume Egyptian tax at 45% instead 32%

UK assessable income - made up of £ 70,000

UK £50000 - Egyptian £ 2000

		=========
UK tax rate at 40%		£ 28,000
Less Double tax relief Egyptian tax 45% x 2000		
	= 9000	
restrict to 40% x 20000	8000	8,000

UK tax payable		£ 20,000

The above example indicates that the credit limitation for

Corporation tax purposes is not to exceed the U.K. corporation tax while the Egyptian tax of £1000 (900-800) is unrelieved.

5.9 UK Double Taxation Relief

To mitigate the effect of the double taxation it suffers, a company needs relief for two types of foreign taxation, namely the tax which is charged directly in respect of profit arising abroad, and the tax on dividend income, particularly from its own subsidiaries. The UK has tackled this problem firstly by the conclusion of double taxation agreements with each of a number of other countries, and secondly by the great amount of unilateral relief which is made available to a UK resident in respect of overseas tax not covered by any subsisting bilateral agreement between the U.K. and the country imposing the tax.

The UK has double taxation treaties with about 74 countries and most members of the Commonwealth. There are variations among the agreements. In general the double taxation treaties specify in detail the description of the various taxes in respect of which credit can be claimed under each particular treaty. Thus a number of treaties provide such reliefs as the exemption of a particular sort of income in one country; the using of tax levied in one country as a credit in another; and the imposition of tax at a special low rate in the country of source which is used as a credit in the country of residence.(37)

As for unilateral relief, credit is allowed for foreign taxes imposed on income, provided that such taxes correspond to income tax or corporation tax in the U.K., whether levied by a sovereign government or under the law of a province, state or other part of a country, or even by a municipality of local authority.[38]

In general the effect of the scheme of unilateral relief is the same as that provided by the double taxation agreement relief. Unilateral provisions have been brought into line with the treaties: Unilateral relief is therefore available only in two situations, first where there is no double tax treaty with the country of source, and secondly where there is a double taxation treaty which does not cover a particular tax.[39]

U.K. companies, as well as shareholders are therefore allowed to claim unilateral credit for directly imposed foreign tax or taxes withheld at source on dividends paid by foreign companies.[40] Such tax must represent taxes which neither the foreign companies nor the recipients would have borne if the dividends had not been paid. This is a relief that can enhance the competitiveness of UK companies doing business abroad with other foreign companies.

After this treatment of the U.K. approach to the problem of interntional double income taxation it remains now to consider in some detail the double tax relief in respect of the direct or withholding tax and the 'underlying tax' on overseas dividends received by UK taxpayers. It is perhaps necessary to be reminded here that such relief can be granted either under the specific terms of a double taxation treaty or under unilateral provisions.

The direct, or withholding tax is the tax that the foreign company has paid on the dividends it declared under the tax laws of its country of residence. The relief for this tax is given by calculating the UK tax liability on the amounts of the dividend (before deducting the direct, or withholding tax)and then deducting from the liability so calculated, the amount of the direct or withholding tax.[41] Thus, where a UK company receives loan interest from overseas which has been subject to a withholding tax by the foreign country, it can set off this interest against its corporation tax liability. The overseas company too, may be entitled to some relief on the interest payments it has made, as such interest is normally deductible as business expenses. It will therefore be seen that the total tax burden of both the payer and payee company would be less than if dividends were paid. In addition to this, many treaties usually provide for low withholding taxes on interests, or even complete exemption. However, where the rate of interest payable is in excess of the commercial rate, especially if the two companies are related, they may stand the danger of forfeiting this special treatment. A United Kingdom company can also claim credit for direct or withholding taxes on income received for the use of patents, trademarks, copyright, know how etc.

A UK recipient of dividends may be entitled to relief for the underlying tax, either under the specific terms of the double taxation agreement with the overseas country, or to unilateral relief. In the case of unilateral relief, certain shareholding tests must be met before it will be available. Thus, unilateral relief for underlying tax is claimable where a dividend is paid to a UK company which either controls directly or indirectly, or is a subsidiary of a company which controls not less than 10 percent of the voting power in the company paying the dividend, S.498(3)(4), of ICTA 1970, as amended by FA 1971, S26. It can thus be seen that it is of no consequence where the credit for underlying tax is claimed under the unilateral provisions whether the requisite percentages of shareholding is owned directly or indirectly. This will benefit a U.K. parent company with varying percentages of shareholding in subsidiaries that trade overseas in a particular region.

To alleviate the strictness of the 10 percent rule it is further provided that even if the percentage is below 10 percent, the credit may still be claimed if the U.K. company had previously owned 10 percent of the voting power of the foreign company, and this has been reduced below that percentage through no fault of the U.K. compny S.43 (1) of FA 1972.

5.10 Egyptian double taxation treaty

Usually the accepted device for eliminating double taxation is the conclusion of bilateral treaties between capital-exporting and capital importing countries. This device helps to a great extent in encouraging investment in the developing countries generally. Since 1960s there has been an increasing number of double taxation treaties, with the distinctive charactristic of the creation of incentives for investment in developing countries.[42] As the developed countries have extensive investments in the developing countries, they practically bear the entire financial burden resulting from double taxation treaties.

Egypt has signed treaties for the avoidance of double taxation with the UK and about fifteen other countries. All of these treaties are in force. These conventions are obviously of central importance to individual companies' calculattions of the financial advisability of doing business in Egypt, and vary according to relationship between the home country's tax structure and the Egyptian tax system. In order for a company based in one country to be taxable in the other country it must have "permanent establishment" in that other country as defined by the various treaties.

5.11 Egypt/U.K. Double Taxation treaty

The Government of the Arab Republic of Egypt and the Government of Great Britain and Northern Ireland wanted to create favourable conditions for greater economic co-operation between them, and in particular for investments by nationals and companies of one state in the territory of an other state.

Recognising the encouragement present under reciprocal international agreements on double taxation, the Egyptian Authority attempted to make some progress towards ending double taxation between Egypt and other countries.

At 25 April 1977 the President of Egypt signed the convention between Egypt and Great Britain to prevent or at least to alleviate double taxation and from that time this convention came into force.[43]

Under this convention with Great Britian, certain trading profit not arising through a permanent establishment, pensions and the earnings of temporary business visitors are subject to certain conditions to be taxed only in the country of the taxpayer's residence. Shipping and air transport profit are taxed only in the country in which the place of effective management is situated. Government salaries and pensions are normally taxed by the paying government only. The remuneration of visiting teachers and certain payment made to visiting students are to be exempt in the country visited.

Where income continues to be taxable in both countries, the convention provides for relief from double taxation to be given by the country of the taxpayer's residence, except where the taxpayer is a UK petroleum company. The credit to be given in the UK for tax payable in Egypt is to include credit for tax spared under certain provisions of Egyptian Law.

Where a UK Company pays a dividend to a resident of Egypt, the UK tax is limited to 20 percent of the dividend. Where an Egyptian Company pays a dividend to a resident of UK Egypt retains the right to impose certain taxes in full, but a further tax withhold from dividend paid to individuals is limited to 20 percent if the beneficial owner of the dividend is an individual who is a resident of the UK

The rate of tax in the source country upon interest and royalities flowing to the other country is in general not to exceed 15 percent. Interest on loans guaranteed by the UK Export Credits Guarantee Department will be exempt from tax in Egypt.

There is provision for the taxation of capital gains on immovable property (and on shares in a company whose assets consist mainly of immovable property) by the country in which the property is situated. Capital gains arising from the disposal of other movable property are normally to be taxed only in the country of the taxpayer's residence, unless they arise from the disposal of assets of a permanent establishment or fixed base which the taxpayer has in the other country.

There are also provisions safeguarding nationals and enterprises of one country against discriminatory taxation and consultation between the taxation authorities of the two countries.

The Convention takes effect in the UK for the tax year which begins in April 1977 and subsequent years.

The Convention shall apply to persons who are resident of one or both of the contracting states.[44]

The taxes which are the subject of this convention are:

a) In the UK of Great Britain and Northern Ireland:

(1) the income tax;

(2) the corporation tax and

(3) the capital gains tax.

b) In Arab Republic of Egypt.

(1) the tax on income derived from immovable property including the land tax, the building tax and ghaffer tax.

(2) the tax on income from movable capital

(3) the tax on commercial and industrial profits

(4) the tax on wages, salaries, indemnities and pensions

(5) the tax on profit from liberal professions and all other non-commercial professions

(6) the general income tax, and

(7) supplementary taxes imposed as a percentage of taxes which are the subject of this convention.

This convention shall also apply to any identical or substantially similar taxes which are imposed by either contracting state after the date of signature of this convention in addition to, or in place of, the existing taxes. The competent authorities of the contracting state shall notify each other of substantial changes which are made in their respective laws.

Permanent Establishment

Article 5 of the Egypt/UK treaty defines the term 'permanent establishment' as a fixed place of business which the business of the enterprise is wholly or partly carried on. The term permanent establishment specifically includes a place of management; a branch, an office, a factory, a workshop, a farm or plantation, premises used as a sale outlet, a mine, oil well or oil field, quarry or other place of extraction of natural resources, an installation or structure used for the exploration of natural resources, and a building site or construction or assembly project which exists for more than six months.

Certain matters are deemed not to be permanent establishments such as:

a) the use of facilities solely for the purpose of storage, display of delivery of goods or merchandise belonging to the enterprise

b) the maintenance of a stack of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise.

c) the maintenance of stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

d) the maintenance of fixed place of business solely for the purpose of purchasing goods or merchandise or for collecting information for the enterprise, and

e) the maintenance of fixed place of business solely for the purpose of advertising for the supply of informtion, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise.

The definition of a concept of a permanent establishment is necessary to determine the rights of a contracting state to tax the profit of an enterprise of another contracting state.

Because this test does not apply to a subsidiary company which would normally be taxed as a separate legal person the Article 9 of the Egypt/UK treaty defines the term 'joint venture' as follows: Where (1) an enterprise of contracting state participates directly or indirectly in the management, control or capital of an enterprise of the other contracting state; or (2) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting state, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of the enterprise and taxed accordingly.

Article 7 of the Egypt/UK treaty provides that the profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state but only so much of them as is attributable to that permanent establishment.

Where an enterprise of a contracting state carries on business in the other contracting state through a permanent establishment situated therein, there shall in each contracting state be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment.

In the determination of the profits of a permanent establishment there shall be allowed as a deductions expenses of the enterprise (other than expenses which would not be deductible if the permanent establishment were a separate enterprise) which are incurred for the purpose of the permanent establishment including executive and general administrative expenses so incurred, whether in the state in which the permanent establishment is situated or elsewhere.

No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

Where profit includes items which are dealt with separately in other articles of this convention, the provision of these articles shall not be affected by the provisions of this article.

Finally, the term 'profits' as used in this Convention includes, but is not limited to, income derived from banking, manufacturing, mercantile, insurance, agricultural, fishing, or mining activities. The operation of ships or aircraft, the furnishing of services, the rental of tangible personal (movable) property, and the rental or licensing of cinematograph films or films or tapes used for radio or television broadcasting, such terms do not include the performance of personal services by an individual either as an employee or in an independent capacity.

5.12 <u>Elimination of Double Taxation According to Egypt/UK Treaty</u>

Article 22 of Egypt/UK treaty provides that (1) subject to the provision of the Law of the UK regarding the allowance as a credit against UK ax of tax payable in a territory outside the UK (which shall not affect the general principle hereof).

(a) Egyptian tax payable under the Laws of Egypt and in accordance with this convention, on profits, income or chargeable gains from sources within Egypt (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any UK tax computed by reference to the same profit, income or chargeable gains by reference to which Egyptian tax is computed.

(b) In the case of a dividend paid by a company which is a resident of Egypt to a company which is a resident of the UK and which controls directly or indirectly at least 10 percent of the voting power in the company paying the dividend, the credit shall take into account (in addition to any Egyptian tax for which credit may be allowed under the provisions of sale paragraph (a) of this paragraph) the Egyptian tax payable by the company in respect of the profits out of which such dividend is paid.

Provided that this paragraph shall not apply to a company which is a resident of the UK and is a petroleum company as defined for the purposes of Schedule 9 to the Oil Taxation Act 1970 (2) Where a resident of Egypt derives income which, in accordance with the provisions of this Convention, may be taxed in the UK, Egypt shall allow as a deduction from the tax on the income of that person an amount equal to the tax paid in the UK. Such deduction shall not however exceed the part of the tax, as computed before the deduction is given, which is appropriate to the income derived from UK. Where such income is a dividend paid to a company which is a resident of Egypt and which directly or indirectly controls at least 10 percent of the voting power in the company paying the dividend the credit shall take into account the UK tax payable by the company in respect of the profits or income out of which the dividend is paid.

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CHAPTER SIX

TAX AVOIDANCE AND TAX EVASION

Chapter Six

Tax Avoidance and Tax Evasion

6.1 Introduction

In the last chapter we considered the UK tax treatment of overseas income and the legal position of double taxation treaties in both UK and Egypt. In this chapter we look at problems of tax avoidance and evasion in both countries. We will discuss in more detail this phenomenon and the serious implications it has for government policy. We will also attempt to make clear both the definition of, and distinction between, avoidance and evasion. Results of tax avoidance and tax evasion will be given.

Under the Egyptian tax system it is very difficult to gather enough useful data and information about tax avoidance and tax evasion, neither do Egyptian tax laws define the concept of tax avoidance or tax evasion.
In addition a distinction is not made between tax avoidance and evasion by any administrative regulation, and I am not aware of any court decisions which set forth a clear distinction between the two concepts. Therefore in this chapter we can give general ideas about the phenomenon in Egypt gathered from different journalistic reports, which give an indication of the frequency of tax avoidance and evasion which is nowadays widespread. We shall attempt to look at the way in which problems of tax avoidance and evasion have been dealt with, in relation to the company tax system in the UK. It is only too evident that many people

exercise great ingenuity in finding ways to minimise their tax liabilty. In the case of The Duke of Westminster v. IRC[1] the covenant was a single transaction, but its sole purposes was the avoidance of income tax and it was only entered into on the 'understanding' that the gardeners would not seek to claim their wages. The object of the scheme was to make servants'wages deductible in arriving at the Duke's total income by paying them by deed of covenant. Although there was no binding agreement to that effect, it was accepted that so long as payments were made under the covenant they would not claim their wages.

The Westminster case helped to provide the legal basis for tax avoidance schemes until Lord Wilberforce, in Ramsay v IRC[2] sowed the limits of the principle in the earlier case. There is now, in effect, a new approach in applying the law to tax avoidance schemes although it is not yet clear how far the new approach goes. It is clear however that present judicial attitudes to tax avoidance are very different from those prevailing in the 1930s. In the case of Furniss v. Dawson, Lord Roskill considered that;[3]

> "the ghost of the Duke of Westminster has haunted the administration of this branch of the law for too long."

The emphasis on a new approach was reiterated, most notably by Lord Scarman in the case of Furniss v. Dawson in which a shareholder wished to sell his stake in company A to company C. He followed what Lord Brightman called:[4]

> "a simple and honest scheme which merely seeks

to defer payment of tax until the taxpayer has received into his hands the gain which he has made."

Also In Ramsay Lord Wilberforce expounded the new approach to avoidance schemes and sought to explain the decision in Westminster's case. He said:(5)

"While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer from to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax, or a tax consequence, and if that emerges from a series, or combination of transactions, intended to operate as such, it is that series or combiation which may be regarded."

The importance of this approach is first, that it enables one to explain the existence of company B and second that it is much wider and more flexible than the simple, almost mechanistic, excision approach of Lord Brightman. Lord Bridge's speech was concerned with a wide approach, he said:[6]

> "When one moves from a single transaction to a series of interdependent transactions designed to produce a given result, it is, in my opinion, perfectly legitimate to draw a distinction between the substance and form of the composite transaction without in any way suggesting that any of the single transactions which make up the whole are other than genuine...".

Finally the Westminster's result of the decision of the House of Lords was that the tax liability of the Duke was reduced from what it might otherwise have been if he had not entered into, and complied with, certain deeds of covenant.[7]

6.2 Definition of Tax Avoidance and Tax Evasion

What, and where, is the border line between the forbidden (tax evasion) and the permissible (tax avoidance)? This is a fundamental question posed by modern society.

In earlier times, the answer was simpler. The criminal law was the basic arbitrator on the distinction between dishonesty and cleverness. Nowadays, these two notions intermingle at some points into a grey area where reprobation is counter-balanced by administration, affording at the same time a challenge to talented, but fair lawyers as well as causing some exasperation in the time-worn opposition between administrations and taxpayers.(8)

In the spring of 1980 Goldsmith J.C. conceived the subject of tax evasion and tax avoidance as an interesting topic for discussion among members of the Committee at the Berlin Conference that autumn.(9) The discussions about those terms took place in Berlin and were continued in the meeting in Budapest in October 1981. The meetings provided a useful forum for lawyers experienced in the tax systems of different jurisdictions to get together and examine what is now a very topical issue. There is no doubt that we are moving into a stage in almost every one of the countries represented at the meetings where the 'game' has reached a critical stage between the professional tax lawyers and accountants on behalf of the taxpayer and the tax administration on behalf of the government.

The terms tax avoidance and tax evasion are not defined in the UK Tax Acts but are normally taken to mean:

Tax Evasion means transactions or schemes which are unlawful, relying for their effectiveness in avoiding tax on non-disclosure or wrongful disclosure or false statements.

Tax Avoidance means transactions which are entered into to avoid or minimise tax, and, however artificial are real transactions and within the tax law.

In relation to tax evasion, the degree of culpability can be very important and this will often depend on the intention of the taxpayer in making an incorrect statement or omitting some income from or adding imaginary expenses on his tax return.

As quoted from Arthur Seldom[10] Adam Smith said:

> "Every tax ought to be so contrived as both to take out and to keep out of the pocket of the people as little as possible over and above what it brings into the public treasury of the state."

Adam Smith's canon of certainty[11] is possibly a most elusive test to satisfy. A general difficulty with taxation as a method of financing services is that it is almost impossible to discover who eventually pays many or most individual taxes. The task of identifying the taxpayer rests on the economist's distinction between impact and incidence. Legislation usually cannot proceed much beyond identifying taxpayers on whom the taxes are levied but do not know where their taxes ultimately come to rest. The tax buck is passed on from stage to stage in economic relationships. If the demand for taxed product is elastic, the producer who is taxed cannot pass any or much of the tax to the next stage, if the demand is inelastic, so that buyers will go on buying if the tax is added, it will be passed on. For example a tax on petrol can ultimately be paid by disabled drivers.[12]

It is clear that there is a general agreement that tax avoidance and tax evasion are widespread and important, though difficult or impossible to measure quantitively; that tax avoidance and evasion have been increasing in recent decades; that their increase is at least as a result of the increase in taxation, but that they would diminish only slowly if taxes were cut. Bracewell-Milnes said:[13]

> "There is a general agreement that tax avoidance and evasion are similar economically but dissimilar morally and politically: tax avoidance is legal and tax evasion is illegal. It is the economic similarity that constitutes the principal justification for the coinage 'evasion'; but the use of this mongrel word assists those who attempt to blur the moral and political distinction between avoidance and evasion and thus imply that avoidance are dishonest."

In the UK, the annual reports of the Board of Inland Revenue disclose how much 'back-duty' has been recorded and the number of assessments involved. Between 1914 and 1919 tax recoveries rose from £229,600 to £1,216,000 - a five-fold increase, which also reflects the scale of inflation during the first World War. Twenty years later the corresponding figure was £3,131,000. By 1959 recoveries were over £18mn but declined to the some £13mn in 1968. The decline was almost certainly due to increased staff recommended by the 1955 Royal Commission.[14] In the Budget of 1965 Mr Callaghan said:[15]

> "We promised to tackle the whole problem of avoidance; and this will link with our general theme of getting rid of the inequalities that have grown up from a misuse of the tax system. A lot of tightening up needs to be done. I cannot cover the whole ground this year, but I propose to make a start."

By 1970 the number of back-duty cases had fallen to 8,500, compared with around 10,000 in most of the preceeding years, and total recoveries plus penalties amounted to more than £11mn. In 1970 the yield from income tax was over £14,000mn, thus under- payment of income tax deducted by Revenue represented less than one-tenth of 1% of the total yield.[16] In 1973 the amount written off as unrecoverable increased to reach a figure of £20 mn[17] in 1972. In 1977 recoveries were still under £40,000mn, an increase which, if allowance is mde for inflation, suggests that the revenue's efforts to contain evasion have not grown to the same extent as has the suspected amount of evasion.

6.3 Discrimination between tax avoidance and tax evasion

Within tax evasion proper a distinction is some time made between the less serious offence of omission, such as failure to submit complete tax return, and more serious offences, like false declarations, fake invoices, etc. . In most countries tax evasion is usually quite unequivocal, although in a few countries, where the courts prepared to take the view that the law is already broken if it can be shown that its spirit or the intention of the legislation is infringed, the distinction between tax avoidance and evasion may not be altogether meaningful. For most countries the difficulty is not so much of distinguishing between the two terms but rather of delimiting what is to be covered by tax avoidance.[18]

As mentioned before there is a general agreemment that tax 'avoidance' 'evasion' is similar economicaly, moreover Henry Simons considered them two words for one meaning. He said:[19]

> "...or avoidance" if one does really prefer that term for "legal evasion".

Lord Houghton does not like the term 'evasion' and prefers to keep the distinction between avoidance and evasion clear. Professor Lewis said:[20]

> "A clear distinction is, however, to be drawn between 'tax avoidance' and 'tax evasion'. In a tax avoidance scheme a taxpayer is seeking to order his affairs by legal form so as to minimise his tax liability, and in so

doing he might be either successful or unsuccessful. Tax evasion, on the other hand, involves the minimising of a person's liability to tax by means, for instance, of omissions from returns of income, mis-statements or even fraud, and the tax acts provide for penalties where persons fail to make returns of income or capital gains, or make incorrect return."

In the case of Lord Vestey's Exors. v. I.R.C. Lord Normand said:[21]

"Tax avoidance is an evil, but it would be the beginning of much greater evils if the Courts were to overstretch the language of the statute to subject to taxation people of whom they disapproved"

Tax avoidance is legal while the tax evasion is illegal. Tax avoidance and evasion are of great significance not only economically, but also politically, socially and morally.

Tax avoidance and tax planning

It is possible to reduce or remove tax liability by perfectly acceptable tax planning e.g. by choosing among tax reliefs and incentives the most advantagous route consistent with normal business transactions, or refraining from consuming a tax product, and it is clearly not the intention of governments to combat activities of this kind.

Tax planning can be considered as the designing of a plan, usually for the long term, to decrease or limit tax.

The more objective a definition of tax avoidance is used, the sooner tax planning will be synonymous with a method of tax avoidance.

"Tax planning" means transactions which are permissable. Hence tax planning will cover transactions which are in accordance with rational thinking and business behaviour in this field. To describe tax planning or abstention from consumption as 'tax avoidance' is, however, to strain the meaning of language, and the governments tend to take an operational approach toward tax avoidance to cover those forms of tax minimisation which are unacceptable to governments. A wider definition of tax avoidance which cover all forms of reducing one's tax liability, could be used and a distinction made between 'acceptable' and 'unacceptable' avoidance. This is only a question of semantics, because under either definition, the same problems of identification arise.(22)

The scope of what is considered as tax avoidance may differ from one country to another depending not only on the form a particular scheme may take, but also on attitudes of governments, parliament, public opinion and the courts,which may themselves change within one country and over time.

In The UK there is no distinction between tax avoidance and tax planning, since neither is defined.(23) The tax practitioner would probably say that tax planning could be described as arranging a commercial transaction so as to minimise the incidence of taxation, whereas tax avoidance is the setting up of a transaction solely for the purpose of avoiding taxation. On the other hand, the Revenue Officer would make no distinction between the two.

4.6 Tax Avoidance and the Company Tax system

The problem of tax avoidance in relation to Company Tax systems stems basically from the fact that the legal personality of companies is usually abused in order to escape or reduce the tax otherwise payable. Thus, one can create a legal entity in the form of company or a trust which may in its turn own a company mainly for the purpose of diminishing his otherwise taxable income. As the Royal Commission of 1955 has explained.[24]

> "It is important to ascertain who is the real owner of each part of income [for the purposes of tax liability]. In some respects the legal system is inadequate to serve as a final determinant upon the question of real ownership if by real ownership we understand the effective control of the enjoyment and disposition of property. The complications introduced by the separate personality attributed to a corporation afford an obvious instance. For , but for the effect of special tax provisions, a man might transfer his land or business or investments to a corporation which he had formed and of which he owned virtually all the shares and yet maintain that the accruing income must be taxed as that of

the corporation and had no connection with his own income for purposes of income tax or surtax".

Therefore, the company can completely avoid tax on part or all of its profits through the transfer of its profits in terms of management fees, royalties, patents, services charges, interest payments, and rentals.

It can be seen that the problem of tax avoidance is an important issue particularly in respect of companies and one that needs an urgent solution if the government is not to be deprived of the required revenue to meet the wider requirements of national policy objectives. The British Courts are not universally agreed on the legal consequences of tax avoidance schemes. There are some judges who maintain that tax avoidance is not a moral or a legal issue, that it has been expressly prohibited by a statute in unambiguous terms and are in the absence of such statute, prepared to uphold its validity. In the case of I.R.C v. Fisher's Executors(25) involving a limited company with large undistributed profits which had resolved to capitalize part of these profits and to distribute them pro rata among its ordinary shareholders as a bonus in the form of 5% debentures stock, the whole aim being to prevent the shareholders from paying super tax on the bonus, it was held that the bonus paid in debenture stock was not income in the hands of the shareholders and was therefore not liable to super tax. In this case Lord Summer said:(26)

"MY lords, the highest authorities have always recognised that the subject is entitled to arrange his affairs as not to attract taxes imposed by the crown, so far as he can do so within the law, and that he may legitimately claim the advantage of any express terms, or of any omissions that he can find in his favour in taxing acts. In so doing he neither comes under liability nor incurs blame. It may be a question whether these considerations of justice and public policy apply equally to a limited liability company, a creature of the law strictly controlled by statute, in a case where it has no interest in either payment of or escape from a tax that is not levied upon it".

Similarly in the case of Duke of Westminster v. I.R.C Lord Tomlin summed up the trend of judicial reasoning on tax avoidance in the following:[27]

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax".

From these cases, it does appear that the judges did not appreciate the significance of taxation as an economic tool for stimulating the overall development of the country, and hence the need to ensure that taxation generates the required revenue by pronouncing against tax avoidance schems aimed solely at diminishing tax that otherwise would be payable.

There are, however, other views against the above standpoint. They frown on any tax avoidance scheme regarding it as an evil to be discouraged. Therefore, judges on many occasions have pointed out that tax avoidance is not a commendable exercise, that indeed it is an evil practice which should be prevented. In the case of Latilla v I.R.C Viscount Simon L.C said:[28]

> "My lords, of recent years much ingenuity has been expended in certain quarters in attempting to devise methods of disposition of income by which those who were prepared to adopt them might enjoy the benefits of residence in this country while receiving the equivalent of such income without sharing the appropriate equivalent of such income without sharing the appropriate burden of British taxation. Judicial dicta may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are 'entitled' to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their effects should be regarded as a

commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is of course to increase pro tanto the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how to adopt these manoeuveres".

Also in the case of <u>Lord Vestey's v. I.R.C</u> Lord Normand while pointing ot that tax avoidance is an evil, he at the same time wans of the danger of stretching the words of the statutes to strike down avoidance of tax. He said:[29]

"Parlimanent in its attempts to keep pace with the ingenuity devoted to tax avoidance may fall of its purpose. That is a misfortune for the taxpayers who do not try to avoid their share of the burden and it is disappointing to the Inland Revenue, but the court will not stretch the terms of Taxation Acts in order to improve on the efforts of Parliament and to stop gabs which are left open by the statute. Tax avoidance is an evil, but it would be the beginning of much greater evils if the courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved".

Also Lord Justice Sellers perhaps summing up what should be the judicial approach to the problem of tax avoidance has this to say:[30]

> "Enrichment without any service to the community and without taxation is hard to countenance"

Therefore, in this way, all purported tax avoidance schemes can be effectively invalidated. It is gratifying that more judges have grappled with the problem of tax avoidance along the same line of reasoning as indicated in the above cases. This is indeed a welcome development, for it must be remembered that CT legislation, like other tax statutes is not simply to collect revenue.[31]

Tax Avoidance Provisions

Although tax avoidance and its natural consequence of anti-avoidance legislation first received public scrutiny as long ago as 1920, the real flow in such activity began in the 1950's with ever increasing sophistication since then on both sides. The major UK anti-avoidance provisions can found them in many sections of the taxing statutes, particularly those granting reliefs, and contain conditions which prevent an obvious or simple avoidance ploy. For example, the exemption of the first tranche of termination payments provides for aggregation of payments made by associated employers, S.188 of T.A 1970. However, the major legislation of general application is grouped at Part XVII of the 1970 Act under the heading 'Tax Avoidance' and those most commonly encountered are the following:[32]

1- Cancellation of tax advantages from certain transactions in securities, SS.460 and 467. A complicated set of provisions, originally enacted in 1960, which were designed primarily to combat dividend stripping. Although a number of conditions are required to operate S.460 its interpretation has been sufficiently wide to inhibit almost any transaction involving shares and stock.

2- Prevention of avoidance by individual by transactions resulting in transfers of income to persons abroad, S.478. This is the major revenue defence against overseas operations by UK resident individuals.

3- Migration of companies, S.482. A Draconian provision which prohibits the transfer of residence, or of a trade or part of trade, by a body corporate from the UK to foreign jurisdiction without consent of the Treasury. Section 482 attempts to control the foreign operations of a UK resident company, but in a way quite different from that of S.478 for individuals.

4- Inter-company pricing, S.485 Tax Act 1970. In general this deals with transactions between persons, including companies, who are under common control or otherwise connected, normally where one of the parties is resident in the UK and the other is not. In such circumestances the Inland Revenue is empowered to impute to the relevant transaction price which reflict a commercial basis.

5- Section 478 T.A 1970 applies when an individual who is ordinarily resident in the UK transfers assets abroad. Where, as a consequence of such a transfer, such an individual has power to enjoy the income of a person resident or domiciled out of the UK, his income is assessable under Case VI of Sched. D (S.480(1). When an idividual receives or is entitled to receive a capital sum which is in any way connected with the transfer abroad, any income which has become the income of a person resident or domiciled abroad (for example, of non-resident trustees) is deemed to be the income of the individual [S.478(2)], and is also assessable under Case VI of Sched. D.(33) This section does not apply if the avoidance of liability to taxation was not one of the reasons for the transfer, and this can be shown to the satisfaction of the Inland Revenue [S.478(3)].

6.5 Tax Avoidance and Evasion Under the Egyptian Tax System

Before turning directly to this matter, it may be expedient to give a brief account of relevant tax provisions and the level of taxation in Egypt in respect of individuals and companies. In short, while individuals are taxed on general income at progressive tax rates up to 65%, the commercial and industrial profits tax at progressive tax rates from 20% up to 40%, the corporation tax, applying to joint stock companies, private companies and branches of foreign companies, is a flat rates of 32% or 40% or 40.55%. These differences in taxation are creating loopholes in the tax system in Egypt. The taxpayers attempt to take advantages from the loopholes to avoid his tax.

Taxable income consists of individuals' or companies' overall income. In the case of a foreign receipiant, the tax may be reduced under the terms of a double taxation agreement.

As mentioned earlier in this chapter Egyptian tax laws do not define the concept of tax avoidance or tax evasion. In accordance with the Egyptian tax rules, both individuals and companies are obliged annually to submit tax returns to the tax offices and in this respect to give detailed information on their taxable income. Hence the tax authorities with the tax rules have a useable tool when assessing the tax returns and looking into tax schemes or transactions.

There are provisions in Egyptian tax laws to prevent tax evasion and tax avoidance. According to SS.35,36 and 40, every establishment, whether owned by an individual or taking the form of a partnerships, limited libility company or joint stock company, should submit the return supported by the books, the documents which must approved in the way specified by provision of Law 133 of 1951 in respect of practising accountancy and auditing professions. In order to consider, and to approve by tax authority, the accounting books and documents must be honest. However if tax authority possesses evidence proving that the return did not conform with facts then the tax authority will in addition to rectifying, amending or disconsider the return and determining the profit by random estimation in addition the taxpayers have to pay extra money 5% of the tax due (the percentage shall not Exeed LE500).[34] However, tax evasion and avoidance is nowadays widespread in egypt. The following Journalistic reports about tax evasion in Egypt, these reports will give us indication about this phenomenon which threaten the development of Egyptian economy.

In a Journalistic report on 14th Jan. 1987[34] nearly 500,000 taxpayers had not submitted their tax returns. A great number of those who had submitted tax returns, as stated by officials in tax adminstration and also the finance minister, tried their best through their accountants to diminish their taxable profits by adding false expenses or omitting part of the income items and their relative expenses. This lead to great discrepancies in the incomes and create a big gap between the rich and poor people, who constitute nowadays the only 2 classes in the Egyptian society.

Mr Ahmed Ghuneim (the head of department against tax evasion)[35] admitted that the presence of tax evasion had, in fact, became phenomenal and nobody could deny it. It is a well known fact to all official people especially in the sector of financial resourses. In the field of Arab and foreign investment, the investors usually wind up the business before the termination of a tax holiday period. Then they start a new business under a new title to get another period of tax holiday and there are no limitations, conditions or obligation in both the tax system and in investment law which force them to carry on their businesses. In addition there are many tax returns accumulated from the preceeding years which have not been examined. So if 5 years have passed without an examination being done the government will lose the main sources and will become handicapped to carry out all necessary requirements for the country, on the other hand the current sources cannot cover current expenditure as shown from table (6.1) below. Therefore, the present Egyptian government, has to borrow from external sources (these loans accumulated and transferred from time to time about LE40,000,000, moreover these loans become a big problem for development of Egyptian Economy.) with higher interest rate.

Table (6.1)

The taxation share in current expenditure

During the period 1976-1985

(1) Years	(2) Tax Proceeds LE	% to (3)	% to (4)	(3) Current Expend. LE	% to (4)	(4) GDP LE
1975	1359.0	32.6	28.4	4216.6	88.2	4778.8
1976	1483.0	33.4	28.1	4445.5	84.4	5268.0
1977	1990.0	40.7	34.8	4887.6	85.5	5715.0
1978	2176.0	32.6	34.9	6680.2	107.2	6232.0
1979	2452.9	59.6	35.8	4113.1	60.1	6843.0
1980/81	4181.1	73.3	29.2	5706.7	39.8	14338.5
1981/82	5479.9	76.7	37.4	7147.9	48.8	14638.8
1982/83	5924.5	67.7	28.1	8754.0	41.5	21104.7
1983/84	6915.7	69.9	31.2	9891.0	44.6	22160.2
1984/85	7646.7	67.3	28.9	11354.0	43.0	26382.5

Sources: National Bank Of Egypt, Economic Bulletin, Nos.4 of 1980, 3 of1982, 4 of 1983, 3&4 of 1984 and 3 of 1985.

In another Journalistic report on 2nd December 1986[36], Finance Minster and Head of Tax Adminstration declared that the problem of tax evasion has been recently increasing. They admitted that there are many reasons that make taxpayers attempt to evade taxation, the following are some of them:

1- Tax Offices have to examine the files of more than 2 million taxpayers in a short period of a few months, in spite of the fact there is a marked shortage in the staff, in addition many of them are newly graduated and have not enough training and experience.

2- A Tax Inspector has to examine 60 files every month in addition to 10 files (cases) which have been presented to the courts. This does not allow him to give a high standard of work because of the pressure he is under to complete all the cases in the short space of time.

3- In one of the Tax Offices, 30 Tax Inspectors have to examine 5600 tax files involving liablity to commercial and industrial profit tax or CT and 25,000 tax files involving liablity to general income tax.

4- The working conditions are unsuitable as there is not enough space or privacy for the Tax Inspectors to be able to discuss problems with the taxpayers. This is due to inadequate accommodation for both the Inspectors and other employees. For example, in Alexandria Tax Office there are 78 Tax Inspectors in addition to Archive Staff working only in 5 rooms.

5- There are no incentives for the employees of Tax

Adminstration to encourage them to perform well at their work.

6- There is no mutual confidence between taxpayers and Tax Inspectors as they are convinced that the Inspectors will not accept the tax return and assess the taxable profits with random estimation.

In the light of the analysis above, it will be seen that the Egyptian tax system cannot realize some of its objectives, as it encounters problems which should be tackled and remedied regarding tax evasion and tax arrears which have become serious phenomena facing the Egyptian economy. Therefore, it seems to me the tax evasion can be avoided or at least aleviated by taking into account the following points:

1- Tax Adminstration should form a committee of experienced staff in the field of taxation to examine and clear up the accumulation of tax returns.

2- Other tax Inspectors start too soon to examine the new tax return while the old one is being examined by the experienced staff which is mentioned in no. 1 above.

3- Incentives should be given to the tax inspectors who are doing their best to examine thoroughly and with great care the tax returns. At the same time strict measures should be taken against those who delay in their work which is causing waste of the State's resources.

4- The authorities which deal with the taxpayers whether these are governmental or not should cooperate with the tax offices by giving the sufficient data about their clients (taxpayers).

5- In order to re-establish the confidence a between taxpayer and the tax inspector the latter should accept the return and its enclosed account statments as it is, disregarding minor mistakes in order to encourage taxpayers to keep or to establish accounting systems, and on the other hand to save a lot of time for both sides.

6- Strict measures should be taken against the inspector who does not accept the tax return without any justified reasons.

7- Tax inspectors should act as advisors and consultants for the taxpayer and attempt to help him to overcome all the difficulties facing him.

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A COMPARATIVE STUDY BETWEEN THE TAXATION OF COMPANIES IN THE UNITED KINGDOM AND EGYPT WITH PARTICULAR REFERENCE TO UNITED KINGDOM BASED MULTINATIONAL COMPANIES OPERATING IN EGYPT

VOL.II

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PART TWO

THE TAXATION OF COMPANIES IN EGYPT

Highlights for Part Two

The purpose of this part is to trace the development of the company tax system in Egypt with particular reference to the period since 1939 when the first legislation on taxation was introduced. In this part we therfore appraise the principal objectives underlying the various tax ordinances, Acts and Decrees introduced over the whole period and we look at tax proceeds and their relative importance during these periods. Also we will be enquire into the present system of corporation tax which was introduced in 1981, including the taxation of dividends.

Thus the current part is divided into three chapters:

Chapter Seven – An Overview of the Egyptian Tax System

Chapter Eight – The present system of company taxation in Egypt.

Chapter Nine – The computation of taxable profits.

CHAPTER SEVEN

AN OVERVIEW OF THE EGYPTIAN TAX SYSTEM

Chapter Seven

An Overview of the Egyptian Tax System

7.1 Introduction

Egypt as a developing country faces a number of challenges in the process of economic and social development. Moves towards economic development emphasize the role played by the State. The importance of this role is coupled with a financial policy which attempts to use some measures such as taxation and control of public expenditure in maintaining economic and social achievements. Taxation policy is designed to channel economic surplus and influence the distribution of resources throughout the different aspects of business activity in line with the aims of economic development. Its function in financing the State budget, is the main factor in promoting economic development. The social aim of taxation is the achievement of equality through minimizing disparities in income distribution and wealth, in addition to ensuring equal distribution of the burden shouldered in the process of economic development.

The decline in public revenue is a common factor in the economies of developing countries, as a result of decreased abilities to pay taxes, added to poor collection methods.[1] This is incompatible with the major role played by taxation in such economies (especially in developing countries) where development efforts require the recruitment of all resources to income productivity to ensure a continual rise in the standard of living, while taking into consideration the need for internal and external equilibrium? Thus it is necessary to reform the Egyptian tax system to meet the conditions required to sustain economic and social growth.

The aim of this chapter will be to examine the development of the Egyptian tax system from before the 1952 Revolution, up to the present day.

7.2 An historical perspective of the tax structure

Egypt has known taxes for a very long time, and its tax systems have been influenced by changing political, economic and social conditions. However, after Egypt was conquered by Amro Ebn-Al Ass the leader of the Islamic Army, at circa 640 A.D., the Egyptian people gradually embraced the Islamic Religion.(2) The consequence was that the Moslim people had to pay Zakat (tax) on animal wealth, agricultural production, commercial activities, mineral extraction, financial and monetary holdings and emoluments.

The Zakat rate is defined and established on a flat rate basis and these rates must be adhered to, as they are fixed by Islamic Laws.(3) Thus, neither the Islamic government nor any one can amend nor abolish them. Although this system is still applicable nowadays, and will remain unchanged, as an immutable religious law, the Egyptian government has adopted a more contemporary tax system. The roots of the contemporary taxation system date back to the era of Mohamed Ali at circa 1830 A.D. Therefore, the

Egyptian tax system has witnessed a number of changes which are as follows:

(1) Prior to the 1952 Revolution. This period can be divided into:

(i) The period of foreign concessions (following the reign of Prince Mohamed Ali until their cancellation).

(ii) The period following foreign concessions, and the issue of Egyptian Tax Law No. 14 of 1939 until the 1952 Revolution.

(2) The Period following the 1952 Revolution until the promulgation of nationalization laws (1952 to 1961).

(3) The Period following nationalization until the issue Open Door Policy law No. 43 of 1974. Also this period can be divided into:

(i) That following nationalization until the June 1967 War.

(ii) War economy (1967-1973).

(4) The Period following the Open Door Policy until the issue of Tax law No. 157 of 1981.

(5) The Period from 1981 onwards

These divisions express the changes in the management of the national economy which have had their influence on the course of economic policy and also upon the taxation policy, and which consequently have affected tax legislation and its development. The study of each period is a survey of its conditions, and a reflection upon the aims projected and the legislation adopted.. It also covers the impact of economic, social and political factors upon taxation policy, and the role of taxation revenue in financing the State budget. In addition, it will cover taxation revenue structure and gross national production (GNP), in an effort to explain the extent to which the tax system has been able to channel part of the national production in financing current public expenditure and investment.(4)

7.3 The period prior to the 1952 Revolution

This period was divided into:

(1) Foreign Concessions. These concessions were first introduced in Egypt as a result of the weakness of the (Ottoman) Empire, and increased with the defeat of Prince Mohamed Ali and the signing of the London Treaty in 1840, which was followed by the Khedevial Decree on the 13th February 1841. Egypt was forced to honour the treaties signed with Turkey, who had in actual fact signed a commercial treaty with England in August 1836 which levied custom duties on imports to the extent of 3% imposed a tax of 2% on retail trade, as a tax on profit, at the same time cancelling additional taxes on imports, besides levying a 12% customs duty on exports.

Although Prince Mohamed Ali refused to abide by these treaties because of the foreign concessions they included, he was obliged to honour them after his defeat. Owing to these concessions, and to the opposition which was raised by foreign communities and foreign investment companies (with the backing of their governments) against any taxation being imposed, the Egyptian Government was unable to levy any of the different kinds of taxes, especially since their application affected the Egyptian citizen only. This differentation gave rise to a feeling of resentment between Egyptian citizens and the foreigners living in the country. The result was that the incidence of direct taxation fell on farmers alone, in the form of taxes on agricultural land. The Egyptian government also depended upon indirect taxes, chiefly customs duties, the proceeds of which were limited because of trade treaties being maintained with foreign countries. This state of affairs remained unchanged until the Customs Duties Law No.2 was passed in 1930, which aimed at increasing state revenue and affording protection to local production, especially to Egyptian industry which had become established during the First World War. This industry had flourished following the 1919 Revolution, and the establishment of Bank Misr. It is for this reason that the customs duties law is considered to be an expression of the interest in the new class of national capitalists who had directed their activities away from agriculture and real estate.

7.4 Period following Foreign Concessions and the Issue of Tax Law No. 14 of 1939 up to 1952 Revolution

Foreign concessions continued until the Montreau Convention of 1937 which cancelled them. In the past, Egyptian legislation had been unable to levy some particular taxes despite the country's needs, but with this Convention Egypt had restored one side of its financial and legislative independence. At that time three committees were set up to formulate the taxation laws required.

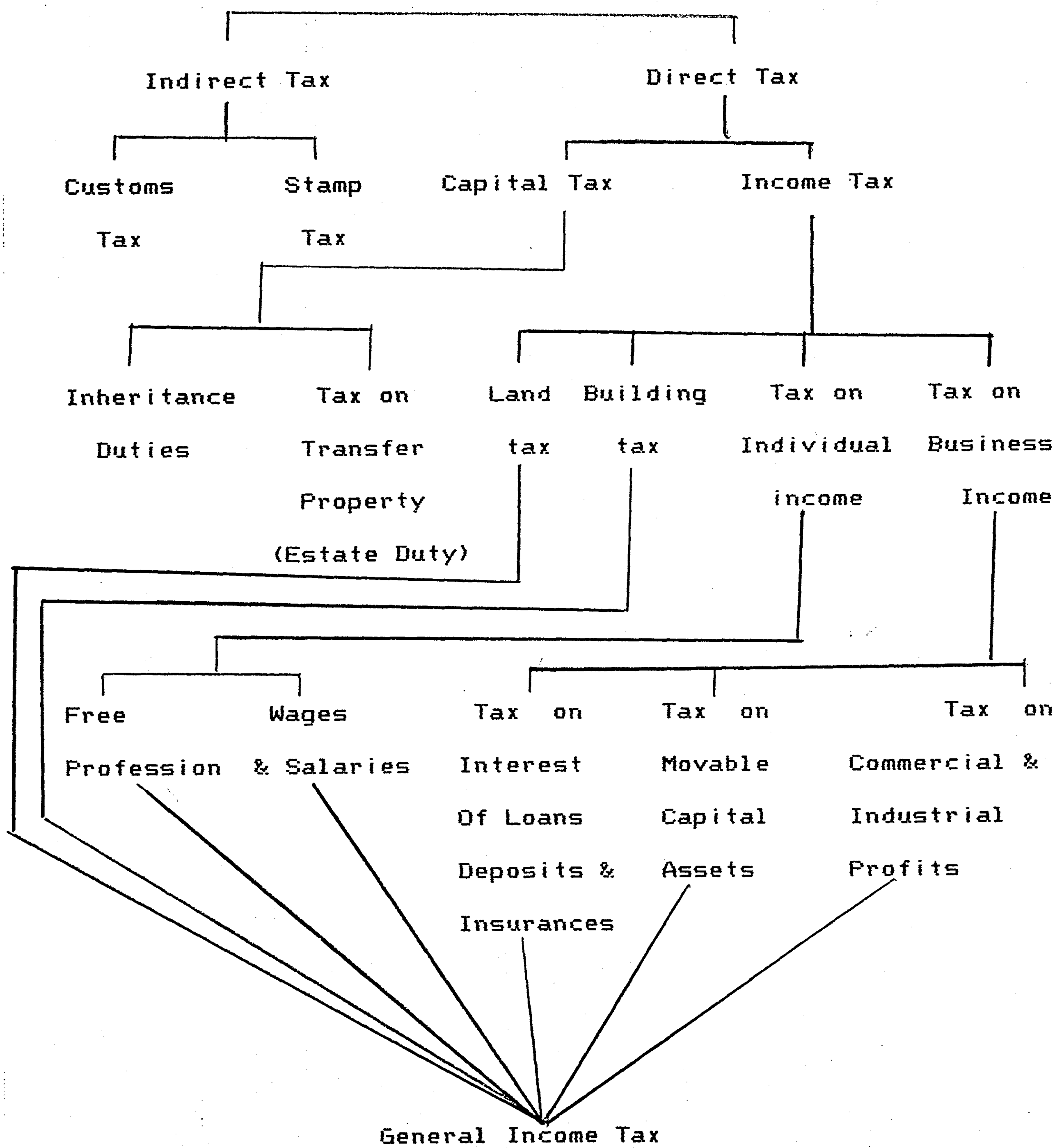
A decision was taken by the Council of Ministers on 11th December 1938 to establish a taxation administration, and soon Tax Law No. 14 of 1939 was issued imposing taxation on movable capital, commercial and industrial profits, labour salaries and wages and other taxes (as shown in Figure No.(7.1)). Agricultural and real estate taxes were however, subject to special legislation.

Tax law 14 remains the essence of the Egyptian Tax system. Law No. 44 of 1939 which related to fiscal stamp duty was issued in the same year (1939). Further tax legislation maintained the financial control and expressed the interest of the ruling class and the rich land owners on whom no taxation was levied for agricultural exploitation until the Tax Law No. 46 of 1978 (which was called the Justice Tax Law). This law was issued imposing a tax on agricultural activities.[5] Estate tax was postponed until 1944 when Law No. 142 was promulgated to levy an inheritance tax, and the duty was very low, at a tax rate of 5.6% for the

Figure (7.1)

The Egyptian Tax Structure According

To Tax Law No. 14 Of 1939



first LE50,000 due on an inheritor of the first degree.

Financial aspects remained dominant over tax legislation, although a duty was imposed in 1941 on profiteering during the second World War as a result of shortages in imports and excessive demand on local products. With the application of this tax, commercial and industrial profits were subjected to Law No. 14 of 1939, and also to the exceptional profit tax, the aim of which was to curb inflation and increase government commitments as a result of war conditions. In 1949 Tax Law No. 99 was issued to levy a general tax on income, and was the first step towards social equity. In 1951 law No.518, amended Law No.99, which raised tax tables. Furthermore a desire for social justice was exhibited in the promulgation of Law No. 217 of 1951 which amended the Law No.142 of 1944 by virtue of which an inheritance duty was imposed, thus raising the tax to 11.5% for the first LE50,000 due on an inheritor of the first degree. Yet the system of accepting settlement of taxes in instalments from returns on inheritance decreased, if not cancelled the latter's effect on income distribution which was one other factor aimed at promoting economic development. Thus, it is clear that the role played by the taxation system during that period in favour of economic development was limited, except for the economic implications of customs duties and their protection of local production.

After the promulgation of Tax Law No.14 and its annex, the role of direct taxation in raising public revenue was increased (compare the total of revenue of 17.1% during

1939/1940 to 27.4% during 1944/45). Also its total tax revenue increased from 29.9% during 1939/1940 to 43.7% during 1944/45. This did not however, continue for long, and the rate declined to 14.5% in 1950/51, but in 1951/52 it increased again to 23%. In the first period from 1939/40 to 1951/52 the State budget was more or less balanced and at many times realised a surplus,(except for the two budgets of 1939/40 and 1951/52 which gave deficits of LE2.6m and LE38.8m. respectively)

The ratio of direct taxation to taxation revenue which represented 22.6% of total taxation revenue in 1950/51 rose slightly to reach 31.0% in 1951/52. This phenomenon indicated the government's continued reliance on indirect taxation, especially customs duties, in financing expenditure, and did nothing to remove the injustices in the taxation system during that period, as shown in table 7.1. On the other hand this phenomenon also expressed the govenment's dependence on specific taxation (indirect tax) which was easier to collect without necessarily requiring an administration with a high degree of efficiency.

It is known that the ratio between tax revenue and GNP indicates the ability of the taxation system to recruit a proportion of economic surplus in the form of government revenue, while the effect is limited to economic development and to the extent of the role played by the State in the process of development and the impact thereof on the private sector. Therefore, table 7.3 shows the ratio of tax revenue to GNP (at current prices) which decreased from 13% in

1939/40 to 10.4% in 1944/45 but later increased to 18.6% in 1951/52. Although the ratio of direct tax revenue to GNP (at current prices) increased from 3.9% in 1939/40 to 4.5% in 1944/45 while decreased to 2.9% in 1950/51, but later increased again to 5.8% in 1951/52. The ratio of indirect tax revenue to GNP (at current prices) decreased from 9.1% in 1939/40 to 5.8% in 1944/45 and later on increased to 9.9% in 1950/51 and 12.8% in 1951/52.

The structure of direct taxation during this period (table 7.6) indicates that taxes on movable property and wages were dominant, being deducted from the source at 8.5%of total income in 1944/45, rising to 11.2% in 1948/49, but dropping to 9.4% in 1949/50, 6.3% in 1950/51 and 7.3% in 1951/52. The ratio to total tax revenue increased to 13.6% during 1944/45, increasing to 16.3% in 1948/49, but the ratio decreased to 14.1% in the following year and later to 9.9% in 1951/52 as a result of the increase in the ratio of immovable taxation to total taxation revenue and also to total public revenue and in general to total taxation revenue and public revenue.

However, the decrease in taxation on movable property was imposed on incomes without deducting any cost. The tax Law No. 14 sets the rate of tax on movable property at 10% in 1939, which increased to 17% in January 1952 with an additional 3% as defence tax according to Law No.277 of 1956. This decrease was a result of certain income being exempted from this tax such as earnings from government bonds interest on professional advances, and other earnings, the taxation on foreign capital for investment in some of the fields of economic development.

7.5 <u>Tax Law No. 14 of 1939</u>

The tax on specific sources of income was levied under Law 14 of 1939 as amended and the general tax on income under Law 99 of 1949.

Egyptian taxation, as shown from figure 7.1, will be described, briefly, in the following:

(1) Income tax on salaries and wages: is payable on all salaries and wages, life annuities which were paid by the government, public administration, provincial, municipal and local councils to any person whether or not resident in Egypt. It is also payable on all salaries, wages, and life annuities which were paid by all organisations and individuals to any person resident in Egypt, or to any person resident outside Egypt, in consideration of services rendered in Egypt.[6] This tax was charged at graduated rates on net income from 2% on the first LE100 up to 22% on the balance of net income over LE4,850. The Defence Tax was charged at the rate of 1.5% on the slice of income up to LE400 rising to 6% on net income in excess of LE1,200.[7] The National Security Tax was levied at 1% on net income up to LE400 rising to 4% on the slice of net income in excess of LE1,200.

This tax was withheld on payment of assessable income, on a monthly basis, in accordance with published tables, the employer being responsible for payment to the tax office of the tax due for the previous month within the first fifteen days of the month following of the tax due for the previous month.[8]

(2) Tax on professions, tax on non-commercial profits: The tax was charged on income derived from the liberal profession and other forms of self employment in which labour was the main constituent of their activity, such as accountants, doctors and lawyers etc., and any other activity which did not come within the scope of another tax. Exemption was granted to agricultural establishments which were not organised as joint stock companies[9] and to individuals in the first three years of practice of their professions. In arriving at chargeable net profit, necessary actual expenses were deductible, including pension provisions and life assurance premiums and 10% of net profit could be deducted for "professional" depreciation. If no account books were kept 20% of gross income was allowable for expenses. The profits from text books produced by staff in universities and higher teaching institutions for the benefit of students were exempted from this tax.[10] Also exempted was the income received in the first three years of the practice of his profession by an individual .[11] Income tax for a tax year (calendar year) was charged on the net profit of the preceding year. This net profit was the total sum received by the individual from all professional activities less allowable deductions. The tax was charged at graduated rates on successive portions of net income from 11% on income up to LE1,500 to a maximum of 22% on the balance of net income over LE5,000. In addition Defence Tax was payable at

the rate of 10.5% and National Security Tax at 8% on taxable income. If the taxable income exceeded LE500 a War Effort Tax was levied at 2.5% on the excess.[12] Tax was withheld at the rate of 25% from any sums paid to non-resident, non-Egyptian individuals who engaged in any of the activities that were subject to the tax on the non-commercial professions.

(3) Commercial and Industrial Profits Tax: This tax was charged on the profits of all trades, concessions, mining establishments, all profits of economic units, (figure 7.2), attached to public establishments and organizatins;[13] the profit of all joint stock companies. The tax applied to capital gains, i.e., profits on disposal of land or developed property in city areas if the proceeds exceeded LE10,000 (LE20,000 for inherited property). There was exemption from liability if there was no more than one such disposal in a ten year period and also for disposals in connection with certain investment projects.[14] Also the profit from the allotment and disposal of building sites; from the letting of more than one property unit or premises; from the brokerage and agency commission whether of a continuing or a casual nature; from the renting of agricultural land; this included over three feddans in extent, and plots in excess of one feddan used to grow medicinal plants all these profits were subjected to commercial and industrial profits tax.

Members of a general partnership were assessed proportionately to their respective shares in the partnership; in the case of limited partnership tax was assessed on the active partners individually on the profits which they obtained, while the remaining profit was assessed on the partnership.[15]

The exempted profits included:

(i) The income from apiculture projects.

(ii)The profit of Arab and Foreign investment projects according to Law 43 of 1974, as amended, which makes provision for a number of investment incentives for qualifying projects by means of tax exemptions. The types of project approved for those purpose are, among others, promoting exports eg., industrial development or mining, land reclamation, tourism and construction. Tax exemptions could be granted for 5 years or longer.[16]

(iii) The income from new livestock or poultry breeding or mechanical incubation.

(iv) The income received by the owners of fishing vessels, who were members of a fishing co-operative, in the first five years of business.[17]

(v) The income from fruit trees in desert areas or reclaimed land, as defined by the Ministers of Finance and of Agriculture, for the first ten years of production.

(vi) The income from breeding or fattening cattle for the individual farmer's own benefit provided that not more than ten head were involved.[18]

The deductions allowed included all costs which were wholly and exclusively for trading purposes, in particular the following items:

(a The rent of the building occupied by the owner, the enterprise; where the building was occupied by the owner, the rent would be paid also.

(b) Depreciation, appropriate to the nature of the activity, for existing plant, in addition to which, 20% (as acceleration depreciation)[19] of the cost of new equipment was allowed in the year of purchase provided that records were kept in the prescribed manner. This allowance was increased to maximum of 30% under special rules promulgated by the Finance Minister.

(c) Sums allocated to meet losses or specific financial commitments that were certain to occur but were of an undeterminable amount, up to a maximum of 5% of the year's net profit of the enterprise. To qualify for the deduction the amount had to be recorded in the accounts and subsequently employed for the specific purpose.[20]

(d) Losses could be brought forward for up to three years.[21]

(e) Tax paid except the commercial and industrial profits tax.

(f) Donations to charities, social welfare organisations, approved by the Egyptian government and having their headquarters in Egypt, up to a maximum of 3% of net profits.

(g) Donations of any amount to the Government and public organisations.

(h) Distributed profit of joint stock companies, which were deducted from taxable profit, were subjected only to the tax on movable capital assets, to avoid economic double taxation.[22]

(i) The profits accruing to the sleeping- partner members of a limited partnership on which the tax on movable capital assets had been paid.[23]

(j) The taxable income from movable capital assets charged to the tax on that income after deduction of 10% for investment charges and costs.[24]

The deductions were not allowed when the expenses were not sums wholly and exclusively laid out or expended for the purposes of the trade, or sums set aside for a general reserve, or to cover probable expenses.[25]

The commercial and industrial profits tax was assessed annually on the basis of the net profit obtained in the previous calendar year or on the twelve month period which constituted the latest accounting year.[26]

The rate of this tax was 17% in addition to Defence Tax at the rate of 10.5% Municipal Tax at 1.7%, National Security Tax at 8%. If the taxable profit exceeded LE500, War Effort Tax was levied at 2.5% on the excess, i.e., the total of commercial and industrial profits tax rate was 39.2%.[27]

In the case of joint stock, and other companies,... a properly certified declaration of profit must be filed with the Tax Office together with an audited copy of the company's accounts, within thirty days of the approval of these accounts. Tax was assessed on the profit as declared by the company but the Tax Inspector amend or reject the amount stated.[28]

In the absence of a declaration of profits and the accounts, the Tax Inspector could estimate the taxable profit, such estimate was being open to appeal.[29]

(4) Tax on interest of loans, deposits, current accounts and on insurance policies etc., by a standard rate of 40.55% and it was deducted at source, unless in certain cases the tax on interest was paid by the creditors.

(5) Tax on income from movable capital assets: This tax was charged on income from:

(a) stocks and shares in all types of public and commercial undertakings however paid or distributed;

(b) from profits held by sleeping partners in limited partnerships or limited partnership with shares;

(c) from loan interest arising in Egypt to non-Egyptians who were not resident in Egypt;

(d) from interest due on balances of foreign non-resident accounts opened in foreign currencies with local Egyptian banks;[30]

(e) sums equal to the total of profit arising, during the accounting period, from foreign companies after the deduction of 10% for reservations;[31]

(f) from all distributions of foreign companies to resident persons in Egypt (Egyptian or foreigner).[32]

The rate of this tax was 40.55% (17% of the taxable income. In addition to Defence Tax at 10.5%; National Security Tax 8%; War Effort Tax 2.5% and Municipal Tax 2.55%).[33]

The tax was deducted at source and had to be remitted to the Tax Office within fifteen days of the end of the month in which a loan matured or foreign income was received or within fifteen days of receipt of income in other cases.

(6) General tax on income (surtax on individuals): This tax was assessed on the net aggregate income of Egyptian nationals wherever resident and on foreign national resident in Egypt. The taxable income of resident foreign nationals was both that arising inside Egypt and that received from abroad. Non-resident foreign nationals were liable to tax only on income arising from sources within Egypt.[34]

The tax was levied under the provisions Law No.99 of 1949 as amended. Rates of the tax were raised on a graduated scale on successive portions of net income, after exemption of the first LE1,200, from 8% on LE1,201-2,000 to 80% on the excess over LE100,000.[35] There was an allowance for each dependant of LE75 (maximum LE300). Deduction for pension contributions etc., life assurance, contributions to investment projects, bank deposits and certain donations were allowed subject to limits and conditions.

(7) Inheritance Tax and estate duties on the different assets left by a dead person (male or female person). These taxes were levied under the provisions of Law 142 of 1944 and 159 of 1952 as amended.[36] The rates of estate duties arise on a graduated scale on successive portions of net wealth starting from 5% (after exemption of the first LE5,000) to 40% on the excess over LE60,000. The rates of inheritance tax were, according to Tax Law 202 of 1960, started from5% on the first LE5,000 to 22% on the excess over the LE65,000.

(8) Stamp duty on documents, vouchers, receipts,

advertisments, insurance premiums, supplying water and electricity, and on the issued capital of limited companies. The duty was levied according to Law No.44 of 1939. It was computed by different rates according to certain tables.

7.6 The Period following the 1952 Revolution until 1960/61

Since the beginning, the revolutionary government aimed at achieving economic development and raising the standard of living. Yet the policy showed no clear direction, being pursued on a trial and error basis, influenced by many differing theories. From the start the State supported a diversified economy, and by virtue of Decree No.212 of 1952 it established a new Authority under the name of the Permanent Council for the Development of National Production. Investment products were to be studied and the Council was later designated as "The Planning Committee". The Permanent Council had already undertaken steps for land reclamation, and had concentrated upon electricity as a basic need for industrialization. Industry evolved as an element of public expenditure, and huge allocations were given to electric power and land reclamation compared with those of previous periods.

At the outset of this period, the aim was to encourage local, private, and foreign companies to participate in economic development efforts, through taxation policy. In 1952 Law No. 306 was issued to exempt foreign companies operating in Egypt from the tax on commercial and industrial profits, and also from the tax on movable property, in connection with their activities in the free zones.[37] The purpose was to encourage the expansion of the commerce and industry needed by the country. In 1953 Law No. 156 was also issued, this Law was amended by Law No.475 of 1954, organizing the investment of foreign capital in economic development projects; this Law gave the foreign investor some facilities related to transfers of profits and invested capital. Since economic development projects required the aid of foreign experts, Law No.424 of 1953 was issued exempting resident experts from the general tax on income relating to inward funds. By virtue of the Decree No.169 of 1952, Law No. 588 of 1953 and Law No.20 of 1959, foreign aviation companies operating in Egypt and abroad were also exempted from the tax on movable capital incomes and the tax on commercial and industrial profits with reciprocal measures to be applied. In attracting capital and its investment in various projects, and to avoid difficulties in the process of their transfer and the duplication involved, Law No. 542 of 1955 was issued sanctioning agreements to avoid double taxation provided such measures ere reciprocated.

For encouraging the national private sector to invest, a number of laws were passed during this period, most important of which is Law No.430 of 1953 authorizing the following exemptions from taxation:

(1) Joint stock companies and shareholder companies established after the promulgation of the law, which included those engaged in mining, engine power, land reclamation and hotels, were exempted from taxes on commercial and industrial

profits, and on movable property.

(2) Existing companies, which increased their capital in the course of their engagement in the above-mentioned fields of activity, were also exempted from these taxes.

(3) Such companies were also exempted from paying taxes on undistributed industrial and commercial profits to the extent of 50% as from the financial year following the application of the said law.[38]

Law No.31 of 1953 was issued during that period allowing instalments in the payment of taxes on commercial and industrial profits over a period of double the number of years taxed, but this facility was applied only where taxpayers faced exceptional cases. In addition, Law No.254 of 1953 permitted for the first time, payment in instalments of taxes due on general income and Law No.224 of 1955 allowed the same conditions in respect of taxes due on non-commercial activities.

Defence Tax law No.277 of 1956 (which was amended by law 266 of 1960 and 108 of 1962) was issued to meet the financial needs of the defence programme. During that period the State used not only direct taxation, but also indirect taxation (basically in the form of customs duties) as a means of encouraging the private sector. A number of laws and regulations related to customs duties were passed for the purpose of encouraging local production, and by virtue of Laws Nos.234 and 325 of 1952, custom duties were either decreased or suspended with respect to production requisites and capital equipment, but they were increased for manufactured goods, the substitutes for which were made locally.

It is clear that tax legislation during that period aimed at achieving economic and financial goals, but these were realized through exemptions from the original regulations, and not through basic amendments. Conditions at home and abroad have likewise limited the effect of such amendments in supporting economic development.

After the end of the Suez War of 1956, a number of laws were issued for the nationalisation and confiscation of British and French property. The tendency towards encouraging foreign capital ended; any such encouragement was confined to national capital. Following the nationalisation of Belgian property in 1960, a Republican Decree No.2108 of 1960[39] was issued forbidding investment of foreign capital in Egypt, except by a republican decree.

Concerning the role of tax legislation in maintaining social justice during that period a law was issued for agrarian reform on September 1952. It is in fact considered to be an example of the direct methods adopted by the State to ensure social justice through redistribution of land property in excess of limits set. Tax legislation in itself is considered to be an indirect method for maintaining social justice. It was with the promulgation of the first Agrarian Reform Law that an additional tax was imposed as of 1st Jan., 1953 on all holdings in excess of 200 feddans[40] at a rate of five times the initial tax; the aim of this law was to encourage anyone who had more than 200 feddans to dispose the excess before the date of forfeiture. At the same time the State exempted arid land held by individuals, companies or associations in an effort to encourage its reclamation and sale. Law 146 of 1952 was also issued, raising the general income tax in a progressive scale up to 80% for sums over LE50,000[41] and a new progressive tax on estates (apart from inheritance duty) was levied by virtue of Law 159 of 1952 to the extend of 40% for sums over LE50,000. Inheritance duty tax on estates imposed under Law 142 of 1944 was also amended to become 9.3% on the first LE50,000.[42]

The trend towards using indirect taxation as a means of ensuring social justice continued, and in 1952, the tax rate on movable capital, debit interest, deposits, insurance, and commercial and industrial profits was increased from 16% to 17% by virtue of Law 147 of 1952. In 1960 the Law 184 was issued to exempt taxpayers from all, or part of duties due, in respect to the financial year ending 1st Jan., 1956 in case those taxpayers prove to possess no means for payment, but such exemption can only be sanctioned upon request by a special committee set up for this purpose. Further effort was made to secure social justice in distributing the burden of taxation according to financial ability, in Law 199 of 1960, which amended some stipulations of Law 14 of 1939. This law raised the exemption limit in respect to commercial and industrial profits, and labour earnings, which included salaries, professional and non-commercial earning. The scale of taxation on salaries and wages was raised for high earnings, thus expressing social justice and desire to limit disparities in income. The law also set a scale for the taxes levied on free and non-commercial professions at a graduated rate within the range from 11% to 22% instead of the unified rate which was 11%. The aim of this law was to match each taxpayer's contribution according to his ability to pay, and to help raise revenues for the State. Furthermore the law stipulated that representation allowances were to be taxed under the salaries and wages scale, and that taxation of free professions should be based on their actual incomes without discrimination.

In general, it could be said that in spite of the consecutive amendments of the laws on taxation during the period 1952/53 to 1960/61 the taxation policy was used as an instrument for maintaining social justice. The State relied basically upon direct measures and procedures such as the Agrarian Reform Law and others, more than on indirect methods such as taxation.

7.7 The Role of Tax Proceeds in raising Revenue during this Period

Taxation proceeds during the period 1952/53 to 1954/55 as shown in the table (7.6) raised about 66% of total general revenue, but after 1955/56 the rate was only 48.6%. This is attributed to the implications of the War of 1956[43] with shortages in imports and a decline in tax revenue and custom duties, which lead to a decrease in the proceeds of direct taxation (30.3%) and consequently a drop in total tax revenue. Yet the ratio of total tax revenue to total general revenue increased once again to reach about 52.3% following the number of tax laws promulgated with the rise of the 1952 Revolution, designed to realize financial, economic and social aims and thus enable the government to meet increased expenditure, especially since the general budget surplus had become a deficit. The most important of these laws was the Additional Tax Law on Agrarian land and the law amending the articles relative to inheritance duties on estates, and Law 340 of 1953 in respect to procedures pertaining to the support and development of the national economy, and later to the Defence Tax law of 1956

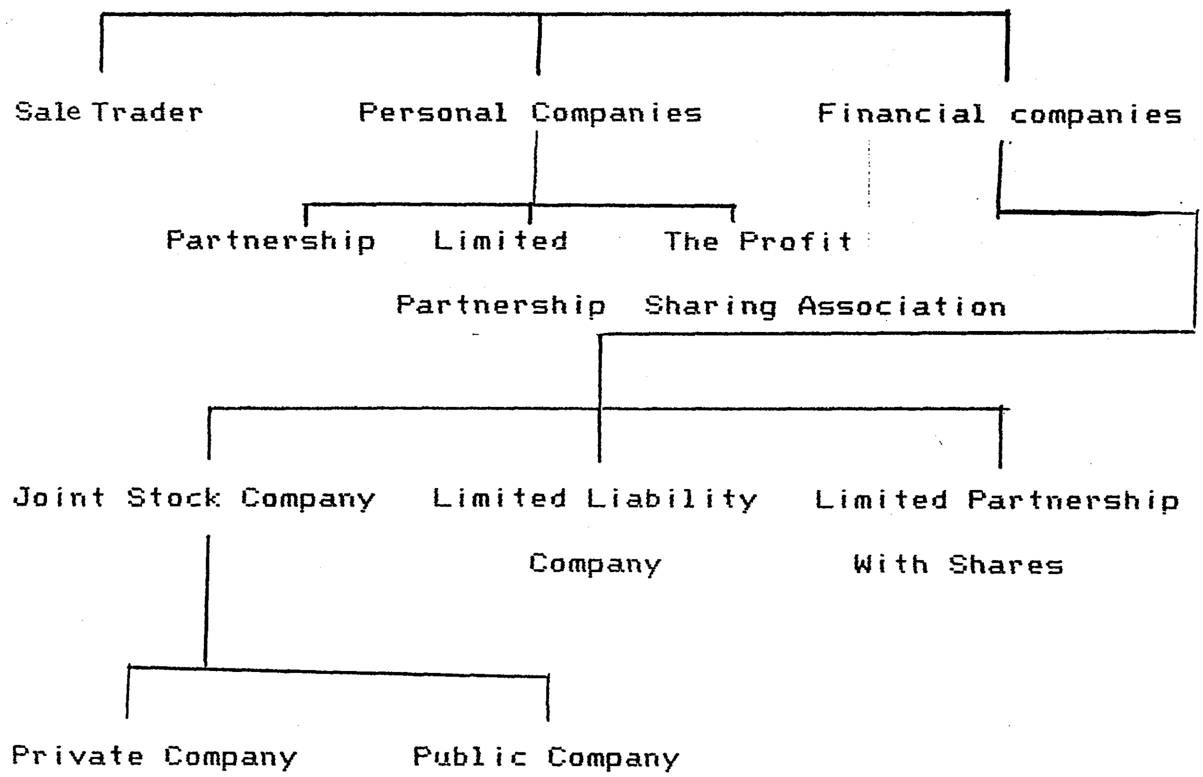
It will be observed that reliance on indirect taxation continued in raising tax proceeds which in 1953/54 represented 72.5% of total proceeds, against 27.5% for direct taxes. Although the latter took an upward trend to reach 30.3% of total tax proceeds while indirect taxes decreased to 69.7% during 1960/61 because of the government's inclination to direct taxation as a means of bridging the gaps between the different incomes. On the other hand, the ratio of tax proceeds to GNP (at current prices) decreased from 14.5% in 1952 to 12.3% in 1960/61.

7.8 <u>The Period following Nationalization until the Economic Open Door Policy (1961/62 to 1973)</u>

This period began with a wave of nationalization as a direct means of achieving social justice, with the State controlling economic life. At the end of this period,

Figure (7.2)

Economic Unit in Egypt



direct methods were no more resorted to as an effort to maintain social justice, and measures were taken to encourage the private sector and introduce a new economic policy, thus attaching a special importance to taxation. The period may be divided as follows:

7.9 The Period following Nationalization until 1967 War

In reviewing tax legislation during the previous period it will be noted that following the 1956 War, the State's position in respect to national and foreign private sector participation in development efforts, was confined to the encouragement of the national private sector only. The stress was laid upon eliminating the wide disparities in per capita income, and on emphasising the promotion of the public sector.

The period under discussion witnessed a number of laws which resulted in the diminution of the role played by the national private sector to a marginal level, against an appreciable growth in the public sector. Following the nationalization of Bank Misr, the National Bank of Egypt in 1960, social laws were issued in July, and the picture of society in Egypt changed. The resolution of the three basic laws Nos. 117, 118 and 119 resulted in the nationalization of companies, either wholly or partially, and later Decree No. 1202 of 1961 was issued establishing public organizations which were given control over public sector companies. These amendments affected tax revenue and legislation, with arrears being collected on business income, later Decree No.1202 of 1961 was issued establishing public organizations which were given control over public sector companies. These amendments affected tax revenue and legislation, with arrears being collected on business income, and tax evasion declining as a result of a large number of private companies being owned by the public sector. Further legislation the promulgation of the nationalization laws, which would impose taxes regarding the ceding of property, and re-evaluate the tax on movable capital assets, commercial and industrial profits and others. From the economic viewpoint, the new tax legislation was in its bulk a reflection of a new method for development, rather than a specific factor influencing the aspect of development. The financial aim was confirmed by the increasing role played by the State in the process of development during the period.

At this period, there was no tax legislation giving incentive exemptions in favour of the private sector in respect to commercial and industrial profits, but laws encouraging private saving in the form of insurance, whether life insurance or for payment estate duties, and other laws granting special exemptions by virtue of payment agreements with other countries,were enacted. A number of agreements for economic and technical cooperation were concluded in respect to credit facilities and easy term loans needed for the execution of products. Law No.22 of 1962 and law No.128 of 1963 which gave exemptions from interest due on debit balances under payment agreements accounts provided reciprocation was maintained. In addition, loans and credit facilities obtained by the government, public authorities and public organisations from foreign sources could be exempted from direct taxation by virtue of the stipulations under Law 14 of 1939. As such, the State would adopt its policy in respect to international trade, and sponsor the public sector it now owned in line with the commercial and industrial principles which was laid down by the State. According to Law 23 of 1962, former shareholders were also granted various tax exemptions which included movable capital assets, commercial and industrial profits and fiscal duties pertaining to nationalization of companies and firms. Law 108 of 1962 doubled the defence tax rate in respect to high incomes with the aim that taxpayers contribute towards meeting the expenditure necessary to increase defence support, especially since the defence duty was cancelled under the general income tax.

The public sector became dominant in the Egyptian Economy and full control over foreign trade, banks, insurance companies and all other companies, in addition to the major and most important part of industrial activity in the country. Therefore, it was necessary to set up a system which would organize this sector, and as a result Law 60 of 1963 which promulgated exempting public organizations from fiscal stamp duty that imposed under Law 224 of 1951, and subscriptions of organizations in company shares were also exempted.

In 1963 Law 61 stipulated that the activities of general authorities should not be subject to the tax on commercial and industrial profits but should bear stamp duty according to the provisions of law 224 of 1951. During this period investment certificates were issued by the National Bank of Egypt according to the Law No.8 of1965 which amended by Law 62 of 1967 for encouraging the people to increase national savings and affording the necessary finance for the five year economic and social development plan. These certificaties and their returns or prizes, together with their redeemable value were exempted from all taxes and duties with the exception of taxes on inheritance and estates.

7.10 War Economic (1967-73)

The beginning of this period was marked by a policy of contraction, with increased burdens being shouldered by the State as a result of the 1967 aggression. This was especially the case, after Suze Canal dues ceased and a large part of the State's petroleum resources ended, in addition to the decline in tourism proceeds. During this period also, the public sector's ability was in abeyance as regards maintaining the surplus relied upon to obtain a large part of its financial needs with its profits being transferred to the State's budget. Defence needs also increased to meet war requirements, while tax revenue from foreign trade (custom duties in general) declined following the diminution of such transactions as a result of insufficient foreign currency being afforded by the State in view of the circumstances which then prevailed. This led to the government's attempt to limit its expenditure, decrease its investments and take fiscal measures, with new rates being applied in an effort to increase revenue.

At the end of this period a number of laws were stipulated aiming at encouraging the new private sector which had appeared just before the 1967 War in the form of small companies, repair workshops and intermediary commercial companies. Law No. 23 of 1967 which was amended by Law 32 of 1968, was levying a national security tax at rate 25% of the defence tax[44] aiming for increasing resources. In addition, Decision No. 39 of 1968 and Law No.54 of 1968 imposed fiscal duty stamps on some transactions. Measures were taken to raise the prices of some luxury commodities, and Law no.14 of 1971 authorized the issuance of Al Djihad bonds to ensure military support, with their interest being exempted from movable capital asset tax to encourage subscription.

The most important of these laws was the investment law which was issued in 1971 relating to Arab capital investment.

In 1973, as a result of preparation for war, Law no. 77 of 1969 was amended by Law No.78 of 1973, by virtue of which some activities were subjected to the tax on commercial and industrial profits, in an effort to subject some income to taxation and attempt to alleviate tax evasion. Perhaps the most important regulation of that law was the deduction from the source for the first time, either by debit or by credit of tax on commercial and industrial profits, and cancelling the interest on arrears.[45]

The Role of Taxation Proceeds in Raising General Income During the Period 1961/62 to 1973

This period is divided into the following periods:

(i) The period 1961/62 to 1966/67

A study of taxation revenue during the period (table 7.2) will show that the majority of amendments in tax legislation were directed towards maintaining justice on the widest scale possible to bridge the gap between social classes and the disparities between them. In spite of this, the State continued to rely upon indirect taxation, the proceeds of which amounted to 73.4% of the total proceeds in 1961/62 and 71.9% in 1966/67 (compared with 26.6% and 28.1% respectively for direct taxation). This indicates that the proceeds of indirect taxation amounted to about fourfold those of direct taxation, in spite of the increase in the rates of many direct taxes, as for example, raising the rate on higher levels in respect to the general income tax, inheritance duty, estate taxation, building taxes, etc. It also indicates that these increases in tax rates remained hypothetical only, and had no impact on the revenue. This is clear from the low ratio compared with total general income, being 9.6% in 1961/62 and 14.7% in 1966/67. There is no doubt that this is attributable to the State's expansion for giving more tax exemption to limited income groups in an effort to bridge the gap between high and low incomes.

It will be noted (table 7.1) that the highest ratios achieved between proceeds of direct taxation and total tax proceeds were 28.4% in 1964, 27% in 1965/66, and 28.1% in 1966/67, as a result of the increase in the rates of defence tax and national security tax as of Jan., 1966, and also of the increased collection of amounts in arrears. The highest ratios with respect to proceeds of indirect taxation were 75.7% in 1962/63, and 75.1% in 1963/64 as a result of raising custom duties(46) on imports to protect local industry from the competition of similar foreign industries, while such duties were lessened on supplying commodities and production requisites.

The continued decrease in proceeds of direct taxation as compared with indirect taxation is attributed to the fact that during this period the state relied on its policy for narrowing the gap between incomes, upon direct methods. These methods can be seen in the phenomenon of nationalisation and expansion of the public sector and the diminution of the private sector. The taxation on business income (commercial and industrial profits tax) became essentially connected with the size of the public sector. On the other hand, with increased nationalisation many people became more evasive, hiding their wealth in fear of sequestration, and so evading taxation, especially general income tax with its higher rates. The ratio of taxation revenue to GNP at current price was 16% in 1966/67 compared with 12.5% in 1961/62 as demonstrated from table (7.3).

(ii) <u>The period 1967/68-1973</u>

The beginning of this period, as shown from table 7.2, was marked by a decrease in total general revenue to an extent not achieved before the June 1967 War, which was in 1966/67 LE753m. against LE643 mn., in 1967/68, but an increase followed to reach LE1018m. in 1973. As stated earlier, this is attributed to decreased revenue other than taxes, especially in petroleum proceeds, Suez Canal dues and public sector transfers in favour of the State budget. This resulted in increased reliance upon tax revenue which amounted to about 68.1%, in1967/68, of total general revenue compared with less than 50% during the previous period. It is noteworthy that the State continued to rely upon indirect taxation, in spite of the sharp decline in customs revenue which was made up for by the increase resulting from price differences, by about two-thirds of taxation revenue representing indirect taxation. This indicates that the structure of taxation proceeds remained unchanged since the introduction of the first tax legislation in Egypt (Law 14 of 1939 i.e., relying upon indirect taxation, especially consumption duties which could be easily levied despite their conflicting with social justice which was the aim of all tax legislation maintained through the exemption afforded. They represented a burden on the consumer in general and on limited income groups in particular, although carrying the burden of taxation during this period was a necessity for war preparation to which all Egyptians were subject.

The ratio of taxation revenue to GNP, as shown from table 7.3, (at current prices) remained almost stable reaching 17% with the exception of 1969/70 and 1970/71 when the ratio was 18.1% and 18.8% respectively.

7.11 The Economic Open Door Policy (the Period from 1974 until the Issue of Tax Law No. 157 of 1981)

Following the war victory in October 1973 the State clearly committed itself towards a new economic policy: exhibited in the economic overture. This gave the national and foreign private sectors more encouragement and autonomy, and it was therefore natural that relevant legislation be passed and formal gaurantees be given to the private sector as a means of protection against non-commercial risks and extra ordinary measures such as sequestration, confiscation and nationalization.[47] For this reason the State abandoned the direct methods previously applied in bridging incomes, and attempted to create fiscal justice by expanding labour opportunities through indirect methods, such as public expenditure, carrying on the subsidy policy, enlarging and improving free services, taxation and pricing policies.

During this period it was important that the aim of encouraging the private sector through exemptions and privileges in the taxation system, and the objective in maintaining social justice with increased reliance upon taxation, should concur. Although the exemption and concessions afforded by Law 43 of 1974, which was amended by Law 32 of 1977,[48] organising the investment of Arab and

Foreign capital and Free Zones, the period witnessed many efforts combating tax evasion, such as setting up a system of tax cards, collecting taxes at source of income, defining taxpayers and imposing taxation on luxury consumption. Law income groups were also granted further exemptions in an effort to achieve social justice. Law 46 of 1978 which was called the "taxation justice law" was also promulgated in the hope that taxation could be used as an effective indirect means of attaining social justice and this included some concessions encouraging savings.[49]

7.12 Laws Encouraging Arab and Foreign Investments

In 1973 the Law 43 was issued for organizing the investment of Arab and Foreign investments, and Free Zones (as amended by law 32 of 1977) and was considered to be the most important legislation during this period. It is an amendment of law 65 of 1971, the first investment law issued to stimulate Arab and foreign capital to operate in Egypt, by virtue of which the Investment Authority was established. The latter Law was amended to be consistent with the requirements of the" Economic Open Door Policy" of the October proclamation calling for economic and social progress, and eliminating restrictions facing the application thereof.

Later, Law No.87 of 1974 was promulgated in respect to tax exemption on Egyptian projects under the development plan, and Law No.24 of 1976 transformed the entire Port-Said city into a Free Zone, and Law No.12 of 1977 laid the system governing transaction in the city.

7.13 Justice Tax Law

The justice tax law No.46 of 1978 was one of the most important laws issued during this period as a result of the amendments introduced with respect to the stipulation made under Law 14 of 1939 and Law 99 of 1949. The Law was promulgated following studies and discussions held, calling for the shifting from a multiple type of taxation system to a unified tax system, which depended basically upon imposing a tax on total incomes of the taxpayer from all sources, after deducting the necessary cost of income production and various personal expenses, before reaching the net taxable income. Such a system was considered as leading to more justice, and was easier to collect.

In 1974 a committee was formed to develop direct taxation laws in Egypt, but the result was a recommendation to sustain the multiple type of taxation system already in force. The justice tax law included amendments which attempted to encourage savings and investments to ensure social justice on the one hand, and to help promote development on the other. One such amendment was the exemption from tax on income from movable transfer capital asset, such as interest on deposits at banks and postal saving banks life insurance instalments (within 10% of net annual income or LE400 whichever is lower). Dividends on shares and bonds in investment projects under the economic and social development plan were also exempted from tax on movable property incomes. Deposits at Egyptian banks for a continous period of not less than five years and representing 25% of net income and not exceeding LE3000 were also exempted from this tax.

One of the important measures introduced by this law was the widening of the definition with respect to sources of commercial and industrial profits tax to cover any commercial or industrial activity. Therefore, the income from a single transaction, such as the sale of land or building inside the city, renting furnished units, agricultural exploition, projects setting up managers for cattle and poultry,[50] was subject to commercial and industrial profits tax. The law stipulated a decrease of 50% in respect of the tax on individual enterprises whose actual invested capital did not exceed LE600 and whose annual profit did not exceed LE800. Also the law stipulated that taxpayers whose annual income exceeded LE12oo must submit a declaration every five years to the Tax Administration indicating their own wealth and that of their wives (or husbands) and their children who were still minors. Procedure for collection were organized and cases of evasion were met with fines or imprisonment or both together, with severe sentences to prevent any repetition.

The Role of Taxation Proceeds in Raising General Income During the Period of Economic Door Policy

Tables (7.2 & 7.6) show that the State revenue was doubled during that period to reach LE3307mn. in 1978 against LE1184mn. in 1974 with an increase of LE2123mn. or 179.3%. Taxation proceeds also doubled to reach LE2176mn. against LE749mn. in 1974 with an increase of LE1427mn. or 190.5%, while the ratio of tax proceeds to total revenue fluctuated between increase and decrease to become 65.0%, 63.3%, 65.8%, 69.9% and 57.5% respectively during that period.

Table (7.1) shows that the relative importance of direct taxation to the total of taxation proceeds rose from 26.3% in 1974 to 28.2% in 1978 owing to the increase in the relative importance of income taxes (business and individuals) from 19.3% tO 26.2%. The increase in taxation proceeds, and also in the relative importance of taxation on incomes, is attributed to direct tax proceeds from business sector from LE105.7mn. representing 41.3% of proceeds in 1975 LE293mn. (representing 47.6% of total proceeds) in 1978. While the relative importance of indirect taxation to the total of taxation proceeds declined from 73.7% to 71.8%, also indirect tax revenues were increased to reach LE1563mn. in 1978 against LE542mn.in 1974 or 188.3% owing to increased proceeds from taxes and custom duties from 30.9% in 1974 to 42.3% in 1975, thus reflecting the effect of increased size of foreign trade during that period, especially following the Economic Open Door Policy. Also the rules organizing the ratio of taxation proceeds GNP fluctuated during this period between increase and decrease to reach 20.2% in 1978 against 17.1% in 1974.

In comparing the UK and Egypt in the period from 1974 to 1978 it will be demonstrated from the table 7.3 and 7.5 that direct taxation is much more important in th UK than in Egypt.

The analysis of the relationship between the tax revenue (direct or indirect tax) and the GNP of both countries reveals that the ratio of British tax revenue to GNP is higher than that in Egypt. Also the ratio of direct taxation to the total of tax revenue, as shown from table 7.1 and 7.4, which represented 54.9 of the total tax proceeds in 1974, rose slightly to reach 56.4% in 1975 and 55.6% in 1976, while it abated slightly to reach 52.6% and 51.6% in 1977,1978 respectively. This phenomenon indicates that the British Government continued to rely on direct taxation while the Egyptian Government still relied upon indirect taxation. Moreover the gap between the ratio of direct and indirect taxation is very small according to UK tax system while too big according to the Egyptian tax system. The reliance of the Egyptian Government upon the indirect taxation affirms the existence of injustice in the Egyptian tax system.

Moreover tables 7.3 and 7.5 show that the ratio of tax revenue to GNP in the UK is 29.1% in 1974 against 17.1% in Egypt for the same year, while increasing slightly to reach 20.2% in Egypt in 1978 and decreased to 27.3% in the UK in the same year. However, the ratio between tax revenue and GNP, in both countries, indicates the abilty of the UK tax system more than the Egyptian tax system to achieve a portion of economic surplus in the form of government revenue, but the effect is limited to economic development and the role which was played by the State in the process of development and the impact on the private sector.

<u>The period from the 1981 onwards</u>

On 10<u>th</u> September 1981, the Tax Law No.157 of 1981 was issued stipulating a tax on movable capital incomes, commercial and industrial profits, labour earnings, and the general income tax organized under Law No.14 of 1939 and Law No.99 of 1949 (and laws amending them). The aim was a complete reform, and in addition to prevent tax evasion because the tax rates were high. The law still maintained the same tax system on all supplementary incomes under the general income tax, and combined the taxes on movable capital incomes, interest on loans, deposits and assurances into one tax, to be called tax on movable capital asset incomes.

The most important stipulation under this law as far as achieving social justice was the raising of exemption limits for family liabilities (personal allowance) to reach LE840 for married persons without children, instead of LE600 according to the old one, and LE960 for a married person with children, instead of LE660. In addition, the first band which was exempted was raised from LE1200 to LE2000. Salaried taxpayers were also given the right to object as regards the tax fixed by the department paying the salaries, provided such objection be made within 30 days from payment day.

An important part of the law provided for compensation to the taxpayer when there was a delay by the tax office in repaying excess tax. In addition professional depreciation was raised from 10% to 15% for writers and artists.

For encouraging savings and investments, subscribtion in new company shares and increase the capital of existing companies, the ruling provided for the exemption of part of these company profits so as to be commensurate with the interest rate announced by the Central Bank of Egypt, calculated on the basis of the paid up capital at the beginning of each financial year. The law also provided tax exemption for dividends on bonds issued by the public sector. Exemptions were provided for dividends on bonds issued by banks operating outside Egypt, as a means for affording foreign currency needed to finance development projects. The upper limits within which a taxpayer could subscribe in shares and bonds related to development projects were raised, , and the purchase of government development bonds for at least three consecutive years was raised to 30% of total annual net income, i.e. up to LE5000 (instead of 25% at a maximum of LE3000). The maximum limit for deduction in respect of life insurance instalments was also raised to 15% instead of 10% of total annual net income.[51]

An important ruling in the field of preventing tax evasion was a requirement for all taxpayers engaged in commercial and industrial activity, and including non-commercial professions, to submit a declaration of total wealth at five years intervals. Therefore, the tax inspector had access to information which enabled him to compare the previous and current declarations, in order to discover if a taxpayer was attempting to hide any source of income and thus evade tax. Another stipulation was that all taxpayers definitely leaving the country, or those suspending their activities must declare their wealth even though the specified period of five years had not yet elapsed. In addition where evasion was discovered there could be a term of imprisonment with hard labour in addition to a further 25% of the tax due to be paid where the source of wealth would not be identified.

Finally it is clear that the income tax law is based upon the same policy behind the previous laws which enforce specific taxes and have the general income tax as their summit. The Egyptian Government has tried to fill the loopholes in these laws whether in subjecting taxation or in the field of tax evasion. The law could be looked upon as an introduction to a unified tax system, and an initiation of taxpayers to its applicaton and to face the heavy burdens to be encountered in such application.

7.14 Tax Law No. 157 of 1981

Tax Law No.157 was issued on 10th September 1981 cancelling the provisions of Law No. 14 of 1939, Law No. 99 of 1949, Law No.155 of 1950, Law No.7 of 1953, Law No.95 of 1973, Law No.27 of 1977 and Law No.46 of 1978. The provisions of Al Djihad Tax under Laws Nos.113,117 and 118 of 1973 have also been cancelled, as well as the defence surtax Law No. 277 of 1956 the national security tax Law No.23 of 1967 and the surtax imposed by the government as a percentage of the initial tax placed on immovable capital income, and commercial and industrial profits.[52]

The new Law includes three main parts which are as follows:

1. The first part deals with the tax on revenues accruing to natural persons. This part comprises five chapters viz, tax on movable capital revenue, tax on commercial and industrial profits, tax on wages and salaries, tax on profits of non commercial professions, and general income tax.
2. The second part deals with taxes on profits of corporations.
3. The third part includes general provisions for the identification and encompassing of taxpayers, their obligations, professional confidentiality, tax appeals, collection of tax debt, penalties etc.

Tax Law 157 of 1981, as shown from figure 7.3, can be described, briefly, as follows:

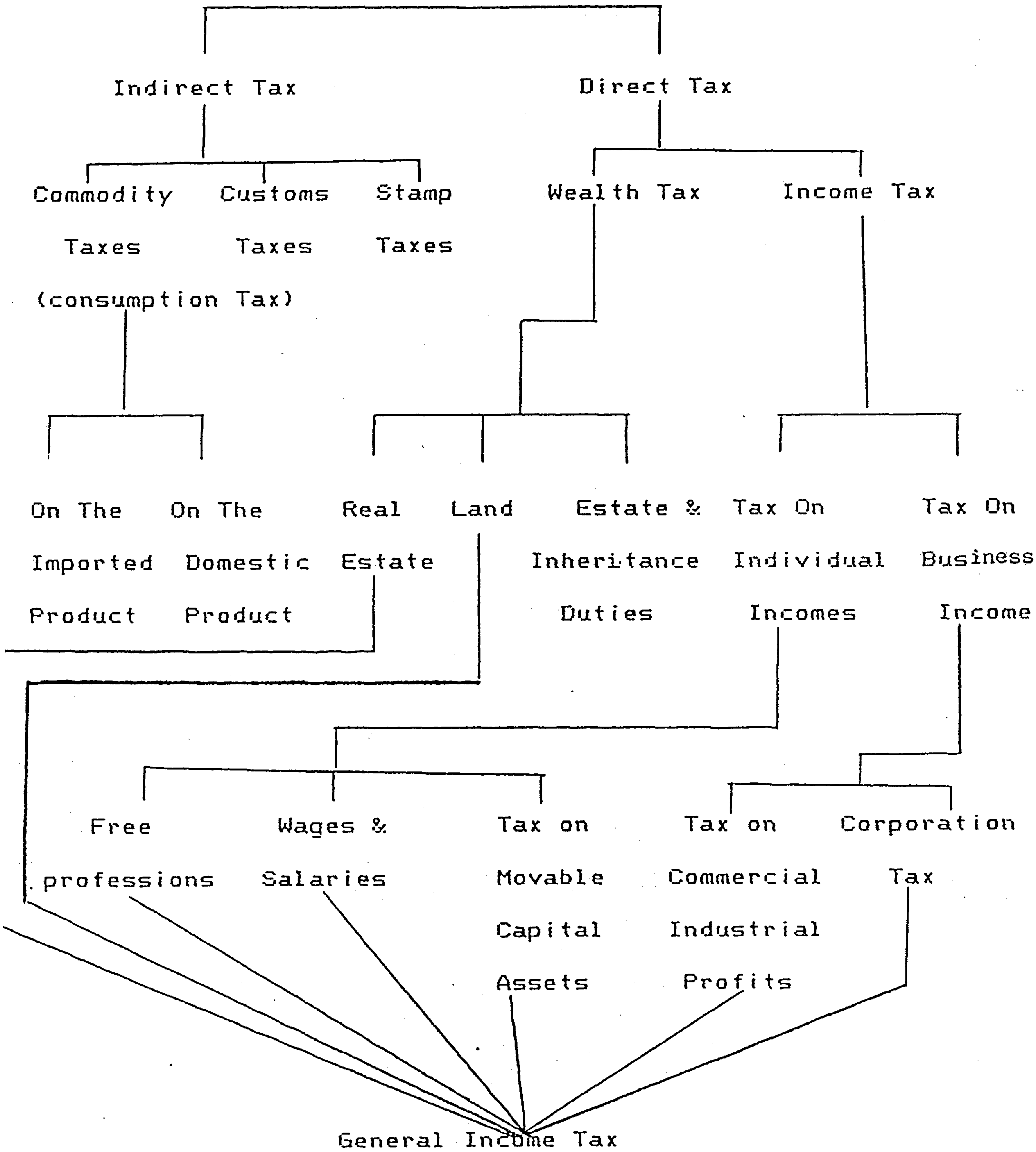
(a) Tax on movable capital revenues:

The tax on movable capital is levied on a number of

Figure (7.3)

The Egyptian Tax Structure According

To Tax Law 157 Of 1981



different items, including the following:[53]

(i) interest on bonds and loans;

(ii) income received by a resident Egyptian, or a foreigner who is normally resident in Egypt, from foreign sources, including dividends from foreign companies not operating in Egypt;

(iii) interest paid to foreign persons resident outside of Egypt;

(iv) attendance fees paid to shareholders;

(v) amounts paid to non executive directors;

(vi) amounts paid to executive directors over LE5000, while LE5000 is subject to the salary tax, in so far as the amount exceeds that paid to the non executive directors; and

(vii) fees and other amounts paid to Egytian directors out of the profits of companies, which are subject to the Law No.43 of 1974, during the tax holiday. The tax in such case shall apply at the rate of 50%.(54)

The tax rate is at 32%. A number of exemptions are provided by the law. For instance, interest paid on foreign currency bank deposits in Egypt is totally exempted from this tax.

The tax is in most cases withheld at source and should be paid to the appropriate tax office within fifteen days following the withholding.

(b) <u>Tax on commercial and industrial profits:</u>

An annual tax shall be imposed on the net profits of owners of the following activities which result in the imposition of the tax on commercial and industrial profits unless the taxpayer is subject to CT:[55]

(i) brokerage or agency activities;

(ii) the leasing of commercial premises or equipment;

(iii) habitually dealing in real estate;[56]

(iv) land reclamation;

(v) most agricultural activities.

(vi) such a tax shall apply to the profits of any establishment operating in Egypt, if it shall take the form of sole trader and the profits of the partner in partnership or the partner in a limited partnership. Also the tax shall apply to shares of sleeping partners in limited partnerships; and

(vii) the tax shall apply to the profits resulting from the sale of any of the capital assets of the professions which are stipulated in this section; it shall also be imposed on the profit from letting mechanical electric and electronic machines.[57]

The method of calculation of the annual net profit of the taxpayer is laid down in the law. A list of deductions including rent, other taxes paid, contributions to Government bodies and to charity, within certain limits.[58] Depreciation is also deducted according to the accepted rate of depreciation for new machinery, with accelerated depreciation in the first year only to encourage renewal of old machinery in manufacturing and production industries.

Losses may be carried forward for a period of five year compared with three years under the old one.[59] Individual traders or partners in sleeping partnership or limited partnerships benefit from the following annual personal allowance: LE720 for an unmarried person; LE840 for a married person witout children; and LE960 for a married person with children.[60] After these allowances are taken into account the tax rate on the remaining income are as follows[61]

20% on the first LE1000, 23% on the next LE1500

27% on the next LE2000, 32% on the next LE2500

35% on the next LE3000, 38% on the next LE3500

40% on the excess over LE13,500. If the project is industrial the tax rate shall be 20% on the first LE1000, 23% on the next LE1500, 27% on the next LE2000, and 32% on the excess over LE4500.

c. <u>Corporation Tax:</u>

Corporation tax was a new tax created by Law No.157 of 1981. Previously companies paid a higher rate of tax on distributed profits and a lower rate on undistributed profits with the lower rate applying to commercial and industrial profits.[62] Now the tax imposed is unified and is applied to joint stock companies, limited liability companies, and limited partnerships i.e. with share capital.This tax also applies to public sector companies, and banks, whether foreign or local. Branches of foreign companies are subject to this tax but only in respect of their profits arising in Egypt.[63]

d. <u>Tax on profits of non commercial professions:</u>

This tax applies to members of free professions as to any other non commercial profession where human effort is the basic element in generating profits provided that such generated profits have not been subject to any other specific tax. The liberal professions, such as doctors, lawyers, accountants and others will be subject to the tax on non-commercial professions. The net profit of such persons is taxed on an annual basis at the following rates:

18% on the first LE1000, 20% on the next LE1500,
25% on the next LE2000, 30% on any amount over LE4500

In calculating the net profit the following items are deducted:

(i) costs of registration or professional practice fees;

(ii) a 10% personal allowance;

(iii) amounts paid to professional organisations for private pension arrangements, up to 10% of the net income;

(iv) life insurance premiums subject to certain conditions; and

(v) donations to Government bodies, or charities in line with the salary tax referred to below. Losses may be carried forward for a period of five years. A tax return must be filed before 1st April and the tax should be paid at the same time. The penalty for filing a late return is 20% of the tax due.

e.Salary and Wages Tax:

All salaries, wages and benefits in cash and kind paid to persons residing in Egypt are subject to the salaries and wages tax. In certain cases even persons residing outside Egypt may be subject to this tax. Foreigners will pay this tax in the event that they work for more than six months in Egypt. The taxable salary will include overtime pay, bonuses, any fringe benefits and other allowances. Executive directors will pay this tax on the first LE5000 received by them. The Rates are as follws:

2% on the first LE480, 4% on the next LE480,
10% on the next LE960, 15% on the next LE960,
18% on the next LE960, 22% on the amount above LE3840.

Certain allowances and deductions are available in order to calculate the taxable salary. Thus the personal allowances are: LE720 per annum for single person, LE840 per annum for married persons without children, and LE960 per annum for married persons with children.

6. The general income tax:

The general income tax is payable annually on an individual's total income during a calender year after allowances and deductions. It is not paid on the salaries of foreigners working for Law No.43 projects.(64) Deductions are made for all other taxes paid on the income taken into account. The following amounts are also deducted:

(i) interest paid on loans and other debts subject to certain conditions;

(ii) donations to Government bodies, or charities within certain limits;

(iii) life insurance premiums; and

(iv) permitted investments.

The general income tax rates are:
the first LE2000 is tax free and thereafter the rate is 8% for the first LE1000 increasing by 1% every LE1000 until LE10,000. From LE10,000 to LE50,000 the rate commences at 18% on the

first LE10,000, 22% on the next LE5000, increasing thereafter by 2% on every LE5000. From LE50,000 to LE60,000 the rate is 35%, increasing thereafter by 5% on every LE5000 until LE75,000 to LE100,000 the rate is 55%, from LE100,000 to LE200,000 the rate is 60% and for the income in excess of LE200,000 the rate is 65%.

A taxpayer must submit a return, reporting the amount of his profits or losses, to the competent tax district office within the following thirty days of the date on which the general assemble of shareholders shall approve the annual accounts or thirty days as from the date specified in the company statues for the approval of such an assembly.[65] The taxpayer shall enclose with his return a copy of trading and operating accounts, a copy of profit and loss account, a copy of the latest approved balance sheet and a list of the depreciations effected by the company while stating the accountancy rules applied on basis of which the figures stated in such a return.

The Role of Tax Proceeds in Raising Revenue from 1981 onward

Taxation revenue during this period as shown in the table (7.1) shows that the change of tax law was aimed at (a) preventing tax evasion and (b) achieving social justice by increasing exemptions and reducing tax rates. Tax proceeds underwent various developments during this period under review recording yearly increases to reach LE7233.mn. at 1984/85. However, the State continued to rely upon indirect taxation, the proceeds of which amounted to 65.1% of the total proceeds in 1984/85 and 62.0% in 1980/81 compared with 34.9% and 38.5 % respectively for direct tax. This indicates that the proceeds of indirect taxation amounted to about double those of direct taxation.

The increase in indirect taxes was brought about by the anticipated rise in the proceeds of customs taxes and duties and the increase of consumption tax, owing to the increase in the rates of taxes levied on the consumption of some goods.

As regards direct taxation, the decline of direct tax receipts may be attributed to the following main causes:

1. Lowering of the rate of the tax on commercial and industrial profits and movable transfer capital assets from 39.7% and 40.55% respectively to 32%.
2. Raising the exemption limits with respect to the tax on earned income.
3. Adjusting the slices of the general income tax and reducing its rate.

Table (7.3) provides the traditional measures of tax urdens. It shows the average tax ratios in terms of GNP in rder to appreciate the changes in 1981, the tax ratios have een calculated for the periods relative to the law No.14 of 939 and Law No. 157 of 1981. The table shows that the ncrease in the ratio of tax proceeds is higher under the tax aw 157 of 1981 than under tax law 14 of 1981.

There are two striking features in tables (7.1-7.3): one s the very large gap between direct and indirect tax; the ther is the tremendous increase in the importance of direct nd indirect tax relative to the total of tax proceeds and NP in both countries. By comparison, the UK became more eliant upon indirect tax after 1979 resulting in an increase rom £29118 in 1979 to £51357 in 1984 i.e. about 52.4% and 1.2% respectively of total proceeds. The gap between irect and indirecct tax in the United Kingdom remained owever very small.

According to the Egyptian Tax System, tax proceeds are nevenly distributed while the tax proceeds are ordered ccording to the UK tax system as shown from from tables 7.1 nd 7.4 respectively.

eason for Disparities in Tax Ratios

When countries which are all fairly well developed have ax ratios as different as those shown by table (7.1, 7.3, .4 and 7.5), one must wonder why. Since taxes are enerally collected to be spent, the reasons for the ifference must be sought in the expenditure side of the difference must be sought in the expenditure side of the budget.

Three basic reasons can be found: (66)

The first may be related to the fact that modern economies require many types of governnmental expenditures as inputs or intermediate goods or services. To maintain its international competitive standing as well as to grow, a country may require certain kinds of expenditure, for example roads, education, etc. The extent of the need and the awareness of it may differ from country to country.

The second reason is related only to its social consciousness which may effect the revenue side of the budget through its impact on the choice of taxes, and may affect the expenditure side through its influence on social areas of expenditure such as transfers to households, government housing, free medical care, etc. (67)

The third reason, the political, has to do with the amount of resources that a country feels it should spend to protect itself from real or imagined foreign aggression. Different reasons will be reflected in differential national ratios of defence expenditure to GNP.

The Egyptian Tax System and Its General Objectives

The Egyptian tax system does not reflect a clear trend or policy. However, some general indications of its principles or objecives may be deduced. There follows a review of the development of the general objectives of the Egyptian tax system. The objectives of the tax system are: (68)

1. The financial objective: The financial purpose of the Egyptian tax system is to provide the State with the resources necessary to cover public expenditure which is increasing every year. Taxation in Egypt is one of the main instruments of financing public expenditure; in fact the tax proceeds during the last five years (1979-1983/84) have accounted for 70% of total current revenues, covering an average about 70% of current public expenditure during the same period.

However, some criticism may be levelled against the taxation system in its endeavour to realize such objectives, in that it has some defects in application. These are mainly highlighted in the accumulation of ever-increasing tax arrears to reach LE356mn and LE230mn. for the Taxation and Customs Office respectively in 1980/81.

Moreover, the tax legislator, in giving some priority to financial targets, has not paid much attention to the concept of transfer of tax. In other words the taxpayer is not necessarily the person who shall ultimately bear the tax burden as he may be able to shift the liability of the tax partly or in full to another person who becomes the ultimate taxpayer. This applies in particular to indirect tax, the proceeds of which account for more than two thirds of tax proceeds in Egypt. It is noteworthly that the reliance on indirect taxes is a common phenomenon in developing countries not only in view of their abundant proceeds, but also in the facility of collection and the difficulty of evasion.

2. The Economic Objective: The ratio of tax proceeds to GDP amounted to about one-fourth on the average during the period 1979-1983/84; a high rate as shown from table (6.1) if compared to other countries such as Brazil and Spain which the ratio of tax proceeds to GDP during the period 1970-79 was 17.1% and 19.1% respectively.(69)

As regards the economic objective of the Egyptian taxation system, mention should be made of the exemptions enacted by the legislation envisaged mainly for the promotion of new projects as a means of economic development. Such exemptions were however, characterized by the exercise of some leniency which may not be beneficial to the process of economic development especially in view of the structural inbalance inherent in the national economy.

3. The social objective: This objective embraces the exemptions granted by the legislator to certain income with a view to exempting the lower incomes necessary to sustain a basic minimum living standard, as well as excluding family charges, pensioners and small taxpayers. The social objective may even go beyond these limits to embarace the raising of tax rates for specific goods with the aim of containing their

use on reducing the tax rates levied on the profits of certain activities by way of encouragement.

As regards direct taxation, which are mainly taxes on income, in the Egyptian tax system, it is to be pointed out that the data available in table (7.7) reveal that the taxes on business incomes (taxes on commercial and industerial profits and movable properties) rank first among the group of direct taxes, the rates of which ranged between 60.8% and 97% of the total proceeds of direct taxes, during the last ten years. This fact highlights the relative importance to the tax proceeds.

The taxation structure in Egypt still depends mainly on indirect taxes as in most developing societies. Moreover, indirect taxes levied on the consumption of essential goods accounted for mor than 40% of such taxes, thus giving priority to the financial objective while the social objective is relegated to less important role in general.

Table (7.1)

Proceeds of Direct and Indirect Taxes in

Egypt during the period 1939-1984/85

Year	Direct Taxes LE.mn	%	Indirect Tax LE.mn	%	Total LE.mn
1939/40	7.9	29.9	18.5	70.1	26.4
1944/45	24.1	43.7	31.0	56.3	55.1
1745/46	26.3	40.9	38.0	59.1	64.3
1946/47	22.5	36.2	39.6	63.7	62.1
1947/48	20.8	33.7	41.0	66.3	61.8
1948/49	27.2	32.2	57.3	67.8	84.4
1949/50	30.0	28.6	74.9	71.4	104.9
1950/51	27.9	22.6	95.7	77.4	123.6
1951/52	49.5	31.1	109.8	68.9	159.3
1952/53	42.9	32.7	88.5	67.3	131.4
1953/54	38.4	27.5	101.0	72.5	139.4
1954/55	41.9	29.7	99.1	70.3	141.0
1955/56	43.1	29.0	105.6	71.0	148.7
1956/57	52.1	33.5	103.2	66.5	155.3
1957/58	52.4	33.1	105.7	66.9	158.1
1958/59	51.5	31.3	112.9	68.7	164.4
1959/60	50.6	30.3	116.3	69.7	166.9
1960/61	54.5	30.3	125.6	69.7	180.1
1961/62	50.3	26.5	139.3	73.5	189.6
1962/63	53.4	24.3	166.1	75.7	219.5

Table (71) cond.

1963/64	68.6	24.9	207.3	75.1	275.9
1964/65	90.0	28.4	227.3	71.6	317.3
1965/66	96.9	26.9	263.0	73.1	359.9
1966/67	110.6	28.1	283.1	71.9	393.7
1967/68	120.9	27.6	316.7	72.4	437.6
1968/69	132.0	29.0	323.0	71.0	455.0
1969/70	156.5	29.4	375.0	70.6	531.5
1970/71	178.9	30.8	401.8	69.2	580.7
1971/72	181.5	30.8	407.7	69.2	589.2
1973	194.6	30.8	436.6	69.2	631.2
1974	197.0	26.3	552.0	73.7	749.0
1975	256.0	24.6	784.0	75.4	1040.0
1976	345.0	25.7	996.0	74.3	1341.0
1977	460.0	23.1	1530.0	76.9	1990.0
1978	613.0	28.2	1563.0	71.8	2176.0
1979	703.1	28.7	1749.8	71.3	2452.9
1980/81	1588.1	38.0	2593.0	62.0	4181.1
1981/82	2269.5	41.4	3210.2	58.6	5479.7
1982/83	2092.7	35.3	3830.8	64.7	5923.5
1983/84	2433.8	35.9	4349.2	64.1	6783.0
1984/85	2525.9	34.9	4707.1	65.1	7233.0

Sources:2. State Budget Project of different years from 1940 to 1984/85. 3. Economic Bulletin, The Jurnal of National Bank of Egypt, vol. Nos.2,3 of 1982; 3,4 of 1983; 2,3,4 of 1984; and 1,2 of 1985. 4. Economic Review, The Journal of Central Bank of Egypt vol.xxii No.1 of 1982. (in Arabic)

The Rate of Tax Revenue to Gross

National Product

Year	Direct Tax LE.mn	Direct Tax % of T.P	Direct Tax % of G.R	Indirect Tax LE.mn	Indirect Tax % of T.P	Indirect Tax % of G.R	Total Tax Proceeds LE.mn	Total Tax Proceeds % of G.R.	Other Revenue LE.mn	Other Revenue % of G.R.	Gross Revenue LE.mn
1939/40	7.9	29.9	17.1	18.5	70.1	40.1	26.4	57.2	19.7	42.8	46.1
1951/52	49.5	31.1	23.0	109.8	68.9	51.0	159.3	74.0	55.9	26.0	215.2
1952/53	42.9	32.7	21.7	88.5	67.3	44.7	131.4	66.4	66.7	36.6	198.1
1960/61	54.5	30.3	14.7	125.6	69.7	33.9	180.1	48.6	190.9	51.4	371.0
1961/62	50.3	26.6	9.6	139.3	73.4	26.6	189.6	36.2	334.4	63.8	524.0
1966/67	110.6	28.1	14.7	283.1	71.9	73.6	393.7	52.3	359.3	47.7	753.0
1967/68	120.9	28.0	18.8	316.7	72.7	49.3	437.6	68.1	205.4	31.9	643.0
1973	194.6	31.0	20.1	436.6	69.0	42.9	631.1	65.0	386.8	35.0	1018.0
1974	197.0	26.3	16.7	552.0	73.7	46.6	749.0	63.3	435.0	36.7	1184.0
1978	613.0	28.2	18.5	1563.0	71.8	47.3	2176.0	65.8	1131.0	34.2	3307.0
1981/82	2269.5	41.4	28.6	3210.2	58.6	40.9	5479.7	69.9	2354.6	30.1	7834.3
1982/83	2092,7	35.3	20.3	3830.8	64.7	37.2	5923.6	57.5	4375.9	42.5	10299.4

Source:

1. State Budget Project of different year 1939/40 tp 1984/85
2. Egyptian-British Trade, The Journal of Egyptian British Chamber of Commerce, September, December 1983.
3. Economic Review, the Journal of Central Bank of Egypt Vol. XXII No. 1 of 1982 (in Arabic)

- G.R. = Gross Revenue
- T.P. = Tax Proceeds

Table (7.3)

The Ratio of Tax Proceeds To GNP

During the Period (1939/40-1982/83)

Year	(1) GNP	(2) Total of DT	2:1 %	(3) Total Of IT	3:1 %	(4) Total Of TP	4:1 %
1939/40	203.0	7.9	3.9	18.5	9.1	26.4	13.0
1944/45	531.0	24.1	4.5	31.0	5.8	55.4	10.4
1945/46	544.0	26.3	4.8	38.0	7.0	64.3	11.8
1946/47	557.0	22.5	4.0	39.6	7.1	62.1	11.1
1947/48	648.0	20.8	3.2	41.0	6.3	61.8	9.5
1948/49	774.0	27.2	3.5	57.2	7.4	84.4	10.9
1949/50	873.0	30.0	3.4	74.9	8.6	104.9	12.0
1950/51	966.0	27.9	2.9	95.7	9.9	123.6	12.8
1951/52	860.4	49.5	5.8	109.8	12.8	159.3	18.6
1952/53	748.1	42.9	5.7	88.5	11.8	131.4	17.5
1953/54	780.1	38.4	4.9	101.0	12.9	139.0	17.8
1954/55	867.5	41.9	4.8	99.1	11.4	141.0	16.2
1955/56	899.8	43.1	4.8	105.6	11.7	148.0	16.5
1956/57	913.1	52.1	5.7	103.2	11.3	155.3	17.0
1957/58	1195.0	52.4	4.4	105.7	8.8	158.1	13.2
1958/59	1256.0	51.5	4.1	112.9	9.0	164.4	13.1
1959/60	1375.0	50.6	3.7	116.3	8.5	166.9	12.1
1960/61	1459.0	54.5	3.7	125.6	8.6	180.1	12.3
1961/62	1513.3	50.3	3.3	139.3	9.2	189.6	12.5
1962/63	1684.6	53.4	3.2	166.1	9.9	219.5	13.1

Table (7.3) cond.

1963/64	1887.9	68.6	3.6	207.3	11.0	275.9	14.6
1964/65	2191.8	90.0	4.1	227.3	10.4	317.3	14.5
1965/66	2388.2	96.9	4.1	263.0	11.0	359.9	15.1
1966/67	2458.9	110.6	4.5	283.1	11.5	393.7	16.0
1967/68	2509.7	120.9	4.8	316.7	12.6	437.6	17.4
1968/69	2657.0	132.0	5.0	323.0	12.2	455.0	17.2
1969/70	2926.6	156.5	5.3	375.0	12.8	531.5	18.1
1970/71	3086.3	178.9	5.8	401.8	13.0	580.7	18.8
1971/72	3403.0	181.5	5.3	407.7	12.0	589.2	17.3
1973	3634.0	194.6	5.4	436.6	12.0	631.2	17.4
1974	4389.3	197.0	4.5	552.0	12.6	749.0	17.1
1975	5230.5	256.0	4.9	784.0	15.0	1040.0	19.9
1976	6837.6	345.0	5.0	996.0	14.6	1341.0	19.6
1977	8643.1	460.0	5.3	1530.0	17.7	1990.0	23.0
1978	10777.5	613.0	5.7	1563.0	14.5	2176.0	20.2
1979	13913.9	703.1	5.1	1749.8	12.6	2452.9	17.7
1980/81	19354.0	1588.1	8.2	2593.0	13.4	4181.1	21.6
1981/82	21591.8	2269.5	10.5	3210.2	14.9	5479.7	25.4
1982/83	22160.0	2092.7	9.4	3830.8	17.3	5923.5	26.7

Sources: (i) Development of Economic Policy in the UAR (Egypt). (ii) Economic Review, Central Bank of Egypt diferent Nos. Of diferent years. (iii)The annual book, July 1972-80.

GNP = Gross Ntional Product. DT = Direct Tax.

IT = Indirect Tax. TP = Tax Proceeds.

Note: There is no data available about Egyptian GNP For Years 1983/84 and 1984/85.

Table (7.4)

Proceeds of Direct and Indirect Taxes in

The UK during the Period 1974-1984

Year	Direct Taxes £mn	%	Indirect Taxes £mn	%	Total £mn
1974	13487	54.9	11101	45.1	24588
1975	17638	56.4	13646	43.6	31284
1976	19837	55.6	15837	44.4	35674
1977	21439	52.6	19309	47.4	40748
1978	23648	51.6	22177	48.4	45825
1979	26399	47.6	29118	52.4	55517
1980	32271	47.5	35652	52.5	67923
1981	37533	47.4	41599	52.6	79132
1982	42399	48.2	45565	51.8	87964
1983	45279	48.5	48047	51.5	93326
1984	48925	48.8	51357	51.2	100282

Source: United Nation, National Accounts Statistics: Main Aggregates and Detailed Tabels, 1984, PP1603-1641.

Table (7.5)

The Ratio of Tax Revenue to Gross

National Product

Year	Direct Tax £mn	Direct Tax %	Indirect Tax £mn	Indirect Tax %	Total Of Tax £mn	Total Of Tax %	GNP £mn
1974	13487	15.9	11101	13.1	24588	29.1	84597
1975	17638	16.7	13646	12.9	31284	29.5	105902
1976	19837	15.7	15837	12.5	35674	28.2	126368
1977	21439	14.8	19309	13.3	40748	28.1	145217
1978	23648	14.1	22177	13.2	45825	27.3	167852
1979	26399	13.4	29118	14.7	55517	28.1	197720
1980	32271	14.1	35652	15.5	67923	29.6	229662
1981	37533	14.8	41599	16.4	79132	31.2	253325
1982	42399	15.3	45565	16.5	87964	31.8	276324
1983	45279	15.0	48047	16.0	93326	31.0	300928
1984	48925	15.2	51357	16.0	100282	31.2	321302

Sources: United Nation, National Accuonts Statistics: Main Aggregates and detailed Tabls, 1984.

Table (7.6)
Tax structure, Total Revenue
Total Tax Proceeds during the period

	1939/40 Val	% of G.R.	% of T.P.	1944/45 Val.	% of G.R.	% of T.P.	1945/46 Val.	% of G.R.	% of T.P.	1946/47 Val.	% of G.R.	% of T.P.	1947/48 Val.	% of G.R.	% of T.P.	1948/49 Val.	% of G.R.	% of T.
Tax on movable capital				5.7	6.5	10.3	5.7	5.7	8.8	5.0	5.1	8.1	11.2	4.5	6.8	5.0	4.0	5.
Tax on exceptional profits				7.5	8.5	13.6	9.0	8.7	14.0	10.6	10.9	17.1	10.5	11.1	17.0	13.8	11.2	16.
Additional Tax on trade revenue				9.6	16.9	17.4	9.8	9.9	15.3	5.3	5.4	8.4		4.4	6.7	6.0	4.9	7.
General Income Tax																		
Inheritance Tax				-	-	-	.3	.3	0.5	0.8	0.7	0.7	1.1	1.0	0.8	1.2	-	1.
Transfer of property duties				1.3	1.5	2.4	1.5	1.5	1.2	1.8	1.3	1.4	2.1	1.4	1.2	1.7	1.8	1.
Total of Direct Tax	7.9	17.1	29.9	24.1	27.4	43.7	26.3	25.7	40.9	22.5	23.1	36.2	20.8	22.1	33.7	27.2	22.1	32.
Stamp Tax	-	-	-	1.6	1.8	2.9	1.8	1.7	2.8	2.2	2.2	3.5	2.0	2.1	3.2	2.7	2.2	3.
Custom	18.5	-	-	29.4	33.5	53.4	36.2	35.0	56.3	37.4	38.4	60.2	39.0	41.4	63.1	54.6	44.4	64.
Other indirect tax	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total of Indirect Tax	18.5	40.1	70.1	31.0	35.3	56.3	38.0	36.7	59.1	39.6	40.6	63.7	41.0	43.5	66.3	57.3	46.6	67.
Total of Tax Proceeds	26.4	57.2	100.0	55.1	62.7	100.0	64.3	62.4	100.0	62.1	63.8	100.0	61.8	65.6	100.0	84.5	68.7	100.
Other Revenue	19.7	42.8		32.7	37.3	-	39.1	37.4	-	35.3	36.2	-	32.3	34.4	-	38.5	31.3	
Gross Revenue	46.1	100.0		87.8	100.0		103.4	100.0	-	97.4	100.0	-	94.1	100.0	-	122.9		

Table (7.6) contd.

	1952/53			1953/54			1954/55			1960/61			1961/62			1966/67			1967/68		
	Val.	% of (1)	% of (2)	Val.	% of (1)	% of (2)	Val.	% of (1)	% of (2)	Val.	% of (1)	% of (2)	Val.	% of (1)	% of (2)	Val.	% of (1)	% of (2)	Val.	% of (1)	% of (2)
Tax on income (individual & business)	23.1	11.7	17.6	20.1	9.7	14.4	18.3	8.3	13.0	34.6	9.3	19.3	32.9	7.8	17.4	99.8	13.3	25.4	92.2	14.3	21.0
Tax on property & Capital Tax	19.8	10.0	15.1	18.3	8.9	13.1	23.6	10.7	16.7	19.9	5.4	11.0	17.4	4.1	9.2	10.8	1.4	2.7	28.7	4.5	7.0
Total of Direct Tax	42.9	21.7	32.7	38.4	18.6	27.5	41.9	19.0	29.7	54.5	14.7	30.3	50.3	11.9	26.6	110.6	14.7	28.1	120.9	19.8	28.0
Taxes on goods & services custom duties, excise & consumption duties, stamp duties	88.5	44.7	67.3	101.0	48.9	72.5	99.1	45.1	70.3	125.6	33.9	69.7	139.3	32.9	73.4	283.1	37.6	71.9	316.7	49.3	72.0
Indirect Tax	88.5	44.7	67.3	101.0	48.9	72.5	99.1	45.1	70.3	125.6	33.9	69.7	139.3	32.9	100.0	283.1	37.6	71.9	316.7	49.3	72.0
Total of Tax	131.4	66.4	100.0	139.4	67.5	100.0	141.0	64.1	100.0	180.1	48.6	100.0	189.6	44.7	-	393.7	52.3	100.0	437.6	68.1	100.0
Other Revenue	66.7	33.6		67.6	32.5		78.7	35.9		190.9	51.4		334.4	55.3		359.3	47.0		205.4	31.9	
Total Revenue	198.1	100.0		206.4	100.0		219.7	100.0		371.0	100.0		524.0	100.0		753.0	100.0		643.6	100.0	-

Table 7.6 (contd.)

	1974 Val	1974 % of T.P.	1974 % of G.R.	1975 Val.	1975 % of T.P.	1975 % of G.R.	1976 Val.	1976 % of T.P.	1976 % of G.R.	1977 Val.	1977 % of T.P.	1977 % of G.R
Tax on income Individual income Business Profit Tax on Properties and C.G.	131.9 65.1	17.6 8.7	11.1 5.5	196.6 59.4	18.9 5.7	11.8 3.6	242.9 102.1	18.1 7.6	11.8 5.0	312.4 147.6	15.7 7.4	11.4 5.4
Total direct Tax	197.0	26.3	16.6	256.0	24.6	15.4	345.0	25.7	16.8	460.0	23.1	6.8
Tax on goods and services(custom excess stamp duties	552.0	73.7	46.6	784.0	75.4	47.1	996.0	74.3	48.4	1530.0	76.9	55.8
Total tax proceeds	749.0	100	63.3	104.0	100	62.5	1341.0	100	65.2	1990.0	100	72.6
Other Revenue	435.0	-	36.7	62.6	-	37.8	718.0	-	34.9	751.0	-	27.4
	1184.0			1666.0			2059.0			2741.0		

	1978 Val	1978 % of T.P.	1978 % of G.R.	1979 Val	1979 % of T.P.	1979 % of G.R.	1980/81 Val.	1980/81 % of T.P.	1980/81 % of G.R.	1981/82 Val.	1981/82 % of T.P.	1981/82 % of G.R.	1982/83 Val.	1982/83 % of T.P.	1982/83 % of G.R.
Tax on income Individual income Business Profit Tax on Properties and C.G.	387.5 225.5	17.8 10.4	11.7 6.8	502.0 201.1	20.4 8.3	14.1 5.6	1078.4 509.7	25.8 12.2	15.3 7.2	1750.1 519.4	31.9 9.5	22.3 6.6	1942.6 150.1	32.8 2.5	18.9 1.5
Total direct Tax	613.0	28.2	18.5	703.1	28.7	19.7	1588.1	38.0	22.5	2269.5	41.4	28.9	2992.7	35.3	20.4
Tax on goods and services(custom excess stamp duties	1563.0	71.8	47.3	1749.8	71.3	49.1	2593.0	62.0	36.7	3210.2	58.6	41.0	3830.8	64.7	37.2
Total tax proceeds	2176.0	100	65.8	2452,9	100	68.8	4181.1	100	59.2	5479.7	100	69.9	5923.5	100	57.6
Other Revenue	1131.0	-	34.2	111.6	-	31.2	2878.0	-	40.8	2354.6	-	30.1	4375.9	-	42.4
	3307.0			3568.9			7059.1			7834.3			1029.9		

Table (7.7)
Proceeds of direct taxes during the Period 1979 - 1983/4

	1974 Value	1974 %	1975 Value	1975 %	1976 Value	1976 %	1977 Value	1977 %	1978 Value	1978 %	1979 Value	1979 %	1980/81 Value	1980/81 %	1981/82 Value	1981/82 %	1982/83 Value	1982/83 %
Land Tax and Building Tax	49.8	17.0	61.7	24.1	33.8	9.8	34.0	7.4	39.2	6.4	24.6	3.5	34.9	2.2	37.0	1.6	39.9	1.9
Tax on Movable Capital	62.3	31.6	57.1	22.3	98.3	28.5	143.5	31.2	221.3	36.1	196.2	27.9	501.8	31.6	511.0	22.5	138.3	6.6
Commercial & Industrial Profit Tax	65.4	33.2	105.7	41.3	158.0	45.8	219.0	47.6	293.0	47.8	418.3	59.5	971.9	61.2	284.6	12.5	417.3	19.9
Corporation Tax	-		-		-		-		-			-	-		1342.1	59.1	1378.8	65.9
Tax on Wages & Salaries	29.2	14.8	25.3	9.9	44.5	12.9	50.1	10.9	41.7	6.8	40.8	5.8	47.6	3.0	51.1	2.3	51.5	2.5
Tax on Liberal Professions	2.0	1.0	2.0	.8	3.5	1.0	4.6	1.0	6.1	1.0	9.1	1.3	12.7	.8	17.5	.8	16.4	.8
General Tax on Income	2.0	1.0	1.8	.7	3.1	.9	4.6	1.0	7.4	1.2	7.7	1.1	11.1	.7	17.8	.8	37.7	1.8
Estates and Inheritance duties	2.8	1.4	2.3	.9	3.8	1.1	4.1	.9	4.2	.7	4.9	.7	7.9	.5	8.4	.4	11.8	.6
Total Direct Tax	197.0	100	256.0	100	345.0	100	460.0	100	613.0	100	703.1	100	1588.1	100	2269.5	100	2092.7	100

Source: National Planning Institute. Issues of planning and development in Egypt. No. 12 Taxation system. The Financial Accounts of the State Budget, Central Auditing Agency. Egyptian British Trade: The Journal of the Egyptian - British Chamber of Commerce August 1985.

Chapter 7 Reference

1. See table (7.3).
2. Tabary A.G.M., History Of The Nations and Kings, Dar El Kamoose Al Hadeese, Vol. No.4, Beyrouth, P.226.(in Arabic)
3. Zakat is an obligatory duty upon the Muslims which must be paid under all circumstances to please God. It is leived upon the Muslim members of the State only and the non-Muslims are exempted from its payment. It is in fact, like prayer, a form of worship or a religious duty based on entirly different psychological feelings than an ordinary tax. The muslim government is given special instructions by the Holy Quran as to how and where to spend the revenue from the collection of Zakat. therefore the government has no option to dispurse the Zakat revenue on items specified by Holy Quran. Zakat differs than ordinary tax because Zakat is a religious duty and an act of worship whereas a tax is only an economic tool adopted to collect revenue for the State; the source and rate of Zakat are determined by the Holy Quran and Sunnah and can never be changed by any person or government. The source and rates of tax on the otherhand, can be changed from time to time according to requirements by the government of the country.
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8. SS.69-71 of Tax Law No.14 of 1939.
9. SS. 61 and 62, Tax Law No.14 of 1939.
10. Ibid, S.76.
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17. S.40, op cit, Law 14 of 1939.
18. S.32, of Tax Law14 of 1939.
19. For more detail, see capital allowance in chapter four.
20. S.39 (5), op cit, Tax Law 14.
21. Ibid, S.57.
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24. Ibid,S.36.
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27. Ibid, S.37.
28. Ibid, S.42.
29. Ibid, SS.42-47.
30. Ibid, S.1(1).
31. Ibid, S.11.

32. Ibid, S.4.
33. Ibid, S.7.
34. S.2, Tax Law, 99 of 1949.
35. Ibid, S.11.
36. Soliman S.R., Inheritance Tax in Egypt, Cairo, 1984, at P.10.
37. Economic Review, op cit, p.13.
38. S.28, of Tax Law No. 46 of 1978.
39. Published in the Official Journal No. 278 dated 5th December 1960.
40. Fiddan = 4200 Square metres.
41. Soliman S. R., (1984), op cit, at pp.9-11.
42. Nasif F., op cit, P.14.
43. State Budget Progect For 1957/58.
44. National Bank of Egypt, (1984) Economic Bulletin, Vol. XXxVII- No.1, Cairo, PP.12-15.
45. Inland Revenue, op cit,P.7.
46. Rate and validity date amended by Law No.32 of 1968.
47. Republic Decree No.1953 by virtue of 1961 which was applied in 1962.
48. See Appendix 4 (Egyptian Investment Law No. 43 of 1974).
49. National Bank of Egypt, op cit, P.13.
50. Central Bank Of Egypt, op cit, P.22.
51. Ibid, P.27
52. Abd El Azime A.H., and others, op cit, P.3
53. S. 1 of Tax Law No. 157 of 1981.
54. Ibid S.1(11).
55. Ibid, S.13.
56. Ibid, S. 15.
57. Ibid, SS. 16 and 17.
58. See Chapter 9 in this research.
59. Tax Law 14 of 1939.
60. S.32,Tax Law 157 of 1981.
61. Ibid, S.31.
62. Tax rates on distributed profit was 40.55% and on undistributed profit was 39.7%
63. More detail in the following chapters.
64. Abd El Azime A.H, and others, op cit, P.95.
65. SS.131 and 132, op cit, Tax Law 157.
66. Op.cit, National Bank Of Egypt, No.1, 1984, P.19.
67. Ibid, P.20.
68. National Bank of Egypt, Economc Bulletin, Vol. XXXVII No.1, Cairo, 1984, pp.20-22.
69. Ibid, p.19.

CHAPTER EIGHT

COMPANY TAXATION THE PRESENT SITUATION IN EGYPT

Chapter Eight

Company Taxation the the Present Situation in Egypt

8.1 Introduction

In Chapter Seven we traced the development of the Egyptian tax system before 1939, we examined tax laws 14 of 1939 and 157 of 1981; the role of taxation in financing public revenue, and its importance relative to gross national production. Also we classified the Egyptian tax structure and the Egyptian tax system and its general objectives.

In this chapter we will be inquiring into the present taxation of companies' income in Egypt, including the taxation of distribution, by examining the basic provisions of the current legislation on the subject namely the corporation tax which was issued for the first time in Egypt according to Tax Law No.157 of 1981, and the tax treatment of a company under tax law 14 of 1939.

Accordingly we shall, in this chapter, deal first with the taxation of companies income under the past and the present tax systems and later on with the tax treatment of distributions. Before doing this, it is necessary to point out the meaning of "company" and its forms according to Egyptian law; which type of forms of business are suitable for foreign enterprises to operate in Egypt; classification of companies for tax purposes; why a company is subject to CT, the administration requirements of CT in Egypt, and the effect of CT upon the Egyptian economy.

8.2 The Meaning of "Company" and Its Forms According to Egyptian Law

The Egyptian Law of business associations is based on French legislation. The basic organisational concept for any business association in Egypt is the "sharika" company.

The word company, according to Egyptian Laws has no strictly legal meaning. It is clear, however, that the term implies an association of a number of people to realise some common object or objects. Under article No.505 of the Egyptian Civil Code the definition of "company" is a company or"association", i.e. a contract by which two or more persons oblige themselves to contribute capital or labour to pecuniary enterprise. According to this definition, and Egyptian Law, the word company is applied to both partnership and company. Also the Egyptian Law does not permit a one-man company.

I) Types of company

The Egyptian Commerce Code (ECC) determines the various types of companies available to an enterprise contemplating business in Egypt, one must refer to articles 19-25 of the ECC, as well as to Law No.26 of 1954 which are amended by Law No.159 of 1981. Basically, the law recognizes five forms of business associations:

(1) The partnership;

(2) The limited partnership;

(3) The limited partnership by share;

(4) The joint stock company; and

(5) The limited liability company;

Each of these forms will be considered briefly below.

(1) The partnership is defined by article 20 of the ECC and Article 505 of the Civil Code as a contract by which two or more persons agree to undertake a business for their common account under a business name. The name of one or more of the partners only, may figure in the business name. All partners are liable for the obligations of the partnership contracted by one of the partners in the business name. The Act establishing the partnership must be in writing, but it may either be a simple private agreement or a notarized contract. The Law requires the partnership to file an extract of the agreement with the Clerk of a Court in the first instance and also publish it in a local newspaper. This extract should contain the names of the partners, and the duration of the partnership.

There are restrictions on what can constitute a capital contribution of a partner. His 'influence' or credit-worthiness, for example, cannot be treated as capital.(1) Influence would include his contacts in business or Government or his position in politics or society in general. Interest is automatically payable on capital to be contributed of capital in cash if the money is not paid up on time. Also designation of at least two partners who are authorised to administer the enterprise and sign on behalf of the partnership.(2)

(2) The limited partnership is defined as a partnership between one or more partners (general partners), who are jointly and severally liable, and other partners who contribute to the capital but who do not take any part in the management of the partnership and are called limited partners.[3] In this type of partnership there are one or more partners who are fully liable for the obligations of the partnership, and others, i.e. limited partners, who have liability only to the extent of the assets which they have contributed to the enterprise. To preserve his protection from general liability, the limited partner must not take part in the management of the enterprise and his name must not appear in the business name. He does, however, have the right to undertake acts of inspection and supervision without losing his status as a limited partner. Generally speaking, the formalities associated with the creation of this form of business association are the same as those required of the simple partnership.[4]

(3) The partnership limited by shares is governed basically by the ECC and Law No.26 of 1954 as amended by Law 159 of 1981. The partnership limited by share has two types of partner. The management of the partnership is undertaken by certain partners who are fully liable for the debts of the partnership. The other partners are only liable to the extent of their contribution to the share capital of the partnership. The name of the partnership must include the name of one of the managing partners. Most of the provisions of the Company Law 159, applicable to joint stock companies

also apply to a partnership limited by shares. Therefore, shareholder partners may not take part in the management of the company and their liability is limited only to their contribution to capital. The general partners in the enterprise are fully liable for its obligations and may take part in its management.[5]

Generally, the capital of this type of company is subject to the same provisions governing the joint stock company. Thus its paid in capital must not be less than LE 20,000 and its shares unlike those of regular limited partnership, are negotiable.

The formalities for establishing a partnership limited by shares are generally similar to those required of a joint stock company. The management of the company is entrusted to one or more directors who must be general partners.

(4) The joint stock company is governed by the ECC as well as Company Law No.159 of 1981. A joint stock company is defined as follows:[6]

"A joint stock company is a company whose capital is divided into shares of equal value, ... The liability of each shareholder is limited to the value of the shares to which he has subscribed. A shareholder is not liable for the debts of the company beyond the said value of the shares subscribed by him." So the capital of a joint stock company is divided into negotiable shares, and the liability of the shareholders extends only to their investment in the company. As a general rule, 49% of the stock must be subscribed by Egyptian nationals or corporate bodies, however, this restriction does not apply to projects approved under Law No.43 of 1974 and to certain other enterprises.

To establish a joint stock company, the paid-in capital must be at least LE20,000; it is divided into shares of equal value having a minimum value of LE1. In addition, the law requires at least seven founders. The management of a joint stock company is entrusted to an administrative council (Board of Directors) consisting of at least three members. The council meets at least four times a year. Company law requires the company to submit to the General Director of Companies in the Ministry of Economy an annual list of the names, ages, qualifications and nationalities of the members of the Administrative Council.

The stockholders of the company are convened in a general meeting at least once a year. Under the law, the invitation to the meeting must be published twice, in two newspapers (one of which is in Arabic) and the second publication must take place not less than ten days before the meeting. Such invitations must include the agenda of the meeting.

(5) The limited liability company is defined in the Company Law 159 as follows:(7)

> "A limited liability company is a company whose shareholders do not exceed fifty in number, each of the shareholders being liable up to the value of his shares. The company may not be incorporated by way of public offer

of shares nor may it increase its capital nor raise loans by way of a public subscribtion. It may not issue freely negotiable shares or debentures. The transfer of shares shall be subject to the other shareholders' rights of preemption in accordance with the provisions of the company's Statutes and with the provisions of this law."

This form of business association is designed to give shareholders limited liability in closely held ventures. The number of shareholders in a limited liablility company may not be more than fifty, and its shares may not be the subject of a public offering. The law forbids the limited liability company from undertaking certain types of activity including, insurance, receiving deposits, or engaging in the general investment of the funds of others.

To establish a limited liability company, the law requires a minimum capital of LE1000 which is divided into shares having a face value of not less than LE20 each. Except for projects approved under Law No. 43, only physical persons may become shareholders in the company, the number of shareholders may never be less than two, or, in a case where the two shareholders are husband and wife, three. One of the principal characteristics of this form of company is that its shares are not freely transferrable. A shareholder wishing to sell must inform the other shareholders of his intention and offer his shares to them first. In addition, the law permits the company's articles to impose additional conditions and limitations on the sale of shares.

(II) Foreign Business operating in Egypt

There are four different forms of business which foreign companies can operate in Egypt: an Egyptian registered company, a branch office, a representative office and business through an accredited Egyptian agent.

The basic choice for the foreign investor is between the two company forms. A joint stock company is required by law for banking, insurance and investment enterprises. It also has the advantage of issuing public shares which can be used to raise capital. This will become a major advantage, however, when Egypt redevelops its domestic capital market.

The limited liability company is not encumbered with the corporate requirements of the joint stock company and it is easier to form. But apart from being forbidden to operate in certain areas of business, it cannot raise capital publicly, and changes in ownership may be difficult to achieve. For the present, it represents the most usual form of company for foreign investors.

The first step in the formation of a limited liability company is preparation and signature of the articles of incorporation. The limited liability company is in the nature of a contractual relationship which is formed through the signing of the articles of association as follows:

(1) The name, kind, purpose and Head Office of the company, including local registered address;

(2) name, places of residence, occupations and nationalities of the partners;

(3) name of managers, whether or not they are partners;

(4) name of board members, if any;

(5) amount of capital, value of shares, and a description of the donated capital, the names of people contributing each, and whether or not the shares are transferable;

(6) acknowledgement by all partners that all capital shares have been paid in full and properly allocated;

(7) a profit and loss distribution formula

(8) The forms of notices that will be used in communications between the company and the partners, and

(9) the name and address of the relevant Egyptian auditor and bank depository.[8]

(III) Classification of companies for tax purposes

The major legal distinction among companies in Egypt is between personal and finance companies. It is significant to note that for tax purposes the classification of companies is slightly more complex than is the simple division into personal and finance companies. Personal companies, which are generally smaller than finance companies, are still subject to commercial and industrial profit tax according to the Egyptian tax law 157 of 1981 at progressive tax rates starting from 20% to 32%.

While the finance companies are subject to CT, there are three major categories of CT rate: first, industrial companies are subject to CT at the tax rate of 32%, secondly, commercial companies are subject to CT at tax rate of 40% finally the oil companies are subject to CT at tax rate of 40.55%.

(IV) The Commercial Registry

The economic units in Egypt consist of the properatorship in addition to the kinds of business mentioned above (as shown in the figure (7.3). All merchants must be entered in the registry. In addition to individual merchants, all partnerships, limited liability companies and joint stock companies must be registerd. Such partnerships and companies should be separately registered if it is in the area of another Commercial Registry.

The general rule is that any applicant must be of Egyptian nationality. However, the Law 34 of 1976[9] permits the following entities to be registered:

(a) A company established under Law 43 of 1974.

(b) A partnership provided that at least one of the managing partners with power of signature is an Egyptian and provided at least 51% of the capital is owned by Egyptians.

(c) Any foreign company with its head office abroad carrying out any commercial, financial, industrial or contracting activity in Egypt provided it has received the approval of the General Authority for Foreign Investment and the Free Zones.[10]

(V) Business Organisations according Egyptian Laws

There are five forms of business organisation, three of which are partnerships, so-called personal companies, and two of which are corporations, so-called finance companies.

Certain matters common to all such organisations will be described in the following points:

1. It should be noted that there are three governing laws: the Commercial code, the Civil Code and the Company Law (Law 159 of 1981). All partnerships and corporations, whether civil or commercial, are considerd to have their own legal personality. Legal entities are entitled to benefit from all legal rights accorded by the law, with the exception of those rights particular to physical persons. The Civil Code states that a legal entity has the following characteristics:[11]

(i) It has its own patrimony i.e the totality of all one's property, movable or immovable, and of all rights over this property and against third parties, which may be expressed in monetary terms.

(ii) It has legal capacity. This means that the entity has the capacity to enter into binding obligations and that all its actions will have legal consequences according to Egyptian laws.

(iii) It may sue and be sued as an entity.

(iv) It has its own domicile. The domicile of a legal entity is stated to be where its seat of management is situate. If a corporation is registered abroad and its board of directors meets abroad, it will nevertheless be deemed to have a domicile in Egypt if it operates in Egypt. In such a case its domicile will be situate at the place where its local management is based. In the case of a joint stock company established in Egypt the Commercial Code provides that the head office shall be located in Egypt. Such a company, therefore, cannot have its domicile abroad. Also it provides that share companies established in Egypt shall be of Egyptian nationality.

(v) A company cannot offer a loan to, or guarantee the loan of, a director.

(vi) A director cannot carry out any technical or administrative function in another joint stock company without permission from the shareholders of the company in question.

(vii) A director cannot be involved in any activities on his own behalf, or on behalf of third party, similar to the activities carried out by the company.

2. The major legal distinction among companies in Egypt is between personal and finance companies. It is significant to note that for tax purposes the classification of companies is slightly more complex than is the simple division into personal and finance companies. Personal companies, which are usually smaller than finance companies, are still sbject to commercial and industrial profits tax according to the Egyptian Tax Law 157 of 1981 at progressive tax rates starting

from 20% to 32%, or 40%. While the finance companies are subject to CT, there are three major categories of CT rate:

(i) industrial companies are subject to corporation tax at the tax rate 32%;

(ii) commercial companies are subject to corporation tax at tax rate 40% and

(iii) the oil companies are subject to corporation tax at tax rate 40.55%.

8.3 Why a company is subject to Corporation Tax

A corporation has been defined in a variety of ways and the form of taxation known as CT seems to be a permanent element in the tax structure of most countries. This is due to the changes in public policy towards Corporations to influence their behaviour. The increasing dominance of corporate forms of enterprise has led to the separate taxation of companies and this kind of taxation is seen as a major element in any co-ordinated government policy to stimulate investment and raise the rate of economic growth.

Moreover, the main arguments for taxing company profits are as follows:[12]

(1) The Company is a separate legal person with certain privileges;

(2) The Company as a separate person is entitled to receive income from trading or investment and distribute such income to its members;

(3) Company status confers certain privileges and a company should pay for such privileges;

(4) Companies can afford to shoulder their fair share of the tax burden;

(5) It would represent a lack of balance in both principle and practice, not to tax a company's profits when the similar profits are directly taxed on the individuals or partnerships;

(6) Companies occupy an important place in the economy, and their profits represent a significant part of national income

which no government can afford to ignore; and

(7) The taxing of company profits is not only necessary politically, but is also perhaps more acceptable because of the impersonal nature of such artificial persons.

(I) <u>The administrative requirements of corporation tax in Egypt</u>

A corporation tax in Egypt obviously requires modern and effective tax administration principles and techniques. Steps have been taken to make the administrative changes required in order to improve the tax administration's capacity, through planning and organizing staffing and the auditing of corporate taxpayers. These changes are intended to improve all aspects of the tax administration from resolving disputes, to collecting the amount due without unnecessary burdens on taxpayers or offficials.

These requirements will be discussed in some detail as they are closely related to the corporation tax and are therefore more important items.

(II) <u>Assessment function and auditing problems</u>

(1) Improvements are needed in the relevance of taxpayer's declarations and the assessment of information in the area of obtaining information for tax assessment. The proposals suggest a comprehensive reporting system (a comprehensive return) as a self-checking system of taxation. There must

be some inducements or penalites to ensure compliance when obtaining assessment information from sources other than the taxpayer without a heavy burden on the informant to keep reliable records of transactions over a particular period. Nevertheless, there are practical limits on the use of information returns to aid tax administration. A national system of tax identification numbers for corporate taxpayers should be developed to facilitate the cross-checking of information returns and to prepare for eventual introduction of computers.(13)

(2) One of the practical problems in separating audit and assessment work is selecting returns for making detailed audits. All returns received should be entered in a Register, and the Commissioner should select a small percentage in selecting the cases for auditing. The adoption of a random sampling method is suggested. The corporation tax administration must develop the capacity for making detailed audits of the selected taxpayers. Such detailed audits typically should go beyond the books presented to the tax authorities. Teams of auditors should be involved, and the usual time pressures on auditors should be removed, since the real pay off from these audits comes from the response of those not audited rather than from the revenue collected directly as a result of audits.

Above all, a common-sense approach to checking and reconciling returns should be developed so that time which is saved ignoring trivial matters can be used on more important ones, particularly in disclosing possible instances of evasion.

(3) Scrutinising major cases where certificates of Chartered Accountants are given and cases which involve complicated legal points or wide ramifications should be dealt with by the Inspecting Assistant Commissioner himself who would pass assessment orders. Officers in the field do not have sufficient experience and breadth of vision necessary for handling important cases.

A pool of the best professional tax auditors available who are capable of swift and effective action can be a highly valuable instrument for encouraging taxpayers to be straightforward with the tax authorities. It can foster a greater degree of voluntary compliance with laws which is the basis of all modern systems of tax administration.

These administrative changes are required to improve the tax administration's capacity in resolving the problems resulting from noncompliance that now take a variety of forms, for example, the failure of some taxpayers to file a tax return, or where they may file it, but understate receipts or overstate deductions, allowances and credits. So, a taxpayer may avoid taxes or try to minimize his tax liability by tax cheating.

8.4 Company Taxation The Present Situation In Egypt

The income tax system in Egypt is based on schedular taxes on the different categories of income. At the present time, Egypt levies a personal income tax on dividends and a tax on corporation income from commercial and industrial profits. In the last ten years, many foreign corporations carried out their activities in Egypt through agencies, branches or subsidiaries. On the other hand, the activities of many Egyptian corporations have extended beyond Egypt especially in the Arabian and African countries of the Middle East. Egyptian corporations were liable to tax on commercial and industrial profits whatever the object of such corporation.(15) Even if it runs an agricultural business, a corporation will pay a commercial and industrial tax on its profits. The tax on commercial and industrial profits is payable on the profits made by all establishments operating in Egypt.(16) The rate of this tax, including additional taxes and duties, was at 39.7 percent. The tax is levied every year on net profits made during the previous year, or during the period of 12 months covered by the last balance sheet. The net profits subject to tax were computed on the basis of the general result of all business transactions, either continuing or closed, carried out by the corporation, including the sale or transfer of any asset after deduction of all charges and expenses. The taxpayer is entitled to carry forward loses for three years.

There are some provisions in the law which allow the deduction of other kinds of income from the taxable profits in order to avoid double taxation. According to S.35 of Law No.14 of 1939, corporations are entitled to deduct from their taxable profit a sum equivalent to the total amount distributed out of such profits on which the tax on dividends and interest has actually been paid. In some cases, the commercial and industrial profits of a corporation include revenues from transferable securities or from land and buildings. These amounts are subject to tax imposed in another schedule, and it is not considered fair to ask the corporation to pay another tax when these revenues are entered among business profits. For this reason, according to S.36 of Law 14 of 1939, a corporation is allowed to deduct from its commercial income 90% of the income derived from transferable property forming part of its assets which is liable to the tax on dividends and interest, or is exempted from taxation by other laws. The 10% which is not deducted is the proportion of expenses or charges pertaining to these assets. In a similar manner, the income derived from rural or urban buildings, forming part of the assets of the corporation, after deduction of 10% thereof, may be deducted from the net income of the corporation.

According to the Law No. 14 of 1939 and Law No. 99 of 1949 corporations withhold a schedule tax on distributions to their shareholders who at the same time pay the general income tax, if the total net annual income of each taxpayer is more than 1200 L.E. per year.

According to the provisions of Book 1 of Law no.14 of

1939, a tax on income from movable capital asset is levied on income derived from securities (stock, shares, etc.) as well as an interest due on debts, deposits, and guarantees. The rate of this tax is a 40.55%.[17] The tax is also levied on dividends, interest, arrears, repayments, etc., paid by foreign companies or enterprises as well as on all interest and annuities of every kind derived from foreign bonds, securities or foreign public funds, if the persons entitled thereto are Egyptian, or foreigners residing in Egypt. In addition to encouraging the private sector to work and increase its productivity, the government issued Law No .430 of 1953 exempting the following companies from commercial and industrial profit tax;

(1) Limited Companies and limited partnerships with shares operating in mining, electric power and hotels;

(2) Limited companies and limited partnership with shares which were standing and working in mining, electric power, and hotel all of which were entitled to this exemption if such companies increased their capital; and

(3) These companies which operated the aforementioned activities were exempted from half the commercial and industrial profit tax on undistributed profit.

In 1956 the government enacted Defence tax, which charged on commercial and industrial profit, at tax rate 10.5%. In 1962 the Law No.23 was issued to provide the taxpayers with a personal allowance and more exemption from commercial and industrial profits tax to encourage their to invest. In 1967

National Security Tax, charged on commercial and industrial profit, was enacted by Law 23 of 1967 at a tax rate 8%. Moreover, in 1973 War Effect tax was charged on commercial and industrial profit at a tax rate 2.5%.

In 1981 the Egyptian Government abolished Tax law 14 of 1939 and enacted Law 157 of 1981. According to this law, limited companies, stock companies and other kind of companies were subjected to a new tax: so-called corporation tax.

8.5 A separate corporation tax in the Egyptian Tax System

Egypt is, as metioned earlier, now applying a new economic Open Door Policy to encourage Arab and other foreign funds to invest all over the country, especially in the Suez Canal Zone. For this reason, a tax reform plan has been discussed since 1977. In 1979, the Minister of Finance established a technical committee on tax modernization to carry on the technical work of reform [18].

This Committee held periodical conferences during 1979 and 1980. There were may discussions of the Egyptian Tax Modernization Group during 1978/1980 and reports on "Egyptian Tax Modernization Project" were presented by consultants of the Egyptian Tax Modernization Committee and the members of the sub committees. The participants in these conferences reached a consensus that a separate tax on corporations should be established and that drafting and planning should be started immediately for this separate corporation tax.

It had to be determined what administrative change would be required, and what the major structural features of that tax were to be.

Although one of these new issues is the adoption of a separate corporation tax in Egyptian tax system, there are some arguments for and against a separate corporation tax for Egypt.[(19)]

(i) Argument for: The primary rationale for the taxation of business income at the corporation level in any country is simply revenue. CT in Egypt produces a significant amount of revenue. As a rule it is both administratively and politically easier to collect a given amount of revenue through a separate tax on company profits than through additional tax on personal income. Most of the revenue comes from a small number of relatively large companies, mostly organized in the corporate form. A great amount of the total revenue comes from company taxation in Egypt e.g. the corporation tax proceeds in 1984/85 was EL2022.5mn. as shown from table (8.3). Anothe potential advantage of the CT is its role in stabilization. Since profits tend to be more volatile than national income as a whole, revenue responds strongly to changing economic conditions.

The corporation tax is also seen as increasing progressively in the tax system insofar as dividend recipients are primarily high income individuals so that the incidence of this tax, especially in the large and closely held private corporations, will be highly progressive.

(ii) Arguments against: The view that we should have a separate CT has come under some attack; to summarize the undesirable consequences to taxing corporate Source income; dividends are taxed more highly to individuals than are other sources of personal income; retained earnings are taxed less heavily than dividends; reliance on retained earnings, rather than equity capital raised by new issues, is encouraged, low-income taxpayers pay much higher taxes on their corporate source income than on their income, but the differential for high income investors may be just the opposite; capital is unfairly distributed between the corporate and non-corporate sectors; and debt financing is, in general, favoured as opposed to equity financing.

Thus it seems to me, the separate corporation tax is more suitable to Egypt, as a less developed country, because its rules both administratively and politically are easier for assessment and collecting amounts of revenue through the company than through additional taxes on personal income. On the other hand this kind of tax does not need higher experiences for working.

8.6 <u>The basic structural features of a corporation tax in Egypt</u>

The formulation of corporation tax policy, for Egypt as a developing country must take into account essential differences from industrial countries in its economic, legal and social structures. Perhaps the most striking distinctions are the relative scarcity of capital and the critical role played by the corporations in mobilizing capital for investment. The internal capital market in

Egypt is relatively unorganized, so that the mobility of capital is limited. The corporations themselves are a major source of capital for new investment. These factors also influence the form the corporation tax will take, as well as that of special provisions to promote domestic savings and wider public ownership of corporations. On the other hand, the relationship between shareholders and corporations in different stages of economic development, especially after the new open-door economic policy now applying in Egypt, call for a re-examination of the tax treatment of corporations which is most appropriate for the new policy.

The basic problems of taxing the corporation in Egypt stem from its treatment as a juridical person separate from its shareholders. Finally (i) there are three rates of corporation tax, Law 87 of 1983, Tax rate on commercial activity is 40%, Tax rate on profit of industrial and export activities is 32%, and Tax rate on profit of prospector company is 40.55%;

(ii) when making any payment in excess of LE10 to the private sector of commission or supplies and services an amount not exceeding 20% must be deducted, by the following:

(1) The Government, local administration, public service organisation.[20]

(2) Companies, newspaper editors organisation and unions.

(3) Associations, clubs, Joint stock companies and branches of foreign companies.

(4) Hotels, Educational establishments and other organisations whose capital is in excess of LE5,000.

8:7 Effect of CT on Methods of Corporate financing

Loan interest is deductible from corporate income before the CT imposed, so that the recipient of bond interest pays tax only on the interest.[21] Dividends paid on stock are not deductible. Under a corporate tax rate, supposing the rate is 40%, a corporation with large earnings must earn approximately LE1.67 in order to pay dividend LE1.00 out of current earnings, while it need earn only LEI.00 to pay LEI.00 of bond interest. Therefore, the tax discrimination between dividend and bond interest is apparent, and on the surface would appear to influence individuals to buy bonds rather than shares, and corporations to react to this demand.

There is some evidence that this discrimination has affected the method of corporate financing. Therefore CT can affect the choice between internal and external financing in three ways through its influence on:

(1) the level of company profits;

(2) the decisions of management to retain these profits or to distribute them, and

(3) the terms on which outside capital can be obtained.

More detail discussion on these methods is as follows:

(1) The level of company profits. What is the effect of CT on the level of corporate profits and hence on internal sources of funds potentially available for expansion? As we understand, the CT will directly reduce net corporate profit especially when the burden of this tax falls on the company. Therefore firms will tend to restrict expenditures on

business investment or, alternatively, they will be stimulated to increase their reliance on external finance. However, it would appear that higher corporation tax is most likely to stimulate external financing rather than to curtail expansion during a period of boom when the incentives to expand are greatest. However, it cannot be assumed that large companies with easy access to the capital market will make expansions that necessitate external financing as readily as those that are internally financed.

In theory, Egyptian tax laws can influence both the quantity and quality of finance available to business. In regard to quantity finance, economic theory recognises the cash flow effect of taxation, whereby the funds available for investment in the private sector are reduced by taxation. Additionally, in Egypt, two other provisions of the law may have a bearing on finance available for business. Firstly, tax exemptions are available for deposits in state-owned saving banks and on investment in treasury bonds, and consequently funds may be channelled away from business into the investments for tax reasons. Secondly, Law 43 of 1974 is expected to encourage investment and to increase funds available for the financing of investment. Article 18 of Law 43 of 1974 says:[22]

> "Interest due on loans in foreign currency concluded by the project even if in the form of a deposit shall be exempted from all taxes and dues. such exemptions shall apply as well to the interest on foreign currency loans

> concluded by the Egyptian participant to finance his share in the project."

Furthermore, the tax law positively discriminates in making provisions for tax minimisation via financing alternatives: the following provisions favour the use of debt capital in preference to equity.

(1) The tax deductability of interest payments favour the use of debt finance in preference to equity.

(2) The provisions under which small companies, i.e. companies with issued share capital of less than LE400 and annual profits of LE800 or less, are taxed at half of the standard company status and thereby make tax savings. This benefit may be used not only by individual investors but also by partnerships.

(3) Investment in some fixed assets, e.g. motor cars which are bought for use of executives, does not attract capital allowances. In such cases, it may be more profitable for a company to lease these assets as the lease charges are an allowable expense.

On the other hand, the benefits of tax-free dividends during a tax holiday, and investment relief (to both individual and corporate investors) are available only on equity investments. These considerations may outweigh the benefits of debt-financing described above when the investment being financial is in an activity entitled to a tax holiday or investment relief.

In our survey result and discussion the question asked was: Has tax been a consideration in your general borrowing policy decisions?

The answer to this question is summarized in the following table.

Table (8.1)

Relevance of taxation in borrowing policy decision

Taxation a relevant consideration Response	MNCS NO.	%
Yes	27	62.8
No	14	32.6
No answer	2	4.6
Total	43	100.00

From the table above about 62.8% of the firms replying to this question said that they considered taxation in their borrowing policy decisions.

We arrived at approximately the same result in interviews with tax inspectors in investment tax offices. They said that the multinational companies (MNCS) prefer to use either external finance specially the interest due on loans in foreign currency which is exempted from all taxes or to use the internal finance when the MNCS are still in the tax holiday period because these companies will be exempted from the tax on commercial and industrial profit and CT for a period of five years of the profits which are reinvested in the enterprise.

Listed below are the answers to the question (Does your company require extra finance? If yes please specify.

(a) Internal finance.

(b) External finance (loans).

(c) Others.

Table (8.2)

Tax incentive for finance policy

Types of finance	Multinational Companies No	%
External Finance (loans)	27	62.8
Internal Finance (increase capital)	14	32.6
Others (increase the current account)	2	4.6

The results indicate there are significant relationships between the finance policy and tax exemption.

The main object apparently is not only to minimise the tax liability by using a suitable borrowing policy but also that as it is quicker to borrow than to obtain owners capital, in addition the loan interest will reduce taxable profit.

Table (8.3)

Proceeds of commercial and industrial profits tax and corporation tax during the period 1974-1984

Value LE.mn

Years	Total of Direct Tax LE	%	Commercial and Industrial Profits LE	%	Corporation Tax LE	%
1974	197.0	100	65.3	33.2	--	--
1975	256.0	100	105.7	41.3	--	--
1976	345.0	100	158.0	45.8	--	--
1977	460.0	100	219.0	47.6	--	--
1978	613.0	100	291.8	47.6	--	--
1979	703.1	100	418.3	59.5	--	--
1980/81	1588.1	100	1032.3	65.0	--	--
1981/82	2269.5	100	160.0	7.1	1342.1	59.1
1982/83	2092.7	100	317.3	15.2	1378.8	65.9
1983/84	2433.8	100	362.4	14.8	2022.5	83.1
1984/85	2525.9	100	318.3	12.6	1977.5	78.3

Sources: National Planning Instiute. Issus of planning and development in Egypt.No. 12 Taxation System. (in Arabic) Egyptian-British Trade August 1985. National Bank of Egypt Economic Bulletin Vol. Nos. 3 of 1982; 3 of 1983; and 1 of 1984. (in Arabic)

It is worth observing that in the last eleven years receipts from direct taxes, as shown from the table (8.3) reflect the increasing importance of direct taxation in the Egyptian system. The increased role of direct taxes is due to the boom which has taken place in the Egyptian economy since 1980/81, resulting in increased profits and personal income, and also to an improvement in the methods of tax collection. Moreover, most of direct tax revenues since 1981 come from a small number of relatively large companies, about 59.1% in 1981 and 83.1% in 1984.

8.8 The effect of corporation tax upon the Egyptian Economy

Taxation is used to meet the public expenditure of the state in addition to the reduction of unnecessary investment which is not in harmony with the national plan for economic and social development. Taxation could provide new resources for the finance of development in this way.

Taxes could be co-ordinated with positive inducements for financing the national investment plan, or, on the other hand, they could be employed in association with certain restrictions that would curtail undesired investments.

In addition, taxes are an effective medium for tackling the large gaps between incomes, thus helping to achieve social equality, particularly in that distribution of wealth is more apparent in underdeveloped countries than in the more advanced nations. What is more, this phenomenon of inequality represents a great danger in underdeveloped countries on account of their extremely low standards of living.

Taxation should also be employed in combating the pressures of monetary inflation which come about as a result of economic development. This is achieved through the reduction of the aggregate effective demand.

The main reason for the existence of company taxation as such is to preserve equity between the company shareholder class and others. However, the levying of taxes on corporate income may have significant effects on the functioning of the economy.[23]

At the outset it can be noted that the effect of corporate tax on economic factors in both the domestic an international field has largely been the subject of a prior statement rather than economic practice.

Moreover, the increasing dominance of the corporate forms of enterprise has led to the separate taxation of companies and this kind of taxation is seen as a major element in any co-ordinated government policy to stimulate investment and raise the rate of economic growth. However, the incidence of corporation tax and its effect upon economic areas such as growth, stability and income distribution has led to a great deal of intellectual dispute and disagreement among economists. This has led to repeated and various suggestions on reforming the system of company taxation.

Internationally, the role of corporation tax was to attract foreign capital for supporting the financing of economic development.

8:9 Distribution of profits in Egypt

Egyptian Legisltion has not thought it necessary to widen the scope of taxation of dividends, therefore, there is no definition of distribution. The only type of distribution to which the tax on income from movable capital assets refers to, is the dividend, which includes a dividend paid to shareholders. This 5% out of the net proofits, which are liable for distribution, inexchange of government bonds, nd 25% for the employees.

Meaning of distribution

The meaning of distribution is widely defined as all payments and transfers by a company to its members other than the repayment of the capital originally subscribed liquidation distributions.

The following are treated as distributions:

(1) Any dividend paid by the company, including a capital dividend;

(2) Any other distribution out of assets of the company in respect of shares in the company, if the distribution out of assets wholly or partly represents a repayment of capital on the shares; when it is made equal in amount or value to any new consideration received by the company for the distribution is not treated as distribution;

(3) Any redeemable share capital or any security issued by the company in respect of shares in, or securities of, unless

issued wholly for a new consideration. Where there has been partial consideration for the issue then such part not properly referable to new consideration is treated as a distribution;

(4) Where a company transfers some of its assets or liabilities to its members or from its members to a company, the excess shall be treated as a distribution if the amount or market value received by the members exceeds the amount or market value of any new consideration given by the company.

In calculating the income of the company liable to Corporation tax, income from dividends, or from the distribution of profits, received directly or indirectly from another body or persons. Only 10% of gross dividends (F1) is liable to Corporation tax. While the distributed profit should be deducted from taxable profit, e.g. taxable profit is LE 6000,000 the company paid Franked payment to its shareholders LE400,000 then the Corporation tax profit is 600,000 less 400,000 = 200,000 which is subject to corporation tax at the tax rate of 32% and dividends (400,000) will be subject to CT at the same rate.

If, however, the amount to be set off exceeds the tax payable, the amount of that excess shall be repayable by the tax office to the company. The purpose of this provision is to prevent economic double taxation since the dividend has already borne tax.

8.10 Non resident companies

The Egyptian Law provides for absolute equality of taxation between Egyptian and foreign corporations according to SS. 14 and 111 of Law 157 of 1981. However, circumstances may differ in the case of a foreign corporation which is situated in Egypt or which carries on business in Egypt. Egyptian Law makes a distinction between two kinds of foreign corporations as follows:

(1) Foreign corporations which carry on business solely in Egypt;[24]

(2) Foreign corporations whose activities extend to countries other than Egypt; in these cases there are difficulties in determining the amount of distribution liable to Egyptian income tax because the amount of distribution is decided and declared in the head office of the foreign corporation outside Egypt. Therefore, the Egyptian tax system provides that every foreign company whose activities extend to countries other than Egypt, its profit is liable to CT or commercial and industrial profits tax if it is a dependent establishment. The profits of an independent establishment are not liable to these taxes. Section 4 says:[25]

> "The profits of an establishment operating in Egypt derived directly from activities practised abroad shall also be taxable unless such activities shall take the form of an independent establishment."

<u>Discrimination between domestic (resident) and (non-resident) foreign shareholders</u>

A serious policy question arises over the treatment of earnings distributed to non-residents. The problem is not only a question of tax equity between foreign and domestic shareholders, but also of the possible effect on economic development of the taxes on corporate profits and dividends. Dividend tax policy must be guided by considerations of equity as well as by its effects on investment in the source country. A number of nations who do not tax dividends paid to residents nevertheless withhold tax on dividends paid to non-residents. Developing countries with an undistributed profits-tax impose a compensatory tax on distributions to non-residents; otherwise, the source country might unduly sacrifice revenue that would, instead, accrue to the shareholder's home countries. In the absence of a tax on dividends received by resident shareholders, a question of discrimination might arise. Tax equity calls for a tax on distributions which does not discriminate between foreign and domestic investors. The question of discrimination might be resolved by tax treaties between the developing countries and the capital exporting countries.

The Egyptian tax law now provides for absolute equity of taxation between Egyptian companies and foreign companies according to SS. 14 and 111 of Law 157 of 1981. Foreign branches and domestic firms in Egypt are now subject to the same corporation income tax. Foreigners not domiciled in

Egypt are only subject to the tax on that part of their income which is realized in Egypt.

Generally speaking, non residents of Egypt ought to be taxed on income arising in Egypt.[26] Investment income should be taxed at as high a rate as is consistent with economic development and international standards and should be subject to withholding, subjecting foreigners to the normal rate. Schedules designed for residents may be inappropriate for two reasons.

(1) The Egyptian rates of tax may appear prohibitive to the foreigner, especially if he comes from a country with a much higher standard of living than that of Egypt;

(2) Egypt would normally tax only a portion of the foreign individual's total income, making it impossible to tax a foreigner on a truly global basis. In deciding how to tax foreigners working in Egypt on income derived from business-activity in Egypt, the tax in many cases would be creditable against taxes which are otherwise due in the foreigner's home country. By imposing a tax on salaries derived in Egypt, Egypt gets some additional revenue with no loss in competitive position and this tends to balance out the position of countries with different approaches to foreign income.

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CHAPTER NINE

COMPUTATION OF TAXABLE PROFITS

Chapter Nine

Computation of Taxable Profits

9.1 Introduction

Corporation tax is chargeable on the full amount of profits or gains of the company in respect of its trading activities. But this is not to say that the income of a company is treated as a gross receipt, rather it is treated as a balance of receipts over the cost of obtaining them. Therefore, to ascertain the quantity of profit to be assessed for tax, there are four main types of transactions which must be considered, namely:

1- the rule of compute taxable profits;

2. trading receipts;

3- trading expenditure allowed by statute; and

4- Where necessary an adjustment of trading stock, debtors and creditors as at the beginning and the end. However, there is no general principle stating precisely how the above items are to be treated in the ascertainment of taxable profit. This is where the ordinary principles of commercial accounting come in to provide the criterion by which to judge whether an item should or should not be taken into account in determining profit.

Taxable profits include all trading receipts of the company, non trading receipts, and capital gains. But before considering the various types of receipts it is important to deal first with the distinction between income and capital to enable us to decide which items should rank as trading receipts and which as capital receipts. This chapter will discuss concepts of taxable and business income, the rules for calculating a company's profit for tax purposes, expenses allowed and disallowed according to Egyptian tax system, gains and losses on fixed asset, accounting method and CT, accounting period for CT, taxation of capital gains and losses, annual returns and tax payment.

9.2 Concepts of taxable and Business Income

The differences between the concepts of taxable and business income, important though they are, can easily be exaggerated. Indeed, by focusing attention on the differences rather than on the essential similarities of the two concepts. In this section we start with a brief of the concepts. Attention can be concentrated on the points at which they diverge with less danger of over emphasis on the differences.

The Egyptian tax law has long recognized the fundamental dependence of the concept of taxable income upon approved accounting practices.[1] The basic provision of Egyptian Tax Code with respect to accounting methods lays down the following general rule. Sections 34 to 36 are determining the above idea:

> "A taxpayer shall submit a return reporting the amount of his profits or losses according to this law... The taxpayer shall enclose with his return a copy of trading and operating

> account, a copy of profit and loss account, a copy of the latest approved balance sheet and a list of depreciations effected by the firm while stating the accountancy rules applied on the basis of which the figures were stated in such a return... In order to consider the books, registers and documents kept by the taxpayer as being honest, true and in order as regards the form, these shall be in conformity with the proper accountancy rules."

On a more specific level, businesses are of course taxable on their income as measured according to the legislation, either in the case of a trade, profession or vocation as part of the total income of an individual or, as with a corporation, as an entity in itself. In both categories the rules for the measurement of income are the same. Nowhere in the statute is business income or profit defined. What is to be included and what omitted from computation is the subject of a few statutory provisions and numerous decided cases.[2] A receipt or payment is by its nature either capital or income; there are no all-embracing concepts. The question to be decided in each case was whether the payments were to be allowed as deductions in measuring income; whether they were capital or income payment. In the case of <u>Regent Oil Co. Ltd. v. Strick</u>[3], the proprietor insisted on a form of tie, known as the lease-sale-lease transaction, whereby the proprietor granted the petrol company a lease of the garage for the period of the tie in consideraton of the payment of a lump sum premium plus a nominal rent. On the same day the petrol company sub-let the premises back to the proprietor for the same period as the lease less three days, and for a nominal rent – £1 per annuum. The sub-lease contained the appropriate covenants by the proprietor to buy all his petrol requirements from the suppliers during the term of the sub-lease and providing that the suppliers could enforce the covenant by re-entry and restricting the proprietor's right to part with the garage without ensuring that the assignee was bound by the covenants. In this case it was decided that the lump sum premium was inadmissable as an expense. But in the other case(4) the lump sum was held to be deductible.

Therefore, from the last two cases above, it is difficult to follow the reasoning behind these apparently inconsistent decisions but it would seem that the fact which really distinguished the first case from the second was that in the Regent Oil case the payments were made for the acquisition of interests in land which were assets of a capital nature.

It can thus be seen that there is no fundamental concept of income, profit or capital is gained by recourse to the courts.

Moreover, it has been emphasised that the basic principle of income, to be taxable, must be money or something capable of being turned into money. However, there are three essential problems to be overcome in tryng to define income. The first is that money receipts may arise from numerous sources other than income, they may be gifts, inherited wealth, and so on. Secondly, they may be benefits which are equivalent to income but they do not involve any receipt of cash, e.g., an employee may be given free accommodation, free meals, and free clothing by his employer. The third problem arises from the income which may be less than the gross amount. The position in this last respect tends to vary according to type of income involved.

With regard to these problems Professor Lewis M. said:[5]

> "The basic problem of identifying income can be more difficult, where, say, a person receives some advantage which does not appear to be income in an immediately recognisable form. For instance, if an employee is provided with rent-free living accommodation by his employer under the terms of his contract of employment it may be asked whether the value of the rent-free accommodation represents "income" in the hands of the employee and, if so, by what means is such income to be measured. It is thus apparent that (i) it is difficult to arrive at a comprehensive definition of income and, in many instances, to identify income, and (ii) even where income can be clearly identified it is not always easy to measure that income unless certain rules are applied."

So, the income is not only money actually received but may also include money's worth. In the case of <u>Tennant v. Smith</u> Lord Holsbury said.[6]

"I do not deny that if substantial things of money value were capable of being turned into money they might for the purpose represent money's worth and be therefore taxable."

According to the British tax system, income tax is levied on the basis of a system of schedules of income from various sources. Thus, Sched. E deals with employment incomes, Sched. A addresses real and other payments in respect of the use of land and Sched. D taxes income from trades and professions, as well as certain other amounts with respect to business and professional income, Sched. D provides simply that tax is charged in respect of the annual profits or gains arising or accruing to any person residing in the U.K. from any trade, profession or vocation whether carried on in the UK or elsewhere.[7] There are several specific statutory rules to deal with some items such as bad debts, capital allowance, inventory, and expenses.

English jurisprudence establishes clearly that profit for tax purposes in the UK is to be determined in accordance with the ordinary principles of commercial accounting. Lord Holsbury in the case of <u>Gresham Life Assurance Society v. Styles</u>, stated:[8]

"Profits and gains must be ascertained on ordinary principles of commercial trading."

Also in the case of <u>Odeon Associated Theatres Ltd. v. Jones</u>, Slamon L.J. stated that:[9]

"...in order to arrive at the profit for tax purposes in any particular year, the courts will follow the established principles of sound commercial accounting unless they conflict with the law as laid down in any statute."

The general rule that profit is measured in accordance with accounting principles is also subject to another exception. Where ordinary commercial principles conflict with the principles of income tax law, they must yield to the latter when computing profits or gains for tax purposes. In the case of B.S.C. Footwear Ltd. v. Ridgway, Lord Reid said:[10]

"The application of the principles of commercial accounting is, however, subject to one well-established non-statutory principle. Neither profit nor loss may be anticipated. A trade may have made such a good contract in year one that it is virtually certain to produce a large profit in year two. But he cannot be required to pay tax on the profit until it actually accrues."

Although, it is clear that the profit for UK tax purposes is determined by reference to accounting principles and practices, the precise relationship between accounting principles and income tax law is still unclear. In one view, the function of the codes is to determine the appropriate accounting principles as a matter of fact; such accounting evidence is then conclusive of the tax issue unless there is an overriding statutory provision or principle of income tax law. On the other view, the accounting evidence is treated like any other evidence which is relevant to the matter under issue. The question of the profit of the business however, is one of law for the court. Accordingly, it may accept or reject accounting principles and practices. The best example of this approach is found in the reasons for judgement of Pennychurch, V.C. in the Court of Appeal in the Odeon Associated Theatres case.[11]

As mentioned above, the net profit shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Inspector does clearly reflect the income.

The differences between the concept of taxable income and business income are both numerous and important. Most of them may be grouped into three broad categories:

(1) differences in the timing of various income and expense items. For example the tax requirement that prepaid rent received must be included as income in the year when received, while under accounting method (on an accrual base) though the rent is a single payment covering several years use;[12]

(2) differences arising from the use of surplus charges and credits for business purposes which are not accepted for tax purposes. In determining taxable income substantially all gains and losses as well as income and expense items are taken into account and subject to CT or commercial and industrial profits tax,[13] though certain types of gain and loss may be treated in special ways. The distinction between business and taxable income arising from the disallowance of surplus credits and charges for tax purposes. For example, in some cases of bad debt do not deduct from taxable profit in the term of taxation, while they deduct from profit in the term of acounting, also certain charges including certain taxes, fines and penalties are non-deductible in the tax term, but are deductible under accounting term. Certain charges are deductible only in accordance with specific rules. For example, in the case in relation to remuneration paid to employees;

(3) another serious difference between taxable income and business income arises from legislative action to provide special treatment for certain types of income in the computation of taxable income; for example, the requirement that only specified percentages of capital gains and losses be included in taxable income, the limitation on capital loss deductions, the partial or complete exemption of the interest on certain government bonds, the partial credit for dividends received by corporations, and the extraordinarily generous discovery-value and percentage depletion allowances. The provisions for the carry-forward of net operating losses

should perhaps also be mentioned.

9.3 Rules for calculating a company's profits

The Egyptian tax is due on "the net profit which arises from all the activities whether in the nature of the firm, including fixed asset disposals or whether in the course of carrying on the trade, or in the course of closing it down". In other words the net profit is the difference between the value of the net asset at the beginning and the end of the accounting period, as mentioned earlier, less amounts introduced and plus amounts withdrawn during the period by the proprietors.

The first approach for determination of net income is more descriptive but the second is more precise, and it is on the basis of the second approach that the courts(14) have ruled that taxable profits include passive profits not arising from actual trading, but from, for example, evictions and compulsory purchases. Although in principle all profits, including the gains on fixed asset disposals, are taxable, neither profits nor capital gains are taxed unless and until they are either realised or treated as realised in the accounts.

Although accounting principles form the basis for arriving at taxable profit, there are a number of respects in which the taxable profit and the accounting profit will differ in the following matter:

(a) certain charges including certain taxes, fines and penalities are non-deductible;

(b) certain charges are deductible only in accordance with specific rules. This is the case in relation to certain provisions, and also in relation to remuneration paid to controlling directors, and to depreciation;

(c) conversely, certain amounts credited in accounts are not subject to tax,[15] for example foreign profits, are only partly taxable, for example dividends from subsidiaries.

This difference between tax profits and accounts profits has led to the expression "autonomy of tax law" which is used to underline the way in which tax law and commercial law have departed from each other. However, for measuring the profit of each accounting period the concept that the tax is an annual tax is fundamental, and every item of income and expenditure must be allocated strictly to the period to which it relates.[16] This rule is particularly significant in relation to depreciation. It is very important to know that there are two necessary conditions for an asset to be the object of depreciation (amortisation): it has to be a fixed asset, and it has to be one which loses its value. Hence land cannot be the object of depreciation. The first requirement for the deduction of depreciation is that it should be booked in the accounts. Not only must depreciation be booked if it is to be claimed, but in addition if not booked it will be lost; that is to say that if accumulated depreciation booked at any time falls short of the maximum straight line depreciation allowed by law, the excess will not be allowed in a later period.[17]

As mentioned in part one, depreciation must be calculated by reference to historical cost, even where replacement costs are very much higher as a result of inflation.[18] Moreover we shall discuss in more detail the following points:

(1) Gross trading profit which is the difference between sales and purchases, adjusted for opening and closing stock, less manufacturing costs where applicable. Sales and purchases are accounted for on a "date of invoice" basis irrespective of whether payment has been received or made as the case may be. In the case of contract, a contract sale is binding as soon as the parties have reached agreement. However for accounting purposes, no account is taken of the debt by either vendor or purchaser until such times as the purchaser has control over the goods and carries the risk of their loss.

Assets which are held for the purpose of resale, either in their present state or after processing of some sort, are regarded as trading stock.[19] Such assets can of course include immovable property in the case of a company whose object is the acquisition or construction of buildings with a view to their resale. Packaging materials are also considered as stock except such materials which are charged out to customers and remain the property of the enterprise, in which case they are treated as fixed assets. Stock also includes consumable stores of various kinds including lubricants. Under both the accountant's principles and Egyptian tax law trading stock is valued at cost price or at market value if this is less.

The cost of goods manufactured will include raw material costs plus direct charges and an appropraite uplift for overheads directly attributable to the manufacturing side of the business; overheads attributable to sales, for example, must be excluded. While the cost of goods purchased will include the purchase price, plus incidental expenses of acquisition, including freight, handling insurances, and so on.

(2) Accessory profits: As well as gross trading profit all other profits of the company are taxable, including profits on fixed asset disposals, rental income, interest, guarantee payments, deposits, dividends etc. but in the case of any income which was subject to other tax, 90% of the taxable income is deducted from total profits to avoid economic double taxation.

(3) Expenses: The tax deductible expenses are divided into the following groups:

(i) Overhead expenses, i.e:

(a) expenditure which does not create an asset, and which has the result therefore of reducing the net assets employed in a business and;

(b) expenditure on assets which do not last more than a year.

Two other requirements for deductibility of expenses are that they should be incurred in the normal running of the business, for the purposes of the business, and that they should be supported by suitable evidence that they have been incurred. To be deductible for tax purposes overhead expenses must meet the following requirements:

(i) the company must be able to prove by the production of appropriate vouchers that the expense has actually been incurred;

(ii) the company must establish that the expense was incurred for the purpose of carrying on the business;

(iii) the expenses must be incurred in the normal course of carrying on the business and not for some illegal purpose or a purpose which is contrary to public policy.

(iv) in relation to depreciation there are two conditions which are necessary for an asset to be the object of depreciation: it has to be a fixed asset, and it has to be one which loses its value. Therefore, land cannot be the object of depreciation.

Moreover, the salaries and wages paid to staff are normally deductible expenses, and this includes ancillary payments as well as benefits in kind, but the remuneration paid to employees is dissallowed if it exceeds the salaries of three months.(20) The Tax Code provides that remuneration paid is deductible, for tax purposes only, up to the limit of three months salaries of employees.

In general the rule is that all taxes are deductible (include the wages tax, land tax paid in relation to properties forming part of the business fixed assets..) except those which are expressly disallowed e.g, commercial and industrial profits tax and corporation tax.

The first objective of the tax inspector is to satisfy himself that the expenditure has actually taken place. The second object is to verify that the expenditure has been incurred for the purposes of the business.

However, when taxpayers have failed to declare any of the above expenses this involves their disallowance for CT purposes.

Gains and Losses on Fixed Assets

There is a capital gain where the value of a fixed asset exceeds its book value, after depreciation where applicable, and capital loss where the opposite is the case. Capital gains and losses can be:

(1) latent or potential where the difference is not booked in the accounts, or

(2) established or declared where the difference is booked, or

(3) realised where the asset has ben sold or transferred to another company.

According to the first approach, unbooked in the accounts, estimated gains or losses relating to other assets and liabilities may not be taken account of. In the second, gains or losses will therefore generally be disadvantageous to book an unrealised profit unless there are losses brought forward and about to expire, in which case they can be used up by a revaluation of fixed assets giving a higher base for a future depreciation. In the last one these gains or losses arise on actual disposal both voluntary and compulsory and the rules relating to these are, when an industrial or commercial establishment sells part of its fixed assets, the proceeds realised will generally exceed the book value of the assets concerned. This profit differs from normal trading profit in the sense that it is of an isolated nature, it is generally reinvested in the business and it frequently arises to a large extent from inflation. For these reasons gains arising on fixed asset disposals are liable to CT or commercial and industrial profits tax.

9.4 Taxation of capital gains and losses

The key issues in the treatment of distributions under corporate tax depends on the treatment afforded capital gains on stock and business asset transfers. The issue of capital gains is closely related to the issue of the corporate tax. If preferential treatment is to be given to capital gains, the treatment of distribution becomes very complex. Thus, not much can be done about the corporation tax until the capital gains issue is at least tentatively decided.

The present practice is one of taxing capital gains which may be classified as business profits at regular rates.

For casual capital gains, the following three methods must be considered:

(1) Full taxation of all gains;

(2) Full taxation of capital gains from business and partial taxation of casual capital gains. This method may be supported by administrative considerations.

(3) Same as (2) above except that deferral on gains would be permitted, where those gains are realized on stock-market transactions and are re-invested in the stock market.

One of the alternative methods to provide a preference for casual sales of stocks, agricultural land and personal residences in the new law should be outlined.

Capital gains are traditionally taxed only when realized.(21) This traditional rule is supported by administrative considerations and some popular views of fairness. It produces, nevertheless, significant economic distortions and unfairly low tax burdens on persons with substantial unrealized gains.

It is suggested, therefore, that Egypt considers making accrued but unrealized gains taxable at the death of the taxpayer.

The possible approach to the taxation of capital gains, relating to the treatment of casual gains and investment gains, is full taxation of all capital gains at the time of sale; all sales at exchange of property, however arranged, would be subject to tax at normal rate. This approach is supported by the Egyptian Tax Administration.

Basis of Assessment

The basis of assessment is the income of the year preceding the year of assessment or during the period of twelve months when its results shall be taken as basis of latest balance sheet, that is to say, the previous year's income. The year of assessment is the year to December 31st. In other words corporation tax is calculated and charged on companies income separately for each year of assessment, running from 1st Jan. in one year to the 31st December in the next year.

9.5 Deductions Allowed

In computing the amount of the profits to be charged under Tax Law No.157 of 1981, one is allowed to deduct any sums which are subject to various special rules. Only expenses of a revenue nature are deductible, however, and these must be distinguished from capital expenditure.[22]

Egyptian tax Law allows for the deduction of all ordinary and ncessary expenses paid or incurred in carrying on any trade or business. Generally, an expense is ordinary if it is commonly incurred in taxpayer's business. The expense must be directly connected with, or pertinent to, the taxpayer's business.

The general principle for deductions from gross income is set out in the statute as all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income. The folowing are examples of currently deductible business expenses according to Egyptian Tax Law.

- Rent and premiums in respect of land and buildings occupied for the purposes of acquiring profits whether such premises are owned by the company or hired from third party;[23]
- Expenditure on repair of premises, plant, machinery and fixtures and for the renewal, repair or alteration of such items used in acquiring profit;
- Bad debts, but doubtful debts are disallowed, any recoveries being treated as income when received;
- Contributions paid to the government, local administration rule units and general organisations without limited amount;
- Contributions and subsidy paid to Egyptian charitable organisations and social institutions registered and made notary of the provisions of laws organising them in addition to education and hospital institutions under government control for amounts not exceeding 7% of the net profit;[24]
- Real depreciations effected as customary according to tradition and the nature of each industry or commerce;
- Allocations made to meet certain losses or certain financial burdens which are sure to take place but not in specified amounts provided that such allocations shall be registerd in company's accounts and that they shall be utilized in the purposes for which they shall be allocated. The total annual allocations shall not exceed 5% of the net profit of the company.[25]

Trading expenditure

Corporation tax is charged not on the total of profit of the Company but on "the full amount of the balance of the profits or gains" which are arrived at by deducting the expenses involved in obtaining the income. It therefore becomes necessary to examine more critically the question of trading expenditure in relation to corporation tax. The expression was described in the case of Coltness Iron Company v. Black "Something very different from the amount of net profits of the year which would appear in the ordinary annual balance sheet of trading company".[26] Trading expenses are deductible if the following conditions are satisfied. First of all, the expenses must be of revenue and not of a capital nature; secondly, the expenses must be incurred wholly and exclusively for the purposes of the trade; and finally, they must not be specifically prohibited by legislation. In fulfilling these conditions due regard must be paid to the ordinary principles of commercial accounting.

The first hurdle to cross, therefore, is to identify the nature of expenditure and this is where a major problem arises, for considerable difficulty is quite often experienced in determining whether an expense is of a revenue nature, which is allowable; or a capital nature, which is not.

9.6 Expenses to be disallowed

This section lists the main items under this heading:

(1) Sums set aside for a general reserve which covers probable losses;

(2) Charitable donations which are paid to social welfare organizations approved by the Government, having their headquartrs outside Egypt;

(3) Corporation tax paid by the company;

(4) Fines and legal costs for court cases

(5) The costs of tax appeals (normal audit fees are deductible);

(6) Donations which are paid to social charities or welfare organizations approved by the governments and having their headquarters in Egypt. If the payment is more than 7% of net profit then the surplus is disallowed;

(7) Compensation paid to employees of the Company which exceeds 3 months salaries;[27] and

(8) Any expenses directly related to non taxable income

Income exempted

Income exempted includes:

1. Profits from projects for land reclamation are exempted from corporation tax as follows:[28]

   a) The companies which were established after issuing Tax Law No. 157 of 1981 were exempted from corportion tax for ten years;

b) Companies existing before the issuing of Tax Law No. 157 but their land is unproductive were exempted from Corporation tax for five years;

c) Companies existing before issuing Tax Law No.157 of 1981 whose lands were productive, were exempted for 2 years.

2. Franked payment equal to share bond interest is exempted from corporation tax if:[29]

(i) 90% of the company capital is invested in share bond;

(ii) Share bond interest was subjected to other tax in the same accounting period,

3. Fishing and poultry projects are exempted from corportion tax as follows:

(i) Companies which existed when the Law No.46 of 1976 was in operation should be exempted from full period of three years as stated by that law;

(ii) Companies which were established after the issuing of the Tax Law No.46 of 1976 should be exempted from Corporation Tax for a period of five years.[30]

4. A lump sum equal to a percentage of the capital paid, which should not exceed the interest of a similar capital from a deposit account.[31]

5. Profit derived from shares or quotas obtained by the companies stipulated under S.111 of Law 157 against which such companies shall submit in kind or in cash in the formation of another share-holding company, provided the affiliated company shall have paid on its profits the tax imposed the profits of corporations or shall be exempted

from it.[32]

6. Profits of Bee-breeding establisments.
7. Profits of industrial companies which were established afterthe enforcement of Law 157 of 1981 and employing fiftyor more workers.

In order to get the exemptions above the company should have honest books, documents and accounts which shall be regular in form according to proper accountancy rules and shall be observing the acknowledged customs and principles in this respect in a manner as will express the true financial standing of the firm.

9.7 Capital and Revenue Expenditure Examined

A number of different criteria have been propounded in deciding what these two items mean and what the distinction is between them. Yet at the end of the day it is still not possible to provide an all-embracing definition of capital and revenue expenditure which will once and for all clearly bring out their distinctive features.

The problem is that the two terms cover such a multifarious area that it is extremely difficult to provide a single definition that will take care of all dimensions of a subject which is becoming more and more sophisticated and complicated.

Determination of capital expenditure may be a difficult task because of differences in meaning that may arise because of the varied contexts in which the terms may be used. The question, revenue expenditure, or capital expenditure, is a question which is being repeatedly asked by men of business, by accountants and by lawyers. In many cases the answer is easy, but in others it is not. Peter Whiteman has stated.[33]

> "One of the most difficult and fundamental problems in income tax is to distinguish between revenue and capital payments. Certain expenditure can quite easily be designated as either of a revenue or capital nature, but there is a twilight area in between where it is impossible to predict with

any confidence whether the judiciary would attribute such payments to revenue or capital account."

In the light of the distinction between capital and revenue expenditure I shall attempt to examine the following criteria:

(1) The capital expenditure is something that is going to be spent once and for all, while income expenditure is something that is going to recur every year.

(2) Where an expenditure is made, not only once and for all, but with a view to bringing into existence an asset for the enduring benefit of trade, this expenditure is treated as a capital expenditure not revenue expenditure.

(3) An expenditure for obtaining actual capital asset or creating a new asset will be capital expenditure, e.g. an expenditure on obtaining a new charter to give a company an improved administrative capital expenditure because no new or actual asset is created.

(4) An expenditure could be incurred on an existing capital asset to enhance substantially its value and this is clearly a capital expenditure.

(5) For determining the distinction between capital and revenue expenditure it is necessary to know:

(a) the nature of the payment;

(b) what is to be obtained by the payment; and

(c) in what manner what is obtained is to be used, relied upon or enjoyed?

The Egyptian Courts[34] defined the capital expenditure as the new assets which are bought by the firms or when the firms existence on assets for enduring benefit, while expenditure which is spent to raise profits and that is going to recur every year is an income expenditure.

Lord Dunder distinguished between them by saying:[35]

> "That in a rough way it was not a bad criterion of what is capital expenditure as against is income expenditure, to say that capital expenditure is a thing that is going to be spent once and for all and income expenditure is a thing that is going to recur every year."

The distinguish between capital expenditure and revenue expenditure is very important to arrive at the true business result. Any confusion between them which tends to magnify or to diminish the profits in the balance sheet creates a faulty balance sheet. For instance, if the company treated the revenue expenditure as capital expenditure then the profit will increase and any distribution will come from the capital.

In the practice some expenditure is by its nature a capital expenditur, but the company obliged to consider it as a capital expenditur may be because the expenditure is too small or hardly to make distinguished between them. So the Egyptian tax office accepted that idea. For example, if a sum is spent on an advertisement, taht sum may be used to reduce the taxable profit over one year if the amount is small or more usually over 3-5 years if the amount is large.[36]

9.8 Accountancy principles and corporation tax law

As has been said earlier, without accountancy principles it would be very difficult to ascertain the taxable profits of companies.

When income tax was introduced there was no systematic accounting so that income tax was of necessity imposed on the balance of the annual revenue receipts over revenue payments. This was considered inequitable in the sense that it did not reveal the true economic profit. It therefore became essential to develop a system that could ensure the proper measurement of profit. Hence this gave rise to the development of accounting theory and practice as a system to facilitate the measurement of taxable profit[36]

In fact, the courts, in the absence of statutory guidelines for the meansurement of taxable profit, were quick to recognise accountancy principles once they became established. Lord President Clyde said.[37]

> "In computing the balance of profits and gains for the purpose of income tax, or for the purpose of Excess Profits Duty two general and fundamental commonplaces have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business during such year or accounting

> period and the expenditure laid out to earn these receipts. In the second place the account of profits and loss to be made up for the purposes of ascertaining that difference must be formed consistently with the ordinary principles of commercial accounting so far as applicable and in conformity with the rules of the income tax act."

The phrase "the ordinary principles of commercial accountancy" has been used countless times by Courts to determine the taxable profit of a trade.

The Company Act and Tax Law no.157 SS.34 and 121 require that the profit and loss account of the companies as certified by the Auditors should represent a true and fair view of the company's profit or loss.

Although general accounting principles form the basis of tax law, tax provisions often depart from basic accounting procedures as follows:

(1) Treatment of contingency reserves and liabilities. In accounting procedures, reserves for contingencies such as those for claim being litigated, for losses from merchandise sales, for reduced value of investment securities, and for cash discounts on sales, may be expended for profit and loss statements, but they are not deductible for tax purposes.

(2) Prepaid and deferred costs. The general accounting rule for prepaid and deferred costs is that on a cash basis an expense is deductible in the year it is paid. On an accrual basis it is deductible in the year in which all the events

occurred with fix the fact of the liability and in which the amount of the liability can be determined with reasonable accuracy.

Commencement and Cessation of Business

The assessable profits of a company commencing a new trade or business are computed on the following basis:

(a) for the first year of assessment in which the trade or business commences in Egypt, the assessable profit is the amount of the profit of that year from the relevant source. In the case of a multinational company the exemption (tax holiday) will be for a period of five years from the first fiscal year following commencement of production or trading activities.[39] In the field study some problems arose as result of the ambiguities of the Law 43 which undoubtedly contributes to creating loopholes, which will, in turn, result in avoidance or evasion of tax liability. So that there are, in practice, the following cases:

I. Company A started its activity on 31st Dec. 1985. The fiscal year starts from 1st Jan to 31st Dec. 1986. In this case there is no problem because the first fiscal year following the commencement of production will start from 1st Jan. to 31st Dec.1986. So the tax holiday (five years) will start from 1st Jan. 1986.

II. Company B started its activity on 1st Jan 1986. The fiscal year starts from 1st Jan 1987 to 31st Dec. 1987. In this case the tax holiday will start from 1st Jan. 1987.

WHat is the tax treatment of profit arising during the period Jan. 1st to 31st Dec. 1986?

In interveiws with tax inspectors in different Egyptian tax offices concerning the above two cases about 60% said the profits which arose before the start of the tax holiday are not liable to tax because there is no relevent tax law. On the other hand 40% said the profits must be liable to tax on the basis of tax justice.

Table (9.1)

The Tax Treatment of profits arising before Tax Holiday

	Tax Inspectors		
	No.	%	Total
The profit is liable to tax	8	40	20
The profit is exempted from tax	12	60	20

Although both Investment Law 43 of 1974 and tax law 157 of 1981 neglected this it seems that this profit is liable to CT or commercial and industrial profits tax for the following reasons

1. The profit does not arise during the tax holiday.
2. The tax holiday of the first company becomes six years, while the second will still be five years (there is no tax justice).

3. There is no tax exemptian without law.

III. Some investment companies will start to produce some goods for market testing and, for advertisements, while other companies do not use their full productive capacity, or their produce does not come once and for all but during several periods; for instance textile companies. Therefore, in practice, there are a lot of problems in determining the production starting date of any company.

So it is very important to fix the date of commencement of the business in order to solve the above phenomenon and for determining when the tax holiday will start and when it will finish, especially as both the tax and investment laws have no accurate dates for commencement or finishing. Therefore, there are many loop holes in these laws which can give a major opportunities to taxpayers to avoid Egyptian tax. For this reason we discussed this matter with tax inspectors to solve these problems which face investors in Egypt.

Survey analysis and discussion

Regarding the start of tax holidays and the tax treatment of profits arising during the period before tax holidays commenced, the researcher interviewed tax inspectors in Egypt. The question asked was Do you think that the tax Authority should fix the date for starting activity?

Fourteen Tax inspectors out of twenty answered yes while four of them said no and two did not answer at all as shown from table 9.2 below.

Table (9.2)

Regarding the start of tax holidays

Yes		No		No answer		Total
No.	%	No.	%	No.	%	
14	70	4	20	2	10	20

Also, the interview carried on with the inspectors answering the question yes to determine what data is more suitable to industrial, commercial and service companies. The question asked was according to the following information could you, please, suggest what that date should be based upon:

For an industrial company

A. the time of manufacturing the first products either for market testing or selling?

B. the time of manufacturing the first products for selling? or

C. the time of full productive capacity?

For a commercial company

A. the time of selling first transactions?

B. the time of purchasing goods? or

C. the time the company becomes ready to start its activities?

For a service company

A. the time of the first contract between the firm and consumers?

B. the time of completing its regulations for starting?

C. the time signing the participation contract between partners?

In terms of determining the suitable date for starting activities, Table 9.3 summarises the viewpoint of tax inspectors toward the above problems.

Therefore, we attempt to give suggestions for reforming the law regarding the commencement of business:

(a) The starting date should be:

- for an industrial company the commencement of business when it produces goods for sale or export.
- for a commercial company the commencement of business should be when it purchases the merchandise for selling purposes.
- for a service company the commencement of business should be when the first contract is signed.

(b) After the tax holiday finishes the company's profits are liable to CT or commercial and industrial profits tax from the next day till 31st December of the same year.

2. for the second year of assessment after the tax holiday, the assessable income should be the amount of the profit of the first 12 months of the trade or business;

3. for the third and subsequent years, the assessable income is the profit of the preceding year.

Where a business ceases to operate, it shall notify the Tax Office within 30 days of the cessation of business and supply sufficient details for tax liability to be settled.

Table (9.3)

Suitable date for starting the activity of different types of companies

Activities	No. of Tax Inspectors
Industrial companies	
(A) at the time of manufacturing the first products either for testing or selling	--
(b) at the time of manufacturing the first products for selling	10
(c) at the time of full capacity production	4
Commercial companies	
(A) at the time of selling first transaction	4
(B) at the time of purchasing goods	8
(C) at the time the company becomes ready to start its activity	2
Service companies	
(A) at the time of the first contract between the firm and consumers	9
(B) at the time of it completing its regulations for starting	4
(c) at the time of the signing of the contract by the partners	1

9.9 Accounting method and Egyptian Tax System

Every corporation must submit a return to the Revenue Authorities showing the amount of its profits or losses at the end of the fiscal yeaar. This return must be accompanied by the necessary supporting papers and documents and a statement of the accounting principles. The statement must be presented and authorized by a registered auditor who has full responsibility to submit a correct statement, or will be subject to the sanctions provided by the law. In some cases, the tax authorities in Egypt found many difficulties in examining these accounts because of the absence of adequate accounting records. A great deal of difficulty lies in the matter of deciding a standardised price or services that are transferred from one corporation abroad to its branch or subsidiary in Egypt. To arrive at standardised prices, the tax authorities must study other similar cases in which manufacturing and selling companies are dealing with each other with no interlocking control. However, there are many difficulties in finding similar cases, and even in determining what constitutes a similar case, since selling prices may differ from one concern to another or because a concern may sell its products at different prices.

Administrative difficulties sometimes arise when the adjustment of accounts necessitates an analysis of the worldwide business of the corporation in order to bring out facts relating to operations of its branch within Egypt which will permit an adjustment of accounts on a reasonable basis. Also some aspects of accounting procedure require interpretation; results may differ from one tax agent to another causing unavoidable discrimination.

For the reason mentioned above, many tax officers may find it easier to reject the books results and estimate taxable profits, especially if the accounts of books show little or not profit.

Survey result and discussion

The discussion with tax inspectors about the matter of examining the tax return and accounting statements of the foreign and local companies. The question asked was :
What are the reasons for refusing the tax returns of this company?

In this connection, and apart from the generally held opinions towards the reasons behind the reject tax returns as mentioned by the majority of tax inspectors are summarised as follows:

A. The foreign companies hide some of the aspects concerning their income and the related expenses.
B. Providing unduly high prices of the related services and the goods transferred from the main company to its branches and vice versa.
C. No sufficient data and documents concerning the costs.
D. There are contradictions between the data the foreign companies provide and those provided by the other

companies they deal with.

E. Over estimation of rates of depreciation.

F. Large discrepency in data provided by the foreign companies and other companies operating in the same field in Egypt.

There are many ways of estimating the profits of local branches or subsidiaries of foreign companies. The most important methods are as follows:

(1) The profits can be estimated by taking a reasonable percentage of gross profits in relation to turn-over, or by multiplying the turn-over at the purchase price by the co-efficient of gross profit taken from other similar Egyptian enterprises and deducting the ordinary and reasonable expenses necessary for creating profits.

(2) Another arbitary method of fractional apportionment, a substitute for a detailed allocation of expenses and revenues, is to compute the net profit in Egypt as a fraction of the total world wide net profits of the enterprise on the basis of factors which are primarily important to the earning of profits. For example, the profits may be determined indirectly by means of their probable relation to invested capital. In this the tax authorities may choose a ratio based on the assets of the branch to the assets of the enterprise all over the world. The taxpayer may on the other hand decide that the ratio should be based on the total receipts of the branch to the total receipts of the company.

The objections to these estimated methods are that they are all arbitrary and that in many cases the estimated profits are not the true profits of the taxpayers. Moreover, they are sometimes very difficult to apply and are impractical because of the lack of information; many foreign branches in Egypt will not supply the tax authorities with the financial statements of their head offices abroad.

9.10 Accounting periods for Corporation Tax

The taxpayer's accounting period is used as the basis for determining taxable profit. The rules of tax accounting do not necessarily follow accounting principles and the amount and timing of an income or expense item is not always the same for tax purposes.

Ordinarily, the taxable year is the twelve month period used for accounting purposes. It alwayes ends on the last day of a given month. Taxable years can be classified in one of the following ways:

(i) Calendar year which will be a 12-month period ending on December 31st.

(ii) Fiscal year which is a 12-month period, ending on the the last day of a month other than December.

(iii) Fifty two or fifty three week period. An annual period which always ends on the same day of the week. It is either the last day in the final calendar month or the nearest day to the end of the calender month. Because a business firm may wish to close its books on a certain day of the week, for example on Friday, in some years the taxable year will consist of 53 weeks.

Corporation tax is charged in respect of accounting periods. These usually coincide with the periods for which the company prepares its annual accounts but cannot exceed 12 months in duration. Thus, if a compny prepares accounts over an 18 month period, the first 12 months will constitute one accounting period and the remaining six months are treated as another accounting period.

A chargeable accounting period begins immediately the previous one has ended or when the company first becomes liable to Corporation tax such as on commencement of trade.

9.11 Annual Returns

All enterprises liable to CT or commercial and industrial profits tax have to make a tax return each year, whether in fact they have made a profit or not. The return must be made within three months of the end of the accounting period according to commercial and industrial profits tax.[39] In relation to CT the return must be made within thirty days of the date when the general assembly of shareholders shall approve the annual accounts.[40] For financial years ending 31st December, the declaration may be filed as late as 31st March. The taxpayer shall enclose with his return a copy of trading and operating account, a copy of profit and loss account, a copy of the last approved balance sheet and a list of the depreciations suffered by the firm while stating the accountancy rules applied to the business whose figures are stated in such a return.

Failure to comply with these time limits involves having to pay an additional amount equivalent to 20% of the tax due according to the final assessment and such an amount shall be reduced by one half if agreement between the taxpayer and the tax inspector shall be reached before referring the dispute to appeal committees.

The return must be made on the proper form issued by the administration giving details of the profit or loss for the period. Every establishment, whether owned by an individual or that which takes the form of a partnership shall submit the return which lean upon the accounting books, the registers and the documents specified by the executive regulation in the following cases:

(i) If the establishment capital shall be in excess of LE10,000 according to the contract or the commercial or industrial registration.

(ii) If the net profit of the establishment per year according to the latest return or final assessment shall exceed LE5,000.

(iii) If the gross revenues of the establisment current activity shall exceed LE50,000 per year.

Obligation to keep books shall be observed in the last two cases for the year following that for which a return was submitted or a final assessment was effected or when the gross revenues of the current activity shall reach the amount specified above as the case may be.

The return referred with the enclosed documents referred to above, shall be approved in the way specified under the provisions of law 133 of 1951 with respect to the principles of accountancy and the auditing profession, and such documents shall include a certificate incorporating the result of the examination, which has been checked according to the proper and acknowledged methods of accountancy and auditing.

To be accepted, the books, registers and documents kept by the taxpayer as being honest must conform to proper accountancy rules and fully observe the laws and the principles acknowledged in this respect.(41) When the tax office refuses to consider such books and documents kept as prescribed the company has an obligation to prove otherwise.

9.12 Payment of Corporation Tax

The main responsibilities and the basic job of the Tax Department is the collection of taxes to finance the operations of government.

A modern corporate tax obviously requires a modern and effective tax administration to collect the amounts due. The following steps must be taken in order to improve the collection of corporate tax:

(1) The amount of tax subject to collection is, of course, ascertained through the assessment function. The information acquired for assessment becomes important for the efficient completion of collection activities. The principle that assessment and collection functions should be combined in the same organization does not imply that those activities should be carried out by the same personnel. In fact, the skills required for assessment work and those demanded for collection are quite different.

(2) There should be the advance payment of corporate tax, that is, current payment of the tax during the year as profits are earned. Public companies (those owned by the government) could make advance payments based on the budgets prepared each year for these companies. The budgeted profits, whether larger or smaller than those of the previous years, would be used as a basis for current payment. Assessments on private companies might be based on the last years. One consideration is the possibility that the advance payment of corporate tax be designed to parallel as

much as possible the current actual collections of revenue from corporations under the dividend tax in order to preserve revenue flows. Thus, one proposal which could be considered is that whenever a dividend is paid, a company would be required to pay 40% of that dividend to the treasury as an advance payment of corporation tax. One thought was to use the former only for the public sectors, which pays dividends erratically; the private sector would instead pay in instalments under the advance payment system which is tied to dividend payments and designed to produce revenue equivalent to current revenues under the present tax.

The notices for the advance tax should be sent out to the taxpayers, and the dates of the issue of the notices should be entered in the Register. When the notices are received by the company, it should pay the tax according to the notice, failure to do so should entail payment of interest and penalty SS. 124 of 157 of 1981. Current payment of tax, particularly on the part of businesses is essential from the point of view of administrative efficiency and control of inflation [42]

Table (8.3) reveals the following:

(a) Tax on business incomes (taxes on commercial and industrial profits, movable properties and corporation tax) rank first among the group of direct taxes, the rates of which range between 59.1% and 83% of the total proceeds of direct taxes during the period 74-84.

b) The modest contribution of the tax on free professions and the general tax on income (super tax) to the total direct tax during the same year do not exceed 0.9% and 1.1% on the average of total proceeds of direct taxes.

It should be taken into consideration that the increase in the proceeds of taxes levied on business incomes from LE473.2 mn. in 1974 to about LE6129.3mn. in 1983. This highlights the wide scope of company profitability during that period and the method of tax collection.

(3) The real and the more serious reason for having arrears is the tendency on the part of many tax officers to delay the assessments till the end of the financial year and make cumulative assessments for more than one year, particularly in big assessment cases. A suitable time limit should be laid down, and the loss of revenue in such cases should rest on the discretion of the tax officer. In cases of un-traceable assesses there should be no time limit for re-opening assessments.

There should be a committee to consider and write-off all demands below a certain amount. Officers should immediately take steps to remove these demands from the register or the distorted picture of the arrears will continue to remain as it is.

(4) Measures to compel payment: There are two approaches the tax office may take to compel payment. One approach is to rely on civil and criminal penalities provided by law in order to induce taxpayers to satisfy the government's claims. The alternative basic approach to non-payment is by means of direct action by the governmennt to satisfy its claim. Such action may consist of seizure and sale of assets of the

defaulting taxpayer. These measures have the advantage of being simpler and cheaper than imposition of penalties requiring Court action. S.166 of Law 157 of 1981.

The tax lien should have priority over any other type of creditors to protect the interest of the government. The absence of such a priority in favour of the government is being taken advantage of by some companies to avoid payment of tax.

The law should provide simple and inexpensive procedures for seizure and sale of the taxpayer's property to meet out-standing claims.

Another way of preventing delinquent accounts from arising is to make it economically disadvantageous to delay paying taxes by imposing interest charges at rates higher than market rates. S.166 of Law 157 of 1981.

9.13 An Evaluation of Corporation Tax in Egypt

Under the present system, corporation tax applies to company profits as a whole, whether distributed or undistributed. But when the company makes a distribution, the CT is charged on dividends paid to shareholders.[43] It follows that the total tax burden on distributed profits is not additional to corporation tax on profits because, in effect, it replace that tax. Assuming a corporation tax rate of 40%, the tax on dividends will at be the same rate, (40%), and the total amount of tax charged on a company's profits, if all of its profits were distributed, would not be 80%, but would be 40%. If the company distributed none of its profits, the total charge would be the same (40%). Thus it can be seen that whether the company distributes or retains its profit, there is no difference in the tax burden.

In comparison, the company taxation in the UK is based on the imputation system. the imputation system has already been examined in part one,but it may be noted that under this system a company pays CT at a single rate of 35% on its profits, whether distributed or not. Where it distributes profits in the form of dividends to its shareholders it does not deduct income tax as under the classical system, but it is required to make to the Inland Revenue an advance payment of CT called (ACT) at a rate of 25/75 of the dividend paid to the shareholders.[44] The advance payments of CT are set-off against the CT bill on profits for the relevant accounting period. Therefore, when a shareholder is liable to income tax on gross dividends, he can set the tax credit against his total tax liability. If he pays tax at the basic rate, the credit eliminates his liability to tax on the dividend completely, so that he will not be asked to pay any additional tax on the dividend. If, however, the personal tax rate is 40%, an additional tax is payable by anyone who is subject to such higher tax rate. A person who is not liable to tax such as a charity can claim repayment of the tax credit.

From the above it will be seen the Egyptian corporation tax system, in relation to dividends, is easy to operate, but it cannot enhance the government's policy of encouraging investment for the following reasons:

1- The corporation tax rate of 40% is high in comparison to that of tax haven countries such as Hong Kong (where the tax rate is 16.5%), El Salvador (progressive tax rate from 15%-38%), Korea (tax rate is 27%) and Taiwan (progressive tax rate 15%- 35%).(45) The outcome of the survey in this thesis indicates that the majority of respondents, i.e. 90.7% consider that the corporation tax rate in Egypt is too high (see table 14.7).

2- Distributed profits are subject to the same tax rate without discrimination between retained or distributed profit, so there is no incentive to encourage shareholders to invest their profits.

<u>Survey result and analysis</u>

Thirty nine of fourty three respondents said that the tax law entered into consideration in their distribution decision processes. The results are summarised in tables 9.4 and 9.5. The questions are: (1) is the Egyptian tax system a relevant consideration in your distribution? (2) If your answer is yes: Is taxation a

a- Major consideration?

b- An important consideration?

c- Miner consideration?

Table (9.4)

Taxation and Distribution

	Respondents No.	%
Yes	40	93.0
No	3	7.0

Table (9.5)

Taxation and Distribution Decision

Respondents						
Major consideration		An important consideration		Minor consideratio		Total
No.	%	No.	%	No.	%	No.
31	72.1	9	20.9	3	7	43

So most (72.1%) of the respondents considered the tax as a very important factor in distribution decision. About 20.1% take it into consideration.

3- Surveys of corporation tax rates indicate that the tax rate is often fixed by law to stimulate local and foreign investors to operate in Egypt. The interview with tax inspectors shows that about 40% prefer to impose movable capital property tax on distributed profits at a tax rate higher than the corporation tax rate; 25% prefer the present method, while 35% prefer to subject whole profits to CT, and when the company makes distribution to make the dividend subject to tax on movable capital property.

Table (9.6)

Tax Rate of distributed profit

	Tax inspector	
	No.	%
Present treatment	5	25
movable capital asset	8	40
two taxes (CT and movable capital asset	7	35

4- Other criticisms of the Egyptian CT are that its inadequacies and ambiguities undoubtedly contribute to create loopholes, which will in turn, result in avoidance and evasion of tax liability. It does not only waste administrative time and efforts in coping with the enormous volume of queries regarding the interpretation of these ambiguities and discrepancies, and penalties for non-compliance are inadequate. With regard to MNCs, there is a strange phenomenon in the investment field in Egypt, where some investment companies attempt to clear up their projects, often after the end of a tax holiday, as shown by the report of General Authority for Investment and Free Zones (GAFI).[46] The following table (9.7) shows the approved projects, withdrawn projects, and projects in operation.

Table (9.7)

Projects Approved, Withdrawn and in operation

as at 31/12/1984

Sectors	Approved Projects No.	Approved Projects %	Withdrawn Projects No.	Withdrawn Projects %	projects In Operation No.	projects In Operation %
Industrial Projects	783	41.8	261	13.9	522	27.9
Agricultural Projects	155	8.3	61	3.3	94	5.0
Construction Projects	252	13.5	66	3.5	186	9.9
Services projects	348	18.6	127	6.8	221	11.8

Table (9.7) contd.,

Financial Projects	333	17.8	75	4.0	258	13.8
Total	1871	100	590	31.5	1281	68.5

From the table above 590 MNCS cleared up their activities. So that we attempted to study this phenomenon by interviewing inspectors in tax offices, GAFI and with staff of universities who were interested in this field. The majority said although the Egyptian tax system 157 came into effect from 1981 it still does not encourage foreign investment. Its steep rising scale is too high in many assorted taxes (especially in the case of general income tax where the higher tax rate is 65% compared to 40% in the UK). Price controlling by the Egyptian Government causes a big problem for distributing the production of the companies. There is no time-limit on the useful life of a company; furthermore, the penalties in both tax law and investment are not severe and are not restraining. On the other hand a lot of Egyptian employees left their jobs in these companies as result of an unfair distinction between them and foreign employees in their tax treatment. According to Articl 20 of Law 43 all payments subject to the salaries and wages tax, bonuses or other similar payments paid to foreign employees by MNCs shall be exempted from the general tax on income.

5- The efficiency and enforcement of the CT system in a less developed country (Egypt) suffered from the lack of a proper system of books and accounts. We note from studying the annual report of GAFI we found 515 MNCs out of 624 supmitted their statements and balance sheet to GAFI, while 109 MNCs appeared to think it feasible not to do so. The experience with small firms and partnerships has not been satisfactory, as accounting methods are still alien to the majority of taxpayers in Egypt. As a result of discussion with tax inspectors, there is a lack of uniformity in accounting practices, this is not only particular to individual taxpayers but also covers companies. Furthermore, the shortage of an adequate and competent revenue staff either renders these records and accounts useless, or creates an atmosphere of distrust and suspicion which in turn causes misunderstanding and disagreements between taxpayers and tax offices.

6- It should be said that the tax system (CT and commercial and industrial profits tax) can create double taxation if a company subsequently decides to make a dividends from retained profits which have been to leen into a reserve account. Acording to the tax system the reserves are not tax deductible, S.114 (6) says: (47)

> "The amounts deducted by the company from its profits to feed its various reserves in order to meet possible losses or to grant compensations to their workers exceed in aggregation three months salaries per year shall not deducted from the total profits

subject to tax."

Therefore it is understood that this sum of mony is subjected to taxation twice, once when it is transferred to the reserves and again when it is drawn from the reserves and distributed it.

From the above, it becomes obvious that the Egyptian tax system is no longer fitted to tackle the current economic state. In addition to the obvious rush to the consumption of goods and services, the inclination of some to use their moneys in side activities which are not subject to taxation through the exploition of certain gaps in taxation laws have enabled them to make enormous fortunes at the expense of communal interest and production. Furthermore, the Egyptian tax system is still incapable of achieving social justice between the different sectors of the community which are having to bear the weight of the various taxes.

It seems to me the following suggesions may help to reform the Egyptian tax system:

1- Tax rates on commercial and industrial profits which will be: (i) Taxation, in order to reflect ability to pay, should be granted in relation to commercial and industrial activities, from 20% on the first LE5,000, 25% on the following LE5,000, 30% on the followig LE10,000 and 32% on amounts in excess of the above.

(ii) These should be special tax treatment for small companies to encourage them as going consern, to re-invest their profits. These companies must look to internal sources to finance their development because such small companis have limited access to capital other than those profits which they themselves can generate. Therefore, these companies should be chargeable to CT at a lower rate than the normal rate of CT. If a company for an accounting period of twelve months has a profit of not more than LE10,000 (as the 'upper relevant amount') the the lower rate 20% sould be charge on the profit of this company. The levels of profit discussed above are those which apply when the accounting period is of twelve months duration. If the profit of a small company exceeds LE10,000 the company sould be subject to the normal CT rate.

(iii) Using tax credits to avoid economic duble taxation.

(iv) The Egyptian Government should work towards the adoption of a unifid tax system instead of the assorted taxes which at present supplement the general tax system. Especially, I think, the 'unified tax' is the most just of all taxes.

(v) Filing the gaps in the tax system which at present give a chance to dishonest taxpayers to avoid their taxes and distroy tax justice.

(vi) Periodical training should be given to tax officers during their working-life to provide them with sufficient experience and breadth of vision necessary for handling important cases.

(vii) The imputation system, as mentioned earlier in part one in this research, is preferred by developed countries, such as UK, while the classical system is to be preferred for the less developed countries (Egypt) for the following reasons:

1. Distribution policy: the distribution policy of a company is arrived at when the management decides whether or not to pay out dividends to share holders. The decision to make a distribution or to retain profits is based on a number of important considerations and is not arrived at arbitrarily. Under the Egyptian company law dividends can be paid from profit, whether current or accumulated, but not from capital, because such payments of dividends would impair the rights of shareholders. Moreover, companies are forbidden to pay dividends while they are bankrupt.(48) In the light of Egyptian policy for encouraging saving and investment, it is, indeed, sound policy for company taxation law to discriminate in favour of retention of profits. If so what are the advantages of such a policy on company expansion? Therefore, it is more important to do so when one considers the fact that in a less developed country like Egypt where the capital market is not well developed, there is the need to encourage liquidity.

In the study of the annual report of GAFI as at 31st December 1983(49), in which about 515 MNCS submitted their accounts (operated account, trade account, profits and losses and balance sheet to GAFI until 31st december 1983) it was found that they were suffering from shortage of capital. The actual loans which MNCS borrowed until 31st December 1983 were LE16o3.2 million as demonstrated from table 9.8 below.

The table 9.8 shows that the percentage of actual loans to the capital of MNCS was 165% in relation to industrial projects while in relation to construction projects the amount was 102%. It seems to me that the phenomenon indicates that MNCs rely upon loans more than on capital either for tax factors or the shortage of liquidity, under a classical system MNCS can save the sum which they need by retaining their profits.

Table (9.8)

Estimated and Actual Loans

As At 31/12/1983

LE.mn.

Sectors	No. Capital Val.	%	Actual Loans Val.	% (from Capital)
Industrial Projects	197	323.9	534.6	165.0
Agricultural Projects	22	95.0	155.7	164.0
Construction Projects	56	96.5	99.0	102.0
Services Projects	84	205.4	289.8	141.0
Financial Projects	51	570.6	524.1	92.0
Total	515	1670.9	1603.2	95.9

All the above factors point to the fact that it is in the economic interest of Egypt to restrict dividends and increase retained profits, at least for the time being. This function could be best performed by the classical system of company taxation if it was introduced in Egypt.

2- Company Expansion: As can be seen from the classical system, retained profits bear corporation tax only, while distributed profits bear CT plus personal income tax. It is therefore easy to see the underlying objective of this system, namely to encourage companies to retain profits. The premise is that it is good for a business to retain a reasonable proportion of its profits in a country like Egypt where this would promote savings and lead to increased investment. Thus a higher rate of investment and the rate of growth constitutes the most important economic argument for the classical system. By differentiating in favour of retention of profits, a higher proportion of earnings after tax is left in the company's hands for reinvestment.

Other Recommendations

1 - Reduce the corporation tax rate to 25% for all kinds of activities (it may be noted that in the UK the CT rate on profits of small companies is 25%)

2- Taxpayers should be made increasingly awere the needs and requirments of the tax system and of its value to satisfy. This should be associated with effective tax compliance rules involving, as regards business, a good knowledge of these rules, an understanding of book keeping principles and the classifications of documents.

3- The Egyptian Government must put an end to tax evasion and tax avoidance by amending the procedures and penalties for submitting tax declarations. As part of this it should be prepared to apply the law more rigourously by making examples of taxpayers who violate tax regulations.

4 - GAFI should make feasability studies of projects which the Egyptian Government designats as important for the national economy with a view to attractinginvestment.

5 - Tax exemptions of new production projects which serve and support the national economy annd production. Such exemptions should last for periods suited to the nature of the various projects. In this manner we would be adhering to the spirit of law 43 of 1974 which currently grants tax exemption from 5 to 8 years. However, adherence to this law should not be restricted to this period, but it should be possible to increase it to 10 years or more according to the nature of the project, as happens in some countries such as

El Salvador (where the tax holiday is 10 years), Taiwan (where the tax holiday is from 5-10 years).

4 - Every enterprise must have a fixed useful life. The tax holiday should be divided into the useful life to avoid the problems which arise when the MNCS attempt to clear up their activity. Therefore, the following method is suggesed for dividing the tax holiday. Suppose the tax holiday is 5 years, as at present but the productive life of the company or venture is 10 years (tax rate: 32%), then a new system should be devised to spread the tax holiday, as shown below. This suggested system "front loads" the exemption in the earlier years.

Tax holiday as a whole = 5 x 32% = 160%

1st year is 10/55 2nd year is 9/55 3rd year is 8/55

4th year is 7/55 5th year is 6/55 6th year is 5/55

7th year is 4/55 8th year is 3/55 9th year is 2/55

10th year is 1/55.

The exemption, therefore, will be divided into the whole productive life of the company as follows:

a - the exemption of first year is 10/55 x 160% = 29.1%

b - the exemption of second year is 9/55 x 160% = 26.2%

c - the exemption of third year is 8/55 x 160% = 23.3%

d - the exemption of fourth year is 7/55 x 160% = 20.4%

e - the exemption of fifth year is 6/55 x 160% = 17.5%

f - the exemption of sixth year is 5/55 x 160% = 14.5%

g - the exemption of seventh year is 4/55 x 160% = 11.6%

h - the exemption of eighth year is 3/55 x 160% = 8.7%

i - the exemption of nineth year is 2/55 x 160% = 5.8%

j - the exemption of tenth year is 1/55 x 160% = 2.9%

It seems to me the above method is better than enact new penality legislation especially in less developed countries such as Egypt, in Egyptian tax system and investment laws there are a lot of penalities against tax evasion and other things but the corporation helped many dishonest taxpayers to avoid tax. For example an Egyptian business man succeeded to avoid tax and by corruptions he left Egypt with tax evasion about LE7,000,000.(50) Also investment company for soft drinks avoided tax to approximately LE11,000,000.(51) Moreover, the position in Egypt nowadays, that the rich people avoid the tax while the poor people paid tax, not because more of them are honest, but because tax is deducted at source. A report made, in Al Ahram-International at 14h Jan. 1987, about "Tax... why the rich people evade it and the poor pay it" in this report about one and half million taxpayers did not submitted their tax returns while other taxpayers submitted their tax returns with counterfeit accounts to hide some profits e.g. by hiding some bargain of sale and its relative cost, or by adding imaginary expenses.

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PART THREE

THE MULTINATIONAL COMPANY OPERATING IN EGYPT

Part Three

The Multinational Company Operating In Egypt

Introduction

In the last two parts we discussed in general the company tax systems. There was also a more specific discussion of the taxation of companies in the UK and Egypt, with an outline examination of the tax treatment of overseas income.

The corner stone of this part is to find out the Egyptian policy on foreign investment which is promulgated to attract foreign investment by offering many incentives which include tax incentives, allowing foreign investment in all economic fields without limit or restrictions, and with freedom of repatriation of profits and capital. This part attempts to examine the Egyptian policy for stimulating investors, either local or foreign , and the response of foreign investors in order to identify and highlight the motives and tax incentives which have influenced the foreign and local investors' decisions to invest in Egypt, during the last ten years. The study concentrates on the UK investors for a number of reasons, e.g. the UK is one of the leading capital exporting countries, the trade relations between the UK and Egypt have been increasing during the last five years as shown from the table (P.3) which reflects the balance of trade between the two countries. Also, Egypt's exports to the UK of oil, fruit and vegetable have increased, and UK exports to Egypt of food stuffs, especially meat, have witnessed a sharp increase, as have petroleum products, organic chemicals, general industrial machinery, equipment, office machines and automatic data processing equipment, transport equipmment, and finally, clothing and clothing accessories.

Table (P.3)

Exports Between UK and Egypt

Value £.mn

	1980	1981	1982	1983	1984
UK Exports	347.0	339.0	275.1	370.5	427.0
Egypt Exports	337.0	295.3	373.3	79.8	164.9

Source: Egyptian-British Trade, The Journal of the Egyptian-British Chamber of Commerce, different numbers.

Part Three is arranged as follows:

Chapter 10 discusses the "multinational company" (MNC), attempts to define the MNCs, and examines general considerations, such as the historical background of MNCs and their financial policies.

Chapter 11 considers the growth and profitability of direct foreign investment in Egypt, the characteristics of the

Egyptian economy, foreign investment and law 43 of 1974, business profit and tax exemption, the legal treatment of foreign investment in Egypt, foreign investment and Law 43 of 1974, and an evaluation of the results of investment according to Law 43.

Chapter 12 discusses the taxation of MNCS, measuring efficiency and profitability, minimizing tax payment, the tax treatment of dividend payment by subsidiaries, and tax incentives for foreign investors.

chapter 13 examines the problems of foreign investment in general, and of UK investors in particular. It also demonstrates the research design and methodological considerations; MNC's selected for the study, identification of the sample, and development of the questionnaire.

Chapter 14 states the results of this study, some suggestions that may be used to reform both tax and investment laws for improving the investment climate and the performance of foreign investment.

Chapter 15 summarizes the conclusions and recommendations of the study.

CHAPTER TEN

THE MULTINATIONAL COMPANY

Chapter Ten

The Multinational Company

10.1 Introduction

The study of multinational corporations (MNCs) is a very wide subject and the problem of tax treatment, business and technology transfer through MNCs to host countries is one of the aspects of this complex phenomenon. The aim of this chapter is to concentrate on the most important aspect of business transfer by MNCs and their subsidiaries in host countries generally and in developing countries and Egypt, as a developing country, in particular.

The present chapter will focus on the definition of MNCs, historical movement of MNCs joint venture and its problems, and financial policies and practice.

10.2 Definitions of multinational corporations

There are various vocabularies and concepts related to the study of MNCs which explain this field through theoretical analysis and empirical studies. Clarification of these concepts and definitions will help to avoid unnecessary controversy and facilitate an understanding of the time dimensions of MNCs.

We shall review some of the many definitions of MNCs. Dunning has indicated that the concepts of international and multinational producing enterprises are synonymous, and are defined as an enterprise which owns or controls producing facilities in more than one country[1] Also Dunning distinguishes the MNC as an enterprise which is concerned with, and engaged in a specific trade to sell its products domestically and internationally to other enterprises or persons. Ownership of such enterprises and their control may be held by more than one country, as is the case of most MNCs or by one country or shareholder, as in the case of Unilever, Royal Dutch Shell, and Agfa-Geveart.[2]

Hood and Young have defined a multinational enterprise as "a corporation which owns (in whole or in part), controls and manages some generating assets in more than one country"[3] and Vernon sees a MNC as "a parent company that controls a large cluster of corporations of various nationalities.[4] There are similarities among the three definitions above, in their emphasis upon multinational ownership and control, but Vernon also stresses the importance of the size of MNCs, including only those which have over $100 million in sales.

Erdilek's definition is more specifically concerned with the MNC activities and he said "the MNC (a firm with foreign production facilities) is a conduit of direct foreign investment, that involves transfer of technological and organizational knowledge as well as movements of capital and skilled labour"[5]

The differences between the definitions stated will relate to both the nature of the MNC under study and the interests of the writers themselves. But it may be useful to analyse these differences which relate to the legal structures, economic objectives, geographical locations or managerial philosophies of MNCs.

Lall S., and Streeten[6] distinguish between three kinds of concepts: 'economic', 'organizational' and 'motivational'. Economic concepts emphasize the size, geographical spread and extent of foreign investment of MNC and are used, for example, by Harvard Multinational Enterprise study, and Parker's classification of MNCs. Organizational concepts focus on the factors which lead to a spread of one MNC rather than another, such as the nature of their organization decision-making processes and global strategy. This type is used more by organizaton and business schools rather than by economists. Motivational concepts are usually used by management specialists and they deal with the motivation and management philosophies of MNCs.

Reviewing the variety of ways of thinking about MNCs we return to the complexity of MNCs and their operations, which attracts the interest of many specialists. In the present study we wish to stress that the MNC is an economic unit which operates in more than one country.

10.3 Historical Movement of MNCs

The MNC phenomenon was evolving by the end of the last century, though its historical roots began before that date. As Dunning argues [7] the free movement of international capital was uniquely favoured during the half-century before the First World War for several reasons. There was a wide gap between capital exporting and importing countries through increasing demand for capital for development, such capital was available for foreign investment in the industrial nations. There were no obstacles to the international mobility of productive factors during that period, with ready migration of people and capital, although there were some problems of foreign exchange as well as transfer difficulties between borrowing and lending countries. And finally, there was political stability, and revolutionary developments in transport during that time.

International capital movements were affected dramatically during and after the First World War as a result of political instability. There were decreases in the capabilities of the largest creditors, the US and UK before the war and by the beginning of the thirties. France was third largest international creditor, followed by the Netherlands, Switzerland, Belguim, and Sweden.[8]

By the 1930's foreign investment had improved the infrastructure in less developed countries and increased their capabilities to produce and export more food and raw materials to the developed countries.

Dunning indicated that during the fifties and sixties,[9] total capital exports were divided into approximately 38 percent private capital, 51 percent bilateral government transfers and finally 11 percent made up through the international financial agencies, with most of that capital concentrated on establishment of overseas subsidiaries. Total foreign investment capital was dominated by the USA, the UK, France, Germany, Switzerland and Japan.

At the beginning of the seventies, according to Harvard Business School research,[10] the MNCs phenomena had expanded in both developed and undeveloped countries dominated by US firms and their overseas subsidiaries to a level estimated at \$80 billion, and a similar figure was estimated for non-American firms. Most of the US firms were based in the Western developed countries while the UK was a major participant in the number of non-US owned overseas subsidiaries, making up 35 percent of that number. West Germany multinationals accounted for 19 percent, France 10 percent, the Netherlands 5.5 percent and Switzerland 11.3 percent. Japanese capital for direct overseas investment increased rapidly between 1969 and 1974 from \$665 million to \$9,567 million.

During the last 25 years the international economic system was affected by several changes, such as high rates of inflation, the establishment of more economic protectionism and increases in barter agreement, and the MNCs became more political, with interventions by both host and home countries.[11] Effects were inherited during the last years as geo-political stability was affected by new conflicts which threatened traditional economic alliances and established new economic powers such as those of the Arab World. Resources became economic and political weapons and many governments increased profits from their resources through nationalization which had negative implications for the MNCs activities and their operations in the host countries.

10.4 Problems of the Joint Venture

In this section we will illustrate some of the issues discussed, with reference to an Egyptian case study. But before that we will deal with the company, established as an Egyptian/British venture as a vehicle for foreign investment between world nations.

There have been some attempts to define more precisely what is meant by joint venture investment. Friedmann and Kalmanoff's definition of a joint venture is:

"A type of association which implies collaboration for more than a very transitory period"[12]

Tomlinson also sees that a joint venture is:

> "A commitment for more than a very short duration, of funds, facilities and services by two or more legally separate interests to an enterprise for their mutual benefit"[13]

These two definitions see the joint venture as a system of collaboration between partners but it is important to note that they do not point to the joint sharing of control and risk of the investment. Finally Sukijasovic suggests four properties of joint venture as follows:

> "A community of interests involving doing business in common, the sharing of profits, the sharing business, risk and losses, and longevity of co-operation".[14]

Friedmann and Kalmanoff[15] point to the importance of the role of joint ventures as a symbol of improving relationships between developed and undeveloped countries and they emphasize the factor of confidence between the partners as being important for the survival and success of a joint venture investment.

Although there is incomplete data about the size of joint venture investment between world nations, especially in developing countries, and about how far joint ventures are involved in increasing the foreign investment of the third world multinationals or socialist multinationals, we have noted that there has been increased tendencies towards multinationalization since the beginning of the last decade.

However, American and British direct investment overseas in all countries has been growing respectively at a compouned rate of about 9% and 6% annually since 1957. At the end of 1968, the value of total U.S overseas investment reached £27000 mn. while, by the end of 1967, the total of British direct investment overseas, not counting that in petroleum, approached £4700 mn. Earnings and income from these

Table (10.1)

No. of Projects Submitted their Balance

Sheet to GAFI till 31/12/1983

Sectors	total of Projects commenced	Projects Commenced before 1983 & submitted B.S. to GAFI	Projects Commenced in 1983 & submitted B.S. to GAFI	Projects not submitting B.S. to GAFI
Industrial	226	189	8	29
Agricultural	32	21	1	10
Construction	76	54	2	20
Services	103	84	–	19
Financial	187	156	–	31
Total	624	504	11	109

Source: Annual Report of GAFI till 31st December 1983.

(in Arabic)

Table No. (10.2)

Source of Assets finance

Sectors	Indust.	Agricul.	Constru.	Services	Finance	Total
Actual Asset Cos.	1701.8	361.3	587.9	639.7	1563.5	4854.2
a) <u>Source of finance inside funds</u>						
Capital	323.8	94.9	965.0	205.5	570.6	1291.3
Res. & ret.profits	62.0	5.8	7.9	–	18.2	93.9
Forward losses	(34.1)	(2.3)	(11.0)	(17.7)	–	(65.1)
Profits of 1983	80.4	13.6	12.6	3.9	24.5	135.0
Losses of 1983	(22.6)	(7.9)	(11.7)	(15.9)	(16.2)	(74.3)
Locations	231.2	23.0	63.8	88.8	86.1	486.9
Total (a)	640.7	127.1	158.1	258.6	683.2	1867.7

Res.= Reserves; ret.= retain

Cos.= Cost; Indust.= Industrial

Agricul.= Agricultural Construc.= Construction

Ext.= External

Table No. (10.2) contd.

Sectors	Indust.	Agricul.	Construc.	Services	Finance	Total
b)External fund						
Long-term loans	292.5	110.0	13.9	224.3	403.9	1044.6
Short-term loans	242.1	45.6	85.1	65.6	120.2	558.6
Other suppliers	526.5	78.6	330.8	91.2	356.2	1383.3
Total (b)	1061.1	234.2	429.8	381.1	880.3	2986.5
Total (a) & (b)	1701.8	361.3	587.9	639.7	1563.5	4854.2
	%	%	%	%	%	%
Percentage of Ext.fund to Actual Asset cost	94.1	64.8	73.1	59.6	56.3	61.5

Source: Annual Report of GAFI 1984.

investments have also increased substantially during this period. In 1968 American-owned foreign investments earned over £2900 mn. and provided some £2600 mn. to their owners in the form of dividends, interest, royalties, and other payments. In 1967 British overseas investments showed that their total earnings amounted to about £438 mn. and dividends, interest, royalties and other payments exceeded £310 mn.[16]

Most foreign investors preferred a wholly-owned subsidiary to a joint venture; indeed, the preponderance of this form of ownership control was clear from the data on table 10.7 below. Also this table shows that the U.S. and the UK MNCs preferred wholly-owned subsidiaries to other forms of ownership. Moreover, there is however some data from 1975[17] which indicates some change in the tendency of the U.S. firms towards the acceptance of the minority-owned joint venture, although they still favour overall wholly-owned subsidiaries. In contrast, in 1977-78, the distribution of Japanese firm ownerships in Asian developing countries included 65.6 percent of the total 937 firms which were minority-owned (less than 50 percent)while 34.4 percent were wholly owned subsidiaries.[18]

Despite the lack of data about joint venture activities, there is evidence of increases in the tendency towards joint ventures which indicate, for example, that the empirical study identified about 70 percent of the British firms, according to Law 43 of 1974, which are joint ventures.

But the question now is why do the MNCs choose joint ventures?

The answer may be indicated by Janger's survey of managers of the major MNCs, which explains the increase with reference to the MNCs participating in the globalization of markets and gaining access to raw materials. In addition, as Kelling [19] suggested, there are many factors which may provoke the establishment of a joint venture such as government insistence, financial pressures, the need for access to skills, technology or marketing knowledge or the pressures of competition on profit, as well as the encouragement of the public.

In relation to the above arguments, both Beguin and Freedman[20] indicate that there are some particular objectives which explain why the host developing countries and foreign investors are seeking to establish joint ventures as follows:

(1) For the developing countries, joint ventures can be integrated into the national economic development plan of the country, in a way which seems to cope with the shortage of foreign exchange, to develop the skills of the labour force, to improve the productive sector, and develop social services and the infrastructure.

(2) For foreign investors, joint ventures allow them to achieve their commercial goals, to gain access to raw materials, develop new markets, tax holidays, and to obtain guarantees from the local government against the possibility of developments, for example, nationalization. They may also gain privileges from the foreign investment policies

in most developing countries with regard to taxation, customs duties, capital transfer, cheap labour, raw materials, and services etc.

Foreign investors may be faced with a shortage of capital which they are unwilling to place in a project which is a high risk if they invest alone. By association with local investors they are more likely to be induced to invest. In some cases, joint ventures with local partners lead to the best way of utilizing local managerial and entrepreneurial talents, and gaining access to the best local knowledge about markets. Many host countries, both governments and people, and in particular those of Egypt, feel that the joint venture provides a symbol of equity between the partners, with regard to ownership, responsibility, profits and control, and reduces the national attitude of suspicion towards foreign economic domination and associated political dependency. Most governments now believe that the joint ventures are not limited to the capitalist countries but they are able to seek them from socialist countries and other developing countries in order to develop their economic positions.

One of the main problems which needs to be considered in the development of joint venture investment is how control, and management and ownership are to be arranged, and whether it is preferable to establish wholly-owned, majority-owned, co-owned or minority-owned joint ventures. Killing's research findings[21] indicated that there are three types of joint venture management control associated with particular forms of firm-ownership. His classification depended upon the nature of decision-making[22] in areas such as pricing, replacement of functional managers, sales, product design and the manufacturing process. The three types of joint ventures are:

(1) Dominant parent joint venture which is dominated by one partner;

(2) Shared management joint venture in which both the partners play an active role, and

(3) Independent joint venture in which neither of the two partners has a strong role in managing the joint venture.

In October 1975, the Egypt/US Business Council formed a committee to study the critical problem areas of foreign investors. The committee studied a sample of 50 U.S companies and a limited number of companies in Canada, UK, and Germany which had either current or potential operations in Egypt. In reporting[23] the results of the study, the committee grouped the problems of foreign investment under the following headings:

(i) Economic and political risks: Egypt has been involved in the war with Israel since Israel was established in 1948. In spite of this, foreign investors according to the report, did not consider the threat of war as a major concern that will seriously affect their investment in Egypt. Their major concern was about the future of Egyptian Government and the western orientation. Since the Pre-President (Sadat) and the President (Mobarak) have been responsible for Egypt's orientation towards the West, some foreign investors and businessmen expressed their wonder whether they will be able to satisfy the increasing demands of the Egyptian people for improved living standars , strengthening the economy, and maintaining a strong defence posture, all at the same time.

To ease the anxiety of foreign investors over the political unstability in the Middle East in general, and in Egypt in particular, the Pre-President and President Mobarak took the initiative to solve the Egypttian/Israeli conflict by peaceful means and declared the end of the state of war between the two countries.(24)

There are other problems which face about 182 storage projects in Free Zones (about 13 British projects). Although these projects offered more than 4400 jobs to Egyptian employees their salaries were more than LE8,000,000. In addition they reclaimed the land (desert), unfortunately the GAFI refused to renew the licenses and asked them to remove and destroy the buildings. The consequence of the wrong decision will lead to loss of many things, such as about 4400 jobs have gone and about 4400 people becoming unemployed, and tax proceeds will decline approximately LE156200(25).

Problems Related to Foreign Exchange

Availability of foreign exchange is important to foreign investors as it will enable them to import their requirements of raw materials, service their external debts, and repatriate dividends and perhaps capital. The lack of foreign exchange is the most crippling handicap to foreign investors. So the insufficiency of foreign exchange in Egypt cannot provide a favourable climate for foreign investment in the country. Also another problem connected with the availability of foreign exchange, is different exchange rates applied, from time to time or from official and unofficial markets[26]. This phenomenon will have an affect on the financial statement and the competativness between MNCS by the methods of estimation of the raw material, foreign capital and foreign debts. For example the amount of profit in exporting companies is greatly affected by the rate of exchange used in transferring the value of exports into their equivalent in local currency, particularly if these companies export a large amount of their production, and their production costs depend greatly on factors affecting local production. If the official rate of exchange is less than the real value of local currency, the profits will be low and the tax, in consequence, will be less than the real tax. However, if the MNCs re-valuate their assets the profits or losses arising as a result of re-valuation is not liable to Egyptian tax, by virtue of Section 17.[27]

> "The tax shall apply to the profits resulting from the sale of any of the capital assets of the professions and companies which stipulated in this section, also the profits realised from compensations as a result of destruction or confiscation of any such assets whether during the life time of the firm or at its termination....The provisions of the Section shall not apply to the profits resulting from

the re-valuation of the assets".

Until 1973, all foreign exchange transactions were carried out by the Egyptian government at the so-called 'official' rate of 39 piasters to the US Dollar or 97.5 piastres to British Pound. That rate was seriously overvalued, however, and contributed to the distortion of domestic relative prices. The government's response was to shift purchases progressively to the parallel rate of 69/70 piastres to Dollar. The rationale of the partial devaluation was to encourage owners of foreign exchange resident abroad to repatriate it to Egypt at a more favourable rate, thus providing a source of foreign exchange for private imports. To take care of the day-to-day operations of the parallel market, the government created the Commercial Agency for the Parallel Market which was attached to Misr Import-Export Company. By 1977, all transactions were being carried out at the parallel rate except exports of cotton, rice and petroleum, and imports of wheat, flour, bulk tea, petroleum and petroleum productions. The final step towards unification was taken at the beginning of 1979 when the parallel or incentive rate effectively became the new official rate for all transactions. To all intent and purposes, the Egyptian pound had been devalued from the old rate of 39 piastres to the dollar to a new rate of 70 piastres to the dollar, and a rate of LEI.17 to the British pound.

The new exchange system is basically an outgrowth of the liberalisation policies instituted by Pre-President in 1974.

The Egyptian exchange market has experienced surprisingly rapid growth in the last decade. The unexpected growth in this market is explained by the large increase in remittances from Egyptians working abroad. Without this source of funds, it is highly improbable that the market could otherwise have developed to its present size. During the three-year period from 1976-1978, annual remittances totalled roughly $700 million, $1.1 billion and $1.7 billion in eacch of those calendar years.

Although the exchange market has brought many benefits to the Egyptian economy, it has also made certain distortions more obvious. This market, as opposed to the official and parallel markets, operates with a flexible exchange rate set by the forces of supply and demand. As long as Egypt continues to run a deficit on trade and current account and the Egyptian currency remains inconvertible, the demand for hard currency in the official market is likely to be in excess of the supply of foreign exchange. Therefore, the pound is offered at discount against convertible currencies on the free market.[28]

For solving this problem, it seems to me the best way is to float the Egyptian pound. This way will encourage Egyptians to repatriate hard currency, dividends or capital. Tax will be liable on the real income, unofficial rate would not find any place to work and Egypt would stand a much better chance of regulating its foreign exchange movements.

Moreover, in practice, there are other problems facing employees who work in MNCs: They receive their salaries in foreign currency and they pay salaries and wages tax with local currency (LE).

Survey Results and Discussion

Twenty- eight BMNCs paid wages and salaries to employees in foreign currency while twelve of them paid in local currency as shown from the table (10.3). These companies deducted at source tax salaries and paid them, by Egyptian pound either these companies paid wages or salaries by foreign or local currencies) to the tax offices.

Table (10.3)

What kind of currency paid salarie and wages to employees

Foreign Currency		Local Currency		No Answer		Total
No.	%	No.	%	No.	%	
28	65.1	12	27.9	3	7.0	43

But what the exchange rate will be used, is official rate, or unofficial rate?

In interviews with tax inspectors in different offices the discussion was about the tax treatment of salaries paid in foreign currency.

According to the information of Tax Administration No. 1070 (in 29/3/79) the salaries and wages tax will be collected according to the announced rate (official rate). Do you think this treatment is good, especially in Egypt where there are official and unofficial rates of foreign currencies?

Table (10.4)

Tax treatment of Salaries paid by Foreign Currency

No. of Tax Inspectors						
Yes		No		No Answers		Total
No.	%	No.	%	No.	%	
3	15	14	70	3	15	20

Could you please choose a suitable method of tax treatment of salaries paid in foreign currency?

1. Tax should be collected in the same currency?
2. Tax should be collected at the official rate?
3. Tax should be collected at an unofficial rate?

Twelve Tax Inspectors out of twenty preferred that the tax should be collected by the same currency paid to employees, while four Tax Inspectors preferred the current treatment, two Tax Inspectors preferred unofficial rate especially to realise the tax justice between the employees either they will receive their salaries by local or foreign currency. Two did not answer. The results are summarised in Table (10.5).

Table (10.5)

Suggested method of tax treatment of salaries paid in foreign currency

No. of Tax Inspectors								
Tax Collected in Same Currency		Tax Collected at Official Rate		Tax Collected at Unofficial Rate		No answer		Total
No.	%	No.	%	No.	%	No.	%	
12	60	4	20	2	10	2	10	20

Table No. (10.6)

Multinational and other Tax Payment

	No.of Proj.	No. of Employ.	Salaries & Wages	%	Average Salaries	Tax Average	Tax Revenue from Employees
Indus. Proj.	197	43685	94842	47.8	2170	129.6	5661576.0
Agric. Proj.	22	5296	6914	3.5	1306	53.2	281747.2
Const. Proj.	56	12490	25086	12.6	2008	115.3	1440097.0
Finan. Proj.	105	3273	5912	3.0	1806	97.4	318790.2
Banks	51	8160	36256	18.3	44113	466.7	3808272.0
Serv. Proj.	84	11330	29583	14.9	2611	188.2	2132306.0
	515	84234	198593	100	-	-	13642788.0

Indus.=Industrial Agric.= Agricultural Const.= Construction

Proj. = Project Finan.= Finance Serv. = Services

Salaries and wages tax rates are:

First LE480 (after deduct personal allowance) 2%

The following LE480 5% The following LE960 10%

The following LE960 15% The following LE960 18% Over than 22%

Table (10.7)

Pattern of ownership classified according to the percentage of foreign ownership in subsidiary

Value in £.mn.

Subsidiaries-location	Wholly-owned more than 95% No.	%	Majority 50% to 95% No.	%	Minority less than 50% No.	%
UK-owned in developed						
countries (steling area)	605	54	224	20	290	26
the value	482	44	516	47	98	9
Non-sterling area	975	57	269	16	471	27
the value	645	49	546	42	128	9
USA manufacturing (value)	275	94	13	4	3	1
Foreign-owned in the UK						
US-owned (value)	946	75	185	15	132	10
Other countries (value)	446	70	171	27	23	3
Foreign-owned in Germany	3292	61	872	16	1211	23
the value	1600	79	192	19	234	12
Foreign-owned in France						
US-owned (No.)	181	57	94	30	43	13
other countries (No.)	66	33	93	44	40	20
US-owned in Europe (No.)	2050	76	464	17	182	7
the value	1320	76	358	21	50	3
US-owned in Canada (No.)	2301	83	331	12	133	5
the value	2240	62	1040	29	321	9

10.5 Joint Venture and Egyptian Investment

In the early days of the Open-Door policy, when the Egyptian government was endeavouring to encourage foreign investment, the banks and public companies were threatened by the competition they would have to face from foreign companies who had available to them modern technology and financing, and who were not subject to financial as well as employment restrictions. To overcome these fears, Section 4 of Law 43 of 1974 [29] provides that some foreign investments in Egypt must be in the form of joint venture with either private or public Egyptian capital. The joint venture mandate affects only certain industries. Such joint ventures usually take the form of joint stock companies or limited liability companies. The Law does not determine a maximum ceiling for the foreign participation except in the following three cases:

(i) banks dealing in national currency transactions in which Egyptian capital must at least be 51%;

(ii) construction activities in which Egyptian capital must amount to at least 50%; and

(iii) housing projects which can only be effected through Arab capital.[30] Investors may wish their projects to be wholly owned subsidiaries if they get the approval of two-thirds of the Investment Authority's Board.[31] In discretionary matter, the GAFI will consider whether such technology or project is important to Egypt and whether Egyptian capital participation is possible.[32] Reinsurance companies and merchant as well as investment banks may establish themselves in Egypt without Egyptian participation provided they operate through a branch and restrict their activities to free currency transactions.[33]

In determining the identity of the local partner in the joint venture, the investor must decide whether he will opt for private or public capital. His choice will depend upon the availability of acceptable Egyptian partners with enough capital to invest. It should be noted that the government aims at encouraging the private sector and at abolishing the numerous restrictions and regulations applying to economic activities. Therefore Egyptians have been permitted to open foreign currency accounts and keep foreign currencies received through activities other than tourism and export, provided,however, such transactions are done through officially approved banks.[34] If the investor is unable to find a private participant and the government considers that specific project desirable, the involved competent ministry will nominate either one or a group of public sector companies to provide the Egyptian capital participation.[35] The Investment Law specifically declares that if a public company participates in a joint venture, its projects will be considered as part of the private sector. They will therefore not be subject to public sector law which is restrictive in certain matters such as financial procedures and procurements as well as employment and salaries.[36]

10.6 Financial Analysis

The main objective of financial analysis is to assess the profitability of the project and its capacity to fulfill its obligation. This objective would be very important in appraising joint venture projects where an Egyptian public company is involved in the project as an investor. The simple significance of financial analysis is obvious: no enterprise, either domestic or foreign, will engage in a project that is expected to be a losing proposition, and none should be allowed that can not meet its financial obligations. Furthermore, the financial appraisal can help to determine whether or not a project deserves to get other advantages over the normal ones that are granted to a project under investment Law No.43 of 1974. In this case, comparing the results of financial analysis can help the appraiser to make a rational judgement. For example, if the financial appraisal of the project shows low financial profitability, but at the same time the economic and social appraisal shows it desirable on the economic standpoint, it may seem desirable to grant additional advantages to the project in order to make the venture attractive to the investors. From the other side, the projects must not get any additional advantages if the economic and social appraisal proves low economic and social profitability, or shows negative social profitability from the standpoint of the society as a whole. In brief, financial appraisal is an essential part of the entire process of project appraisal, which can contribute to making rational decisions concerning whether or not the project deserves to enjoy the advantages granted by Law No. 43 of 1974, and to make rational and conservative judgements concerning any additional advantages. In addition, financial appraisal can demonstrate any adjustments to be made in the financial plan or the loan's conditions to improve the project's debt-service position. Moreover, financial appraisal can assist in estimating government revenues from custom duties and taxes through the life of the project.

The scope and significance of financial analysis has three important characteristics:

(1) The main concern in this analysis is income distribution and capital ownership, in terms of estimating the return to the equity capital contributed to the project by each of the various participants, public or private. In a situation such as appraising a joint venture project in Egypt the financial analysis can help to clarify some important issues, one of which is estimating the amount of profit that can be transferred abroad. For instance, Article of 22 of Law No. 43 of 1974 points out that: [37]

> "Projects realizing self sufficiency in their foreign currency needs shall be permitted to transfer their annual net profit determined at the highest rate prevailing and declared for foreign currency within the limits of the credit balance of the foreign currency account of the project."

Therefore, if the financial appraisal shows that the share of a foreign investor in the net profit of MNCS is LE700,000, where the surplus in foreign currency achieved by the project itself during the year is only £600,000 then it is indicated that only £60000 can be permitted to be transferred. The benefits gained from such information can also help in estimating the impact of the profits transferred on the balance of payments in Egypt, as a part of foreign currency (38) burdens resulting from the project. Such indicators can also aid the follow-up after the implementation of such projects.

(2) Financial analysis may be applied to the costs and returns of various public entities which participate in a project. At this point, the General Authority for Investment and Free Zone (GAFI) plays an important role in recommending or not recommending the participation of a public company in a joint venture, and the profit to that company if they participate. Most of the feasibility studies of MNCS which are submitted to the GAFI, are, often, prepared by the foreign partners. So the role of the GAFI is significant in estimating the financial indicators and the returns and costs of such investment to the public companies who intend to participate in such projects. Of course this can be done through financial analysis, which must be integrated at the same time with economic analysis, which tries to estimate the economic and social profitability of such an investment from the society's viewpoint as a whole. So that the GAFI can approve the projects which the society

needs them and are useful for national economy, while GAFI can refuse the others which show high private profitability and whether the economic and social appraisal proves low income and low social profitability.

(3) Financial analysis is considered the first step to economic and social analysis. Thus, the whole appraisal process starts with this financial analysis.

In order to do a financial analysis of a project, a projection is required of all revenues, expenses, receipts and expenditures. At this point, it is very important to differentiate between capital and income, capital and revenue expenditure. In brief, for financial appraisal of a project, the following financial statements are normally undertaken:

(I) Profit and Loss Statement: This statement shows the various items of expected revenue, the corresponding costs and expenses and the net profit on a periodic basis.

(ii) Balance Sheet: The projected balance sheet indicates the expected financial position of the project at a specified future date. It shows the assets that are expected to be available for use during the project and how they are expected to be financed. It may cover the period from the beginning of normal project operations up until the last day covered by projected income and cash flow statements. This statement consists of: Assets which include fixed and current assets; and liabilities and equity accounts which include current liabilities, long-term debt and equity (shared capital and retained earnings).

Some attention will be concentrated on company finance, some justification for this deriving from the relative emphasis this point received in the deliberations in Egypt, on the effect of corporation tax on MNCs finance.

The basic point at issue concerns the extent to which corporation tax might distort allocation by affecting the decision an enterprise will make between internal and external financing. It might also be expected to affect the form of external finance.

10.7 Internal and external finance

Corporation tax can affect the choice between internal and external finance in three ways through its influence on:

(1) the level of company profits;

(2) the decisions of management to retain these profits or to distribute them, and;

(3) the terms on which outside capital can be obtained.

The project requires basically two kinds of finance, namely working capital and long or short term finance. Working capital is required to meet current expenses such as purchase of raw material and payment of wages and salaries of employees, while long and short term finance is required to acquire fixed production asset such as real property, plant and machinery. A new company can provide for its financial needs either in th form of equity capital (ordinary or preferred) or debt capital (debentures or loans). An established company has, in addition, the alternative of providing for its financial needs from retainedd profits or other financial reserves accumulated during a period of operation. As shown on table (8.2)[39] about 62.8% MNCs rely upon external finance, while 14% depend on internal finance. Approximately, the same result can be obtained from table 10.2 which demonstrates 61.5% MNCs covered their actual investment cost from external finance while 38.5% MNCs covered them from internal finance. Usually, a company's promoters will be unable to meet the whole of the financial needs of the company from their own resources, but will turn to financial institutions for debt financing. In Egypt commercial banks traditionally provide short term finance while institutional investors provide long term finance.

Sometimes the MNCS needs hard currency to carry on their activity. Therefore the Investment Law 43 allows MNCs operating in Egypt to get foreign currency by bringing foreign currency into the country or obtaining it locally, and using it to pay for goods or services that require payment in foreign currency. The basic principle is that to the extent the company's business activity generates foreign exchange, the company may disburse it, retain it, or otherwise use it as it sees fit. Foreign currency accounts may be fed by capital investments, loans, purchases of foreign exchange on the "own" exchange market and proceeds from both local and foreign sales paid for in foreign currency.[40] Disbursements are permitted to pay for imports, goods and services, debt servicing, and purchases of local currency. Thus transactions in foreign exchange directly related to the firm's conduct of a productive enterprise proceed virtually free of restrictions, while currency speculation is discouraged. According to Law 43 MNCs are free to open local currency accounts as necessary. MNCS may want to repatriate part of their currency, initially in the form of dividends and possibly eventually as capital. Projects that are export-orientated and generate all their foreign exchange needs from their business activity may transfer all of their net profits abroad up to the amount of the credit balance in their foreign currency accounts. MNCS orientated toward import substitution are permitted to buy foreign exchange on the "own exchange market and remit it abroad within limits established by GAFI in their particular case.[41]

Finally, it is known that interest on external finance will be taxable deductible and on the other hand interest is exempted from the tax on movable capital assets if the loan was in hard currency Article 16 of Law 43 of 1974. If internal finance (local currency) is made available, the loan interest would of course be directly deducted from taxable profits.

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CHAPTER ELEVEN

GROWTH AND PROFITABILITY OF DIRECT INVESTMENT

Chapter Eleven

Growth and Profitability of Direct Invstment in Egypt

11.1 Introduction

In the last chapter we considered the nature of multinational companies by examining the defination of MNC, historical perspective and financial policies and practice. It was found that the MNC phenomenon was evolving by the end of the last century. In Egypt, however this field was neglected until 1974 when the Egyptian government changed its attitudes towards foreign investment and adopted a new policy aiming to induce and attract foreign investors (Arab and Foreign) in Egypt.

The principal law governing the implementation of this policy is Law 43 of 1974, which was amended by Law 32 of 1977 concerning the investment of Arab and foreign funds and free zones. According to article No.3 of this law, the main objective of this policy is to promote economic and social development within the framework of the state's general policy and national plan. Foreign investment is used as a vehicle towards this and to accelerate the development process. The aim of this chpter is to discuss the Egypian policy towards direct investment, what the gonernment offered the foreing investors to encourage them to operate in Egypt, the motives for investors, the effect of direct investment on the Egyptian Economy, and an evaluation of foreign investment in the last ten years (1975-1984).

11.2 Foreign Investment is encouraged and motivated by incentive and trust

Many factors are usually taken into account before making a decision to invest in a given country. Among the determining factors, political stability as well as legislative stability are paramount, as are the expected returns on investment and the ability to transfer capital as well as profit out of the country. Of course, there are other investment incentives that are apt to influence the decision to invest in a given country such as:

(a) Favourable trade policies

(b) Measures to enhance investor's confidence

(c) Investment codes

(d) The availability of infrastructure and services

(e) Employment incentives; and

(f) A favourable interest rate structure.

The decision to invest depends on stability, profitability and transferability. The present note is an attempt at applying these criteria to the case of Egypt's stability, in the present context, which necessarily involves political, economic as well as legislative stability.

Political stability has been a permanent feature of the Egyptian scene so far. Few developing countries can claim a similar experience since the Revolutionary Government came to power in 1952 after a bloodless Coup d'Etat that put an end to the monarchical regime, the succession of power in the country has taken place smoothly and in an orderly manner.

As to the economic health of the country it is sufficient to quote a World Bank report dated September 21, 1984 reviewing Egypt's medium term investment program: [1] for the past decade its economic policy has encouraged the development of a vigorous private sector and diversification of foreign economic relationships. For the same period Egypt has experienced one of the most rapid growth rates in the developing world.

With regards to legislative stability the general trend in laws and regulations affecting the investment climate is towards fewer and fewer constraints and more privileges. Hassan Ali the Prime Minister addressed the Egypt U.S. Joint Business Council (reported in Investment Review).[2] He stated that:

> "The government promises not to pass resolutions or acts affecting business before listening to and exchanging views with all parties concerned. Stability of policies, ministerial decrees and laws are our strategic objectives."

On many occasions public pronouncements stressed that no resolution, act or law would be enforced retroactively.

As to profitability and transferability, Egypt has a large population (more than 50 millions with many diversified skills) it has recently experienced rapid growth of income. Private consumption has been growing at an average rate of 6.6% annually, and gross domestic investment at an average rate of 15.5% in the period 1970-1982.

Like other economies in the free world, Egypt has been affected by the lull in economic activity that hit the world economy in the last few years with its main sources off foreign exchange namely, petroleum exports, workers remittances and Suez Canal tariffs.

To keep the momentum of growth going, more resources have to be mobilized. These resources have to come mainly from domestic sources or else from foreign sources, hence the importance of foreign private investment.

The encouragement of foreign private investment became a part of an overall strategy adopted by Egypt. All public pronouncements by the President, the Prime Minister and other policy makers point in one direction namely that giving every possible push to private investment, particularly foreign or joint private investment.

The government policy maker is then concerned with establishing an economic environment within which the economic agent who seeks to make a profit will thereby contribute to the achievement of the employment objective and the income distribution objective, among others.

The main instruments available to the government for encouraging private and foreign investment are prices, tax incentives, and subsidies. Especially important are exchange rates, and interest rates.[3]

As Egypt welcomes private foreign investment the Egyptian government realises that private investment is encouraged and motivated by both incentives and trust, and so, the government is obliged to provide (as the Prime Minister said in his speech) the maximum possible incentives and is willing to avoid any policies or action that might lead to mistrust or misunderstanding.

The government of Egypt knows that there are two main motivations:

(1) The opportunity to earn a higher level of profit in Egypt than elsewhere.

(2) The minimum possible risk.

For getting more investment the Egyptian Government will continue to provide tax exemptions, free transfer of profit and capital, and is considering more privileges for the reinvestment of profits. Moreover the Egyptian Government took the following important matter to improve the climate investment in Egypt:[4]

(i) It approved a list of areas for investment in which both private and joint venture companies are invited to participate in land reclamation, agriculture, industry, food processing, electrical fittings,... A detailed listing of open projects in these areas is available at the Investment Authority.

(ii) The government has assigned to Investment Authority the responsibility of getting all approvals and licences within a maximum of sixty days of application.

(iii) The government has established a permanent committee at the Ministry of Finance. This committee meets every week to settle disputes with the Customs Authorities.

(iv) The Government urges business organisations and associations to arrange regular meetings with concerned Ministers to exchange views and to discuss problems affecting business performance.

11.3 Characteristics of The Egyptian Economy

During the 1950s and 1960s, Egypt's economy became largely state-owned and state-run. Nationalization of foreign companies virtually ended foreign investment of both capital and technology.

In the early 1970's it became clear to Egypt's leaders that a change in direction was necessary if the country were to realize its potential. The Government under the Pre-President brought about this change in several ways. The first was to promulgate the Open-Door Policy, an expression of Egypt's desire and willingness to invite foreign investment into its economy. Another method was to temper the heavy reliance on the public sector, especially in areas that may be better served by private initiative.[5] For example, portions of the construction industry have been transferred to private sectors. The purpose of these changes is to harness the expertise and technology of the private sector for benefit of the country's economy. The Government intends to continue in this direction, but at a controlled pace; too rapid change could be counter-productive. However, certain industries, that are of special strategic importance or that are key to the nation's social welfare, will continue to be state-owned and run.

The economic policy of Egypt aims at achieving three main objectives:

1- the first one is to strengthen and expand the present economic and social infrastructure;

2- the second is to maintain the present production facilities and to utilize their capacity to the fullest; and

3- the third is to marshal adequate domestic and foreign financial resources for investment.

The major instrument for achieving these economic objectives is the five year plan, which provides a framework for the implemention of government policies.

Open Door policy

in October Paper, pre-President presented the policy of "Al-Infitah" or "Open-Door policy". the policy was approved in both the people's Assembly and a national referendum in May 1974.[6]

The policy has several objectives which can summarized as follows:

1- the decentralization of decision-making in state-owned enterprises;

2- the encouragement of the private sector to play its role in the economic development of Egypt;

3- the provision of incentives to stimulate and encourage private foreign investment; and

4- the expansion of economic cooperation with western and Arab countries.

The Egyptian government has taken several steps to implement the above policy, including the abolishing of the general organisations or public sector holding firms, of the aim of decentralizing public sector decision making. The government has also removed some of the heavy restrictions on private business activities, expanded foreign exchange transactions outside the official rate, and loosened many of the restraints on banking activties. In addition to these measures major efforts were directed toward the encouragement of both Arab and foreign investment.

Therefore, a comprehensive theory of foreign investment in Egypt would need to cover the decision making process and the motives for overseas investment, the characteristics of the investing companies, the type of industries and economic activities that attract foreign investment and the effect of such investment in the economy of both host and home countries of investment.

One of the most important characteristics of Egypt as a host countries is its geographical location. It boarders on both the Mediterranean and Red Seas. The Suez Canal which links these two seas together gives Egypt a significant strategic location and an important role in stimulating international trade by saving in both distance and shipping time, and hence, a reduction in energy consumption and transportation cost of manufactured goods from the west to the east.

Moreover, in addition to the geographical location, Egypt has other characteristics can be summarized as follows:

1) The population that exceeds 50 million people provides both large consumer community and large pool of supply of semi-skilled and skilled labour force.

2) The increase in per capita income and the distribution of income within the population provide a well segmented market

with an effective demand for all types of products. The increase in income togerther with the low level of existing investment provides an attraction to foreign investment to set up plants to fill the gap between the demand for goods and the shortage of supply of these goods.

(3) The economic problems of Egypt have led to a favourable government attitudes towards foreign investment and this provides an opportunity to foreign investors to make use of the different government incentives such as tax incentives (tax holidays), subsidies... and

(4) The location of Egypt in the heart of the Arab countries is another incentive to foreign investors who can supply the rich and growing markets of these countries from an established infrastracture and industrial base.

11.4 <u>Foreign Investment and Law 43 of 1974</u>

The Egyptian government is pursuing a policy of encouraging Arab and foreign investors in Egypt. The principal law governing the implementation of this policy is Law 43 of 1974, which was amended by Law 32 of 1977 concerning the investment of Arab and foreign funds and free zones. According to article No.3 of this law, the main objective of this policy is to promote economic and social development within the framework of the state's general policy and national plan. Foreign investment is used as a vehicle towards this and to accelerate the development process. Egypt is faced with a problem in attempting to attract foreign investments for necessary commodities; at the same time foreign investors want something in return from Egypt.

Egypt is seeking to expand the scope of investment, quality, and efficiency of its production base. This requires modern technology, a high level of know-how, and top managerial skills. Law 43 of 1974 was enacted to promote the inflow of foreign capital and technology needed to achieve those objectives. In 1977, the law was amendment by Law 32 which increased the scope of permissible activity, made possible an extension of its holidays, and granted some of the priviliges of the Law to projects fully owned by Egyptians.

The legislations allow foreign majority ownership and provide a package of incentives and guarantees. They also grant tax holidays for periods ranging from five to fifteen years. Their privileges include a large measure of freedom with respect to the repatriation of profits and capital.

Projects in free zones are geared to exportation and are permanently exempt from taxation. Imports into and exports from the free zones are not subject to any restrictions unless the import is into Egypt. All guarantees provided by the law against non-commercial risks apply equally to free zones projects. All projects operating under the provision of investment law are considered to belong to the private sector even when carried out as a joint venture with a public company. In order to attract foreign investment, Law 43 allows for several advantages. Among the most important of these are:

(i) Tax Incentives

The most important incentives are the tax incentives. The Law extends to approved projects and invested capital a number of fisical privileges taking the form of tax exemptions. However there are probably two basic objectives of Law 43. The first and probably the most important is to obtain foreign capital to create exports and thereby create a favourable foreign exchange which the government needs. The second is the need for technology in modern developments. So the tax incentives are designed to accomplish these objectives for stimulating local and foreign investors to invest in Egypt.

Tax exemptions are contained in several articles in Law 43: Articles 16, 17, 18, 46 and 47. The first three articles create a series of temporary exemptions, while the latter two articles create a permanent tax exemption. The following some details of both tax exemptions:

(a) Permanent tax exemption: MNCs which operate in Egyptian free zone qualify for a permanent tax exemption. Other consequences include the ability to import or export without any restrictions and an exemption will obtain, also, from customs duties. Equipment, machinery and equipment for transportation utilized by approved projects may be totally exempted from custom duties.[7]

(b) Temporary tax exemption: All investments approved under Law 43 which do not qualify for free zone status qualify for tax exemption on the net profit of projects, whether distributed or undistributed profits, all revenue from profits that are reinvested or special reserves shall be exempted from the levy of CT and commercial and industrial profits tax for a period of five years starting with the first fiscal year subsequent to the commencement of production of the project or to the engagement in activities as the case may be.[8] This tax holiday may be extended to eight years, provided the Investment Authority recommends and Council of Ministers approves such extention, on grounds of the nature, geographical location and volume of the capital of the project, its importance for economic development.[9] A ten year tax exemption may also be granted to projects undertaking reconstruction, establishing new cities in non-agricultural areas that fall outside the boundaries of existing cities and projects involved in land reclamation

Furthermore, the distributed profits also enjoy a five years tax holiday from tax on income derived from movable property as well as the general tax on income. The former tax applies to income received from securities and interest income from guarantees, deposits and debts, while general tax on income applies to individual investors and not to companies

(ii) Import-export regulations: Production facilities, transportation equipment, machinery, equipment and spare parts required for the start-up or the operation of the project may be importes without license.[10]

(iii) Other exemptions: The Law 43 sought to relieve firms approved under it from many of the more burdensome restrictions contained in Egyptian laws. Thus, it provides that projects shall be exempted from the provision requiring them to distribute annually a certain percentage (25%) of profits to employees. MNCs are also partially exempted from labour participation in management. Employees engaged for approved projects may be exempted from the applications of Egyptian social insurance laws on condition that a more beneficial insurance plan is provided by project and approved by the General Organization for Social insurance.[11]

(iv) Protection and Guarantees: Foreign investors seek protection against non-commercial risks. Therefore, the Investment Law provides that approved projects may not be confiscated or nationalised and that asset of such projects may not be sequestrated, confiscated, seized or blocked except through judicial procedures.[12]

11.5 Transfer of Assets to non-Resident Companies

Where a UK company, which is carrying on trade outside the UK, especially in Egypt, through a branch or subsidiary transfers the whole or part of that trade together with its assets used for the purposes of the trade (or its assets other than cash) to a company not resident in the UK, in exchange wholly or partly for securities consisting of shares or shares and loan stock in the foreign company, so that the UK resident company holds not less than one quarter of ordinary share capital of the transfer company, then the charge to corporation tax on any chargeable gain that would otherwise accrue is postponed.(12)

The deferred chargeable gain is treated as arising and hence the chargeability of tax on the gain commencing where any of the following takes place:

(1) the transferor company disposes of the whole or part of the shares held by it which were issued in exchange by the transferee company.(13)

(2) the transferee company disposes of the whole or part of the assets held by it or ceases to use them.(14)

The idea of deferring the gain seems to be that the gain is regarded as paper gain and so the company is given the time to find cash to pay it. The deferment of capital gain liability applies also to insurance companies.(15)

On the other hands the position of the Egyptian tax code on assets transferred to MNCs in Egypt is that all capital assets and imported construction material and component necessary for funding projects may be exempted from all taxes and custom duties. When British parents or partners transfer any assets, the Egyptian Authority shall assess the value of imported and intangible assets contributed to any approved project by any foreign investor. In evaluating such assets, the General Authority for Investment and Free Zone may consult the opinion of qualified experts appointed by the Board of Directors of its delegate.

The invested capital of approved projects shall be recorded in a register established for such purposes. Invested capital in the form of cash shall be registered in the same units of currency as were transferred. Intangible assets shall be registered as capital contributions in kind, together with statement of their value as assessed by the Authority.

Evaluation and registration of invested capital and issuance of the registration-certificate of the invested capital shall be in accordance with the following procedures.(16)

(1) After all the invested capital of a project has been imported or transferred into Egypt, the investor shall submit an application to the authority for the evaluation and registration of such invested capital. Such application shall include a statement of the nature and value of the invested capital certified by a chartered accountant and shall be submitted together with the following documents:

(a) For funds transferred in foreign currency through one of the registered banks at a Central Bank of Egypt, the investor shall submit an official certificate issued by the bank through which the transfer has been made. The certificate must set down the amount of such transfer, accompanied by a statement certified by chartered account stating how such transferred cash funds shall be utilized in establishing the project. These funds shall be evaluated at the highest rate declared for free foreign currency at the date of the transfer.

(b) For invested capital imported in form of machinery equipment, transportation equipment, and all other capital assets necessary for the establishment of the project, as well as for raw materials and commodity requirements necess · for the first operating cycle, which have been cleared pursuant to the customs releasing licenses issued by the GAFI an official certificate from the customs requested at the time of clearance and stating the clearance date and value assessed by the customs.

(c) With respect to amounts expanded to obtain intangible assets, research or incorporation, the investor shall submit documents proving and justifying such expenses in relation to the proposed project.

(2) In all cases before issuing the registration certificate, the GAFI is entitled to determine through examination and inspection of documents that the transferred funds or imported capital have been in fact utilized for purposes of the project.

<u>Transferability of profits</u>

The general principles that govern the transfer of profit are set down in Law No.43 of 1974 as follows:

(a) A project whose visible and invisible exports cover all elements of foreign exchange requirements is permitted to transfer its annual profits within the limits of the balance of the proceeds of the project's exports;

(b) Projects that are basically not export-orientated and that limit the country's need for imports shall be permitted to transfer in whole or in part their net profits within limits approved by the authority;

(c) Housing projects whose rentals are payable in foreign currency are permitted to transfer their net profits in full. Others whose rentals are payable in local currency, may transfer profit up to a limit of eight percent (8%) per year of the amount of their invested capital.

(d) Popular housing projects and housing in new cities are permitted to transfer net revenues up to a limit of fourteen percent of their invested capital.

The Authority (GAFI) shall determine the amount of funds which may be transferred abroad including net profits accrued by the invested capital registered with the Authority in accordance with the following procedure:

(1) An application for transfer shall be presented to the Authority setting forth the profits sought to be transferred. The application shall be accompanied by the following documents:

i) A copy of the project's balance sheet and profit and loss statement for the period in which the profits were earned certified by a chartered accountant; and

(ii) A certificate issued by a chartered accountant attesting that the project has submitted its tax declaration and discharged all taxes as well as other obligations due to the state.

(2) The authority shall notify the project and its bank of the amount of profits which may be transferred following its determination that such amounts have been properly calculated in accordance with established accounting rules.

(3) Such profit may thereafter he transferred abroad in the manner described in the provisions of item (1) of article 22 of Law 43.

With respect to the following projects, the authority shall issue to the banks the necessary currency exchange approvals for the amount of net profits which it determines may be transferred abroad:

(1) The projects approved under the provisions of item (ii) of article 22 of Law 43 as projects which limit the country's need for imports; and

(2) Housing projects, the rentals of which are payable in local currency, shall be permitted to transfer amount up to 8% per annum of invested capital, and housing in new cities, outside the agricultural area and beyond the perimeters of existing cities shall be permitted to transfer amounts up to 14% of invested capital.

Banks shall transfer these funds at the highest rate prevailing and declared for foreign currency.

11.6 Egyptian View on Foreign Investment

The govenment represented by the foreign investment authority is claiming that the economy will gain from foreign investment as it will bring in foreign capital, and technological know-how, which is badly needed for development Moreover the authority expects foreign investment to create employment opportunities which lead to getting more revenue from tax salary (table 10.6) increase production, and ease the balance of payment problems.

The policy of encouraging foreign investment emerged from the 'Government policy' which stated that the Egyptian economy is in bad need for foreign resources not only to support it but also to hasten its development process by encouraging foreign investment, the government aims to get as much as possible of foreign finance and technological know-how, creating new jobs and extra revenue from tax duty and other kind of direct taxes.

To show that foreign investment is aiding in the development of the economy, the foreign investment authority draw a comparison between the national investment plan for the year 1984, and the approved foreign investment for the same year. The comparison is summarized in table (11.1)

Table 11.1

Relative importance of the economic sectors in the national planned investment and approved foreign investment for the year 1984.

Sector	Planned National Investment	Approved Foreign Investment
	%	%
1) Commodity sector	53.2	47.0
2) Distribution sector	28.3	20.0
3) Services sector	18.5	28.3

Source: GAFI , Investment Projects under Investment Law, Ten years after, 1985. (in Arabic)

According to table (11.1), the foreign investment authority claims that:

(1) Although there is a similarity between the approved foreign investment, and the national planned investment, there is little difference between the approved foreign investment and national planned investment. For instance, in the first two sectors the approved foreign investment is less than the national planned 14.5% while in the third sector the approved foreign investment is more than the national planned 9.8%. Therefore, the Egyptian government has to alter their incentives for the first two sectors to encourage investors to work in these sectors especially as

they are more important for the Egyptian economy. On the other hand the government should make some restrictions on the other sectors which are less beneficial to the Egyptian economy.

(2) The approved foreign investment for the year 1984, represents 12% of total planned national investment for the same year.

(3) The authority also claims that these approved projects for 1984 will provide 84234 jobs, pay yearly LE199 million as wages and salaries.[17]

(4) The authority also estimates the value of goods and services produced by foreign investment projects at LE1366.[18]

(5) Also foreign investment will pay LE13642788 yearly as a salaries and wages tax, table (10.6)

The staff in both tax administration, tax offices and of GAFI in accounting, administrative and statistics departments and some staff of universities who are interested. The majority of them agree in interviews with the researcher that the overall effects of foreign investment on Egypt's economic and social development is positive. This agreement is evident in table (11.2) on the following page. This table shows that about 72% of the respondents interviewed considered the effects of foreign investment as generally positive and 8% of the respondents very positive. While about 6% of the respondents do not know and 14% is negative. In both groups these who did not answer and reject foreign investment argue that (1) it will harmly affect the economic and political sovereignity, and distort the social structure of the country, (2) foreign projects will, through unfair competition, weaken the public sector which is the country's base for economic development, (3) Egypt is divided into about 26 provinces and investment projects are restriction in four provinces only, this means that the four districts will get a good chance to help unemployees in these areas only and the people living in these areas which can get any merchandise without any suffering, and (4) the ODP will lead the country away from planned development.

Table No. (11.2)

Attitudes towards the effects of F1 in Egypt

Very positive Responses		Positive Responses		Do not know Responses		Negative Responses		Total Responses	
No.	%	No.	%	No.	%	No.	%	No.	%
4	8	36	72	3	6	7	14	50	100

11.7 Effect of Foreign investment on The Egyptian Economy

This section will attempt to provide a selective summary of the effect of direct foreign investments on the economy of host countries in general and the different points of views of Egyptian economists, businessmen, and government officials concerned with foreign investment in Egypt.

On the one hand there is a group of economists who argue that foreign investments help to foster the economic development process by introducing capital, new technology and management skills necessary for development. On the other hand there is another group who argue that the costs of foreign investments are for higher than its benefits which could be acquired at a much lower price.

Among the first group of economists is Stretten, P. who argues that the contribution of private investments may help to lay the foundations for further growth in the economy and in strengthening the base from which domestic savings and foreign exchange are generated.(19) Private foreign investment, in his view, is not a zero-sum game where the loss of one is a gain for the other, and host countries may benefit of the following advantages of private foreign investments:

(1) Through tax revenues, it may contribute indirectly to filling the savings and foreign exchange gap.

(2) It helps in the transfer of technology and skills and provides for training of local managers.

(3) It helps in establishing contacts with overseas banks,

capital markets, products markets, and sales organization, thence it may create directly and indirectly employment opportunities.

(4) It may improve domestic wages or improve the terms of trade.

(5) It may change the market structure and thus contribute to vigorous competition and

(6) Foreign investment aids the host government revenues by establishing a new tax income, direct or indirect tax which may substitute for the revenue from corporation tax during the tax holiday.

Meur[20] argues that the flow of private capital contributes to the host country's development programme in general ways by helping to reduce the shortage of domestic savings by increasing the supply of foreign exchange. As a result of this initial contribution real income will expand productivity will rise, domestic labour wages will become higher, and prices will become lower. Moreover, private investment will allow for a large labour force to be employed, and will transfer to the host country technical knowledge, market information, managerial and supervisory personal, organizational experience, and new products and production techniques.

In discussing the welfare effects of foreign direct investment Johnson[21] argues that it increases the capital stock and improves the technology in the host country which will also gain from taxing the earnings of the investment, and its residents will enjoy lower prices and a better quality of commodities.

Reuber[22] in his study of private foreign investment in development argues that like any other kind of investment, private foreign investment will add to the size of domestic stock of real capital which will result in real output and the redistribution of income away from local owners of capital in favour of labour and other non-capital owning members of community. He also found a positive association between foreign investment and gross national production. To calculate the net economic benefits of foreign investment. Reuber uses the following model:

Net economic benefits of foreign investment = Productivity of imported capital − Direct cost of imported capital + External benefits of imported capital − External costs of imported capital

The first part of the right hand side of the equation is reflected in the calculation of each individual investment project, while the other part is experiences by the society as a whole. The benefits cited by Reuber include .[23]

1) The transfer to the host country of not only capital but also a package of auxiliary factors including technology, management, and foreign market access.

2) The opportunity offered to host countries to capture a substantial share of the earnings on foreign capital, and rents earned on the package of auxiliary factors.

3) Training of labour and mangement, increase in productivity of local firms, and redistribution of income within the host

country.

Brooke and Rommer [24] who argue that private foreign investment is involved in a love-hate relationship with government and people of host countries, claim that private foreign investment have the following merits:

1 - Private foreign investment will bring much needed capital to a country which cannot generate sufficient of its own;

2 - Provide jobs and employment opportunities;

3 - Private foreign investment is willing to consider sites in development areas;

4 - Will raise standards of management in general as well as managerial education;

5 - Aid the balance of payment by manufacturing local goods that would have been imported and

6 - Introduce new technologies and new products.

11.8 An Evaluation of the Results of Investment According to "Egyptian Investment Laws"

Before the issuing the 'Open-Door' policy, Egypt's former investment laws did not stimulate foreign investment in Egypt's economy.[25] A short examination of the atmosphere, circumstances and legal setting affecting foreign investment shows that the laws themselves were not unfavourable to the existence of foreign capital in the economy, but rather the political climate prevailing at the time was the impediment to the incoming of foreign capital.

The laws regulating foreign investment have evolved through the following stages:

1- Law No. 212 of 1952 creating the Permanent Council for the Development of National Production.[26] In this law, the use of foreign and Egyptian capital is specially provided for land reclamation, and concentrated upon electricity as a basic need for industrialization. So that the foreign companies operating in Egypt were exempted from the commercial and industrial profits tax according to Law No.306 of 1952.

2- Law No.156 of 1953, which was later amended by law No. 475 of 1954, was the fundamental law regulating foreign investment. This law attracted foreign investments to participate in development projects such as mining, industry, power, trade, tourism and transportation.[27] The major importance of the law, was that Egyptian/ foreign joint companies were allowed to be incorporated which contributed significantly to the technological development of certain manufacturing industries.

3- Law No. 65 of 1971, On Arab Capital Investment and Free Zones, is the law that "carried the seeds of the Open-Door policy" as it invited Arab as well as foreign investors to engage in business in Egypt.(28) Because of the politically unstable atmosphere surrounding Egypt at that time, foreign investors were not feel encouraged by this law.(29)

4- Law 43 of 1974: This law concerning the investment of Arab and Foreign Funds and the Free Zones was enacted in order to attract foreign investors to make their technology as well as their capital available to Eyptians as part of the development process.(30) The Egyptian Government issued Law No. 32 of 1977 to amend Law 43 of 1974 by eliminating many uncertainties and difficulties which discouraged foreign investors to work in Egypt.(31)

In 1974 Egypt introduced the "Open Door" economic policy with a view to boosting private investment. Law 43 of 1974 has offered many different incentives to private investors, the main ones being: tax holidays up to fifteen years; exemptions from certain laws regulating imports, exchange control and labour, and duty free importation of machinery, equipment and tools necessary to investment project.

The law was amended in 1977 to give greater incentives to private investors and this was followed in 1981 by Law 159 which extended similar incentives to investors in the new communities.

The principal goals of the Law 43 and Law 32 of 1977 were as follows:

(1) to create areas of joint interest for the national economy and for Arab and Foreign investors;

(2) to broaden the participation of domestic capital with Arab and Foreign capital;

(3) to improve the climate to make it conducive to the movement of Arab capital;

(4) to establish financial centres in Egypt to meet the needs of the Arab region and to facilitate investment of Arab funds within the region;

(5) to offer adequate guarantees against non-commercial risk, as well as othr incentives, to encourage investment;

(6) to increase employment opportunities and to increase the technical and administrative efficiencies through training in modern technology;

(7) to make available goods and services that could not be provided by local production;and

(8) to introduce modern technology into Egypt.[32]

This analysis will concentrate on Law 43 as the ten years which have elapsed since its introduction offer an adequate standpoint from which to judge its success. The relevance of this assessment is indicated by the fact that the majority of foreign investments in Egypt are still affected by it.

The table below shows that about 62% of the total number of projects approved had already started production by the end of 1984. Over 57% of all approved Inland projects, and

83% of all approved Free Zone projects were in production by the end of December 1984. The reason for the difference of proportions of implemented projects is due mainly to the fact that most Free Zone projects are storage projects and thus need less time to execute than Inland projects which are on the whole industrial, agricultural or service industry projects. It is evident from the figures that both Free Zone and Inland projects are behind Schedule as far as implementation is concerned and this is especially true of the Inland projects.

Over this ten year period, "1975-1984 in table (11.3), 190 proposed projects calling for a capital of LE1003 million, were withdrawn following their failure to sustain their application. The total number of approvals thus falls to 1447 with an equity of LE5514 million. However it should be noted that the withdrawals were all in the category of Inland projects so that a true figure for the total number of Inland projects approved would be 1136 with an equity of LE4698 million.

Considering that three years is the average period it takes an approved industrial project to reach the production stage, the figures for 1983 and 1984 should be excluded to reach a more realistic picture. This entails that from the real approvals of 1136 projects, whose capital amounts to LE 4698 million, one should exclude 281 projects, and a capital total of LE 1220 million. The resultant real approvals until the end of 1982, stand at 855 projects, wih a capital investment of LE 3478 million. Comparing the last figures with those of projects aleady in production by the end of December 1984, one can see that approximately 90% of real approvals are already in production.

Now we must evalute the effects of the approved projects and their importance to the national economy.

Table (11.3)

Projects Approved and Investment Capital

From 1975 to 1984

LE.mn.

Year	Inland		Free Zone		Total	
	No. of Projects	Value	No. of Projects	Value	No. of Projects	Value
1975	157	746	43	189	200	935
1976	54	314	49	40	103	354
1977	122	678	42	75	164	753
1978	123	353	39	26	162	379
1979	150	551	26	30	178	581
1980	153	729	25	17	178	746
1981	211	869	46	72	257	941
1982	75	241	23	190	98	431
1983	157	646	9	40	166	686
1984	124	547	9	137	133	711
Total	1326	5701	311	816	1637	6517
Investment capital	1326	11287	311	1106	1637	12393
Started production	760	4858	258	781	1018	5639
Withdrown	190	1003			190	1003

Source: Journal of Investment Review, different numbers.

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CHAPTER TWELVE

TAXATION OF MULTINATIONAL ENTERPRISES

Chapter Twelve

Taxation of Multinational Enterprises

12.1 Introduction

The growth of multinational enterprises is linked with the increasing economic inter-dependence of the Western and Third Worlds.[1] This inter-dependence shows itself in the international movement of goods and services and in the resulting forms of busines organisation which control and direct such movements. International movements of capital, enterprise and know-how are closely linked with movements of goods and services and in these processes the role of international taxation becomes increasingly important, not least in identifying countries or areas in which new developments may take place.

When a business firm becomes a multinational, a whole new dimension is added to the impact of taxation on its activities. On the one hand more than one government will have a fiscal interest in the income of firm. On the other hand, the firm has looked at greater oppertunities for global tax minimisation in moving goods and funds between countries.[2] The appropriate revenue authority, usually insist that transfer prices between branches of firms or members of a group be fixed on an 'arms length' basis; but the pricing of this requirement is difficult, particularly where the transfers are of technology or patents or specialised goods with no-known comparable market prices.[3]

Tax considerations can be important not only in transfer pricing decisions, but also in decisions relating to the locating of production facilities. Low tax locations may be used with advantage not only as centres for production but also for financial purposes. MNCs are, always looking to minimise their global tax-bill have available to them so-called 'tax havens'.

This chapter is devoted to the following subjects.

12.2 Measuring efficiency and profitability.

The main point is that taxation can change the order of choice. In the domestic market, profit can be used as a measure of efficiency. In the international market the most profitable project may be that which attracts least tax or most subsidy. Efficiency and profitability are not necessarily the same. When some country's ball-bearing manufacturer is looking for a site in a developing country, it is at least as interested in the relative subsidies offered by various governments as by wages rates and productivitiy. For instance, Ireland does not conjure up the same vision of efficiency as say West Germany. But comparing the relatively meager incentives offered by a German Government with the few problems of employment and none of foreign exchange earnings, with the very generous subsidies plus tax exemptions on exports offered by the Irish Government, a decision to invest in Ireland rather than Germany may make sense.

12.3 Minimizing Tax payment:

The enterprise has to deal with at least two tax levying authorities, the host and parent governments. It has, to a limited extent, some discretion about how it will move its tax liabilities between these two authorities; it cannot simply transfer all liabilities to one government or the other, but there is generally some room for manoeuvre, with the implication that it will normally seek to minimize its liabilities. For example, if profits earned by a subsidiary are left with the subsidiary, and not repatriated, it may be able to avoid paying the parent government's taxation on these profits and so pay only the host government's taxation. But if the subsidiary wants to reinvest these profits at home, or has to use them to pay dividends at home then it will incur more tax liabilities at home. In general therefore it can be said that, particularly if taxation is lower in the host country than at home, there is no obvious incentive to repatriate profits to face taxation, if there is any possibility of the funds being invested profitably by the subsidiary. Profits can allocated to lower taxed subsidiaries by raising the price of their exports and or by decreasing the price of their imports.

If the taxes are progressive MNCs are induced to allocate profits until the marginal tax rates are equated.(4) As a consequence, Vaitsos(5) expects multinationals to remit their profits to the home centre at the expense of the foreign subsidiaries since the home office of the multinational is more apt to incur lower profits or losses because of substantial overhead and research expenditure.

The tax penalty which may be incurred by moving profits from one country to another qualifies the notion that an enterprise may have financial assets which can be moved freely from one part of the world to another.

So far it has been assumed that pricing policy is "neutral" so far as taxation is concerned. But the enterprise may use a transfer pricing policy as a means of minimizing taxation. Transfer pricing is not used merely for this purpose, it has other uses, namely in respect of currency or customs duties transactions. But clearly transfer pricing can be used to minimize taxation by moving the tax burden to wherever the tax rate on profits is lightest. Finally, taxation in subsidiaries is at a lower level than in the home industrial territory which would suggest the need for exporting profits as well as products, but if the plan is to recover costs or repatriate profits fast in an uncertain foreign market, this produces a conflict of aims. The reverse applies to customs valuation where attempts to minimize taxation at home can affect tariff payments abroad.

12.4 Dividend payments by subsidiaries

In reviewing the literature relating to distribution of profit there are two questions

(1)Firstly as to whether dividend decisions are actively made by MNCs or whether dividends are residual funds after meeting requirement for reinvestment.

(2) Secondly, as to whether the value of a firm and its share price are affected by the proportion of earnings distributed. One school backed by Modigliant and Miller[6] argues that the value of a company's shares is entirely independent of its dividend policy when tax effects are ignored. Another school supported by Gordon[7] and others[8] insist that current dividends being more certain and nearer in time than future dividends, and are valued more highly by investors, with the result that dividend policy will tend to effect share prices.

Tax systems in most countries assess distributed profits differently from undistributed profit.[9] Where a company is charged to CT on its profits and income tax is charged on dividends, the effect is that distributed profits are doubly taxed. To the extent that such retained profits are reflected in share prices, capital gains will arise. If the MNCs sold these shares then the capital gains are taxable.

However, it would appear then that the dividend policy of a subsidiary may be different from that of a parent company. This is likely to be particularly the case when the subsidiary is not wholly-owned but has local partners or shareholders. The dividend policy of the subsidiary might be to pay the largest possible dividends in order to recover the initial cost as quickly as possible, especially within a tax holiday period. The difficulty of such a policy might be limitations on profits. At the other extreme it might not be expedient to plough profits back with little or no dividend being declared for years, always assuming that there were no local equity holders or partners to be appeased.[10] In general, if there is a degree of uncertainty about the reactions of tax authorities, it makes sense to have a regular dividend and profit repatriation policy, if only to establish that enterprise is not attempting to evade local control in an emergency.

However, the general principles that govern the transfer of profits (dividends) are set down in the Investment Law 43 of 1974 as follows:[11]

(1) A project whose visible and invisible exports cover all elements of foreign exchange requirements is permitted to transfer its annual profits within the limits of the balance of the proceeds of the project's exports.

(2) Projects that are basically not export-oriented and that limit the country's need for imports shall be permitted to transfer in whole or in part their net profits within limits approved by the GAFI.

(3) Housing projects whose rentals are payable in foreign currency are permitted to transfer their net revenues in full. Others, whose rentals are payable in local currency, may transfer profits up to a limit of 8% per year of the amount of their investment

(4) Popular housing projects and housing in new revenues up to

a limit of 14% of their invested capital.

According to the UK tax system, profits of a branch or other form of permanent establishment, will be taxable in both the UK and overseas (Egypt), whether or not they are repatriated to the UK. The UK, being the country of the company's residence, will allow a credit against UK tax on the branch profits. This credit cannot exceed the amount of eligible overseas tax on the same profits.(12) To compute the tax credit it is necessary to find out:

(1) the overseas is withholding tax on the dividend; and

(2) whether, and if so what, relief is available for underlying tax, i.e. tax paid in the country in which the paying company is resident on the profits out of which the dividend was paid.

12.5 Tax Incentive and Foreign Investment

Over the past 30 years, considerable attention has been given to the possibility of influencing not only the volume of private investment but also the realization of desired specific national policy objectives by the use of tax incentives under income and profits taxes. In Egypt, since the early 1950's, the offer of tax incentives to private and foreign firms has always been an important aspect of industrial policy. Egypt has not been alone in this. Many other countries, both developed and developing, have adopted the same policy. In Britain for example, since the Second World War successive governments have made use of initial investment allowances to influence investment decisions in private firms.

In this section we will be reviewing the whole system of investment incentive legislation in Egypt, to assess the effectiveness of the present tax incentives and to determine whether the present practice is the most satisfactory way of fostering industrial development, other important projects, and the growth of the economy along the lines postulated in the National Development plan. Part (i) will deal with the general discussion of the methods of tax incentives legisltion; part (ii) with the specific situation in Egypt; and part (iii) with suggested reforms.

Methods of Tax Incentives Legislation

The discussion which follows now is merely in terms of surveying the existing methods of tax incentives for the encouragement and stimulation of private investment both in developed and developing countries. The usefulness of such a survey is that it affords an understanding of the possible beneficial effects or otherwise of tax incentives on investors both domestic and foreign.(13)

Tax incentive legislations follow, listed according to their types.

Tax exemption

Tax exemption, otherwise known as "Tax holiday", is the most widespread tax incentive. Many investment incentive laws seem to be more commonly associated with it than with any other system of tax incentives. 'Tax exemption' simply means a period of exemption from the payment of taxes imposed by the government and this exemption may be complete or partial. The exemption may also be related to industry, region or type of investment.(14) In general, tax exemption begins with the day of initial production or the day of first commercial sales. Because tax exemption has been generally regarded as an industrial investment device. In Egypt tax holiday for investment and industrialisation offer it as one of their major incentives. It therefore becomes necessary to consider the arguments for and against, the tax exemption measure, albeit briefly.

In support of tax exemption it is argued that it is a simple and effective way of improving the commercial profitability of investments by making tax-free income available to companies within the exemption period. It can therefore be regarded as a simple and direct way to subsidize the cost of entrepreneurial activity. It increases the profit prospects of a new venture and enables a firm to recover its capital costs more quickly so that the risks of investment are considerably reduced.[15] Tax exemption, by leading to a build up of a firm, fixed assets and working capital, quickly enables a firm with long-term approach to investments to re-invest quickly tax free earnings, at least part of them, for the expansion of its business.[16]

Another favourable aspect of tax exemption is that it is neutral between capital-intensive and labour-intensive types of business and seems therefore to be a convenient tool that can be used in countries with surplus labour in attracting industries and other projects that will help to solve the unemployment problem.

Tax-exemption has a very important psychological effect in the sense that it implies that foreign capital is wanted. Thus tax exemption can be a very useful tool in the hands of the developing countries to attract foreign capial as the foreign firms may be reluctant in the first instance to come because of poor investment climate in these countries. Tax exemption therefore reassures them that their presence is needed and welcome.

Accelerated Depreciation Allowances

The term 'accelerated depreciation allowances' briefly referred to as, accelerated depreciation, covers all methods of rapidly writing off of the original cost of new capital equipment less any salvage value in the early years of investment. This is done by deducting the cost from taxable income and for this purpose several methods are employed. The common methods are: (1) the straight-line method, under which the cost of depreciable property is written off in equal annual instalments over its expected useful life; and (2) the declining balance method, under which the deduction is a constant fraction of the unamortized balance of the cost of the assets but a declining fraction of original cost. Both straight line and declining-balance methods have been used in the British multinational corporations in Egypt as demonstrated in the empirical study.[17]

It becomes clear that an accelerated depreciation system has several advantages, as follows:-

(1) Under accelerated depreciation allowances a company realises interest free loans in the form of postponement of taxes; so long as the company continues to expand, there is tax saving. This enhances the profitability and liquidity of companies and in this way it may stimulate investment by increasing the availabilty of financial resources;

(2) Where tax rates are high an expanding company will be able to finance a substantially large fraction of investments from retained profits under an accelerated depreciation system and in developing countries where the capital market is not fully developed and interest rate are ordinarily high a tax incentive measure like accelerated depreciation system that permits greater reliance on international financing is

highly advantageous. Thus an accelerated depreciation system is valuable in respect to many firms which are reluctant to seek outside capital. Even as regards firms bent on raising outside capital, accelerated depreciation will also be useful in that it will make it easier for such firms to do so. This is so because many prospective creditors usually insist that a loan contracted to finance purchase of plant or equipment be repaid within a shorter period than the expected life of the assets. Repayment of the loan will therefore be facilitated far more with the adoption of an accelerated depreciation system. This will also enhance the value of the company's shares as the profit prospects of the company will be good.

(3) The tax benefits to investors and the revenue loss to the state under accelerated depreciation are related to the amount of investment rather than to the size of profits as is the case under a tax exemption. Thus the use of the tax relief under accelerated depreciation is dependent on the behaviour of the individual firm and because the amount of benefit is directly related to the rate of expansion as measured by acquisition of new depreciable assets, this will effectively assist the level of investment required in manufacturing industries. This is particularly so in a developing country like Egypt, because acquiring equipment should lead to industrial expansion, should foster modernization resulting in greater output, and finally.

(4) Accelerated depreciation may stimulate investment through its influence on risk and uncertainty.

Businessmen usually make allowance for risk and uncertainty in investment decisions and one of the ways in which they do this is by insisting that a new asset 'pay for itself' in a considerably shorter period than its normal physical or economic life. Whatever objections can be raised against this practice in the commercial world, this pay-off period approach seems to be a very desirable method of allowing for risk and uncertainty. Accelerated depreciation therefore assists investors to amortize the capital assets out of their net yield within the investor's planning period, thereby giving investors a better picture of prospects for their industries and confidence to make their plan without too much regard to the deterrent influence of taxation on new investment.

From the paragraphs above it seems that a country wishing to encourage the development of manufacturing industry, particularly in the production of intermediate and capital goods will find the accelerated depreciation system a very useful tool.

Accelerated depreciation will only be advantageous to firms if it can be set off against taxable income. It will therefore be harmful where there is inadequate taxable income. Thus its effectiveness can only be enhanced by liberal provisions for averaging accounting losses and profits through liberal carryback or carryforward of losses. Apart from the fact that accelerated depreciation is likely to be less effective in time of depression than during prosperity (with taxable income and tax liabilities tending to be lower in years when investment is large, and higher in years of depression, its adoption will decrease government revenue unless it results into a net increase in activity large enough to offset the reduction in the effective rate of taxation.[18]

Finally, accelerated depreciation is biased in favour of firms in capital intensive industries and industries in which the ratio of depreciable assets total investment is high.

Taxation System and Social Justice

The relationship between income tax and wealth distribution is an important one and in order to realize the nature of this relationship especially in developing countries, it is necessary to understand two points: First, there are differences between the less developed countries with regard to the relationship between income and wealth taxation; this relationship does not depend upon the country's development stage, or upon the existence of foreign investment of MNCs, but upon other kinds of economic constraints, second, in these countries the highest richest classes do not always realize that tax imposed on their wealth may have a clear impact on the income of the poorer classes.[19]

Moreover, the relationship between income and wealth taxation brings us back to the nature of income distribution policies and to the nature of the idea of social justice which has been applied in developing or less developed countries either by the policy makers or the rich classes.

There is a relationship between the rich classes as social/economic groups and their domination of, or, at least, association with political groups, because between them these groups have the power to control and dominate their societies. Their wealth not only helps them to keep their power and strengthen their position, but also makes it possible to further increase their wealth as well.

It may be useful here to specify what we mean by the idea or concept of 'social justice', which we take to be:[20]

> "An ethical compound made up of separable goals, such as the desire to alleviate extreme poverty, to increase mobility, to remove excessively high income, and to reduce income dispersion."

The idea of inequality may be acceptable to some people but not to others.

Unfortunately, most of the sources of tax revenue in Egypt come from indirect tax, as mentioned in chapter seven, which affects only the lower and middle classes and that system therefore has implied negative effects for the income distribution to these poorer classes. [21] In fact, the current taxation system increases the wealth of the richest classes through the availability of many exceptional privileges and concessions, especially in the private sector for merchants and businessmen. This means that this system is very unfavourable to the lower and poorer classes, whilst it is beneficial for the rich classes. Generally, there are still some suspicions about whether the government of developing countries possess the capabilities to achieve progressive tax policies, because of the interaction of policies such as these with the wide range of social, political and economic conditions in these countries.

There are several studies detailing the weakness of the tax systemm in Egypt, especially Tax Law No.14 of 1939, since the beginning of the 1970's. It has been described as an inefficient system and there have been recommended some vital reforms to revise it.[22] For instance, only recently, 650 cases have been discovered where individuals evaded taxes between 1976 and 1983. All were millionaires and had never paid any taxes previously or even registered with the taxation authorities[23]

Moreover, there is tax discrimination favouring foreign investment projects of foreign firms and the local private sector, as against those of public firms[24] Although the former firms have had tax concessions including free customs duties (exports/imports) for between five and fifteen years as a result of the current foreign investment law, the latter firms do not benefit from such privileges so that the current policy has negative consequences for the public firms products and there is unequal competition between these firms and the MNCs so that the MNCs have a better chance of success.

12.6 Taxation and host government problem

It can be said that the problems of the host government are more difficult than those of the parent government, e.g. the host government's difficulty in getting information from the parent company in another country. Such information may be essential in determining whether pricing policies are being used to limit tax liabilities to an unacceptable degree. Nevertheless, and not withstanding the practical limitations imposed on the tax authorities of the host country, the subsidiary will be liable to tax on its declared local profits just as any other locally registered company.[25]

There is, however, a patent political factor in the situation. Many subsidiaries are located in countries which are politically unstable or where anti-foreign sentiment is easily aroused and exploited. ' Tax the foreigner' is a common slogan, even if it is not clear that the ultimate tax burden falls on the foreigner and is not passed on to the local customers.

The other side of the taxation issue is the extent to which fiscal measures can be used as a method of encouraging foreign investment. Some possible forms have already been briefly touched upon - investment grants and allowances which effectively reduce and perhaps neutralize the tax burden for at least the early years of the subsidiary's existence and complete tax exemption on export profits.

12.7 International Transfer Pricing and Tax

The international transfer price is a simple concept; it is defined as a price charged for a transferred product between two economic units, assuming that they are located in different countries, but which belong to the same multinational firm. As long as the performance of the entire firm is being evaluated, it does not seem important to determine which part of the firm contributes how much of the total profit. However, from the perspective of national tax authorities, it does make a difference where the income eventually ends up within a firm.

Eiteman and Stonehill[26] mentioned that the effect of transfer pricing on multinational firms is apparent in seven areas; taxation tariffs, managerial incentive and evaluation, legal problems, risk, bargaining power and joint venture. Arpan[27] listed the following important areas; taxes, duties, inflation, change in exchange rates, exchange control, improvement of the financial appearance of a subsidiary, expropriation, export subsidies and level of competition.

Greene [28] reported that taxation is the most important issue in transfer pricing, while Arpan[29] emphasised that cultural differences affected the orientation of top management as to the purpose of pricing arrangements. It appears that when looking at the transfer pricing problem according to whether these considerations are internal or external to the firm that some aspects are controllable by the firm itself.

Internal Considerations

a) Objective

In establishing international transfer prices, a firm should try to attain a number of objectives which differ from those which apply to domestic transfer pricing. For example, the firm may want to minimise taxes and duties and at the same time win approval from the government of the host country. Yet the basic objectives of profit maximisation and performance evolution are also important. Often it is not possible to satisfy all these objectives simultaneously, so a firm must decide which are its main objectives.

However, transfer pricing can be seen from several points of view, with different objectives in mind.

b) Conflict between objectives

The need for transfer price determination stems from the fact that the subsidiaries of a multinational firm are separate profit centres which are decentralised. Decentralisation brings to light the issues of autonomy, performance evaluation and goal congruency.

Therefore, the transfer prices constructed with the objective of measuring performance is, in MNCs, in conflict with the object of profit maximisation for the whole corporation.

Brooke and Remmers[30] pointed out that the effect of taxes and risk makes it more difficult, sometimes nearly impossible, to measure the performance of a subsidiary.

Also, they found a tendency towards centralisation of policy-making in MNCs, especially in the area of finance. Pohlman et al (31) reached the same conclusions about American MNCs. The objective in an international environment, is generally to further the interest of the corporation as a whole.

External Considerations

In establishing the procedures and policies of international transfer pricing mechanisms, a number of external factors must be considered.

These external considerations include income taxes, import duties, exchange rates, and government influence. They are often in conflict. Nevertheless, a particular transfer price may be established to fulfil the objective of tax minimisation, profit maximisation involving international considerations.

Income Tax

The most persuasive objective in international transfer pricing is tax minimisation. The economic advantages are obvious if a transfer price shifts profit from a country with a low tax rate. For example, suppose a MNC(A) has a foreign subsidiary (B) located in a country with a lower tax rate.[32] By transferring products to (B) from (A) for a low price the overall corporation tax liability of the firm can be reduced, assuming all other factors are the same.

Suppose that the tax rate in country (A) is 40% and in

Table (12.1)

Tax And Transfer Prices

	A £	B £	Company £
Market price 'per unit'		1000	1000
Transfer price	700		
Transfer cost		(700)	
Variable cost	(400)	(200)	(600)
Contribution margin (per unit)	300	100	400
Sold units	1000	1000	1000
Total contribution margin	300,000	100,000	400,000
Fixed cost	60,000	40,000	100,000
Taxable profit	240,000	60,000	300,000
Tax payment	96,000	18,000	114,000
Net profit after tax	144,000	42,000	186,000

Table (12.2)

Tax and Transfer prices with

regard to reducing transfer prices

	A £	B £	Company £
Market price 'per unit'		1000	1000
Transfer price	500		
Cost price		(500)	
Variable cost	(400)	(200)	(600)
Contribution margin 'per unit'	100	300	400
Sold unit	1000	1000	1000
Total contribution margin	100,000	300,000	400,000
Fixed cost	60,000	40,000	100,000
Taxable profit	40,000	260,000	300,000
Tax payable	16,000	78,000	94,000
Net profit after tax	24,000	182,000	206,000

the country (B) 30%; this can be illustrated from the situation in the tables (12.1) (12.2).

Obviously, it is to the economic benefit of the country to decrease the transfer price as low as the government of the host country (B) will allow.

If the company decreases the transfer price down to £500, the result is as shown on table (12.2) the transfer price of £500 increases the profit after tax from £186,000 to £206,000 because of the £20,000 reduction in total tax.

Import Duties

The best known inducement for the use of tranfer pricing is international differences in tax and tariff rates. Import duties, as well as corporation or income taxes, can be minimised. For example, a MNC benefits if it transfers products at low prices to a foreign subsidiary in a country with high import duties, the company can reduce the total cost for import duties through transfer pricing.

Although import duties minimisation sounds easy, frequently it is complicated because 'all other factors' are rarely equal. A host country with low import duties may have high income tax. Therefore, a multinational firm must take into account duties along with income taxes in both the home and host countries. Benke and Edwards [33] found that in order to minimise import duties and income tax in Belgium, the receiving country, a multinational company invoiced identical goods into Belgium at different prices. It drew the attention of custom officials and income tax authorities. The result was a comprehensive review of pricing practices used by the company in Belgium, which led to required changes in pricing practices and higher total income tax.

12.8 Taxation of Multinational Corporations in Egypt

In the multinational corporation, tax problems turn out to be concerned almost entirely with income tax, particularly corporation tax. The individual income tax, too, affects multinational corporations but only indirectly by raising questions of how to treat dividends received by resident individuals from abroad; also affected are corporate dividends paid to individuals abroad on undisturbed profits and capital gains from the sale of corporated shares. The taxation of corporate income varies from one country to another not only in the levels of tax rates, but also in definitions of taxable profits, and the allocation of a firm's worldwide income among the taxing jurisdictions in which it does business or engages in some other taxable activity. Home countries differ in the degree to which they make allowance for host country taxes. From a government's point of view, there are a large number of more or less legal patterns from which a multinational corporation can choose to try to minimize its worldwide tax bill. Differences in the rates of tax on corporate profits are perhaps not so great, however, differences are somewhat greater among developing countries than among the developed. These differences in corporate income rates are sometime minimized by differences

in rates of withholding taxes on dividends, interest and other remittances by a subsidiary to a parent company elsewhere. What is fast becoming more serious than differences in tax rates are the gaps and overlaps in definitions of taxable net profit. There are differences, for example, in the allowances and methods of depreciation of assets, in granting investment credits, in the valuation of inventories and in the methods of computing net income (the balance sheet method, or the income profit and loss method). Even if taxable net income were similarly defined in all countries, there would remain the problem of how to allocate a given firm's worldwide profit among the countries in which it operates. Every country claims the right to tax net income that arises within its borders. Most countries claim the right to tax more than income arising outside the country's borders, when that income is received by a corporation domiciled or incorporated within the country.
The chances for double taxation are obvious. The subsidiary's books and documents which record the activities carried on in the host country may not be readily available to the tax authorities in the home country.

One of the most troublesome aspects of the allocation problem is that of transfer pricing. Often there are no market prices for comparison, in this case, cost plus a normal profit might seem to be a ready alternative. Determining cost involves allocation of overhead cost. in view of the importance of transfer pricing some of the major trading nations have published some rules or guidelines to be followed for major groups of transactions. This effort has not, of course, succeeded in avoiding all disputes and uncertainty. A group of tax experts and observers from international organizations has been meeting under the auspices of the United Nations to formulate guidelines in a series entitled "Tax Treaties Between Developed and Developing Countries".(34) The series reveals in considerable detail the problems encountered by multinational firms and host country governments and discusses allocation of income 'transfer pricing'.

There is a need at the international level to devise ways and means of an active exchange of experience and the dissemination of useful information. The assistance of tax experts well-versed in foreign and international tax law could be called in from developed countries to assist developng countries in the auditing of multinational companies.

The problems of taxation of MNCs are becoming more and more complex. There are many techniques that multinationals may use to minimize their local profits and therefore reduce the amount of income tax they may pay to local government concerned. Often, the effect of transfer pricing has resulted in a loss of tax revenues and increased flow of funds out of the country in which the company operates. Also there is a need for limiting the overhead costs of parent companies. Various developing countries have devised agreements for limiting those expenditures. One useful device for a developing country might be to require a copy of all of the tax laws affecting the parent company in order to know about the laws of a country in which the subsidiaries of the company operate. The audit system must also be strenghthened to cope with these problems effectively, as a smoothly-functioning, well organized tax system is necessary for dealing with multinational corporations. In Egypt there are two main sectors of conflict in respect of taxation of MNCs. These sectors are:

1) Foundation of a permanent establishment, and the definition of a foreign corporation;

2) Trade and transfer of profits between associated enterprises.

Therefore, a company which starts a new economic activity has the choice between forming a branch and a subsidiary company. The branch is not a separate legal entity; on the other hand a subsidiary must be formed in conjunction with at least one other person. The choice between these two structures turns on legal, economic, financial and commercial considerations as well as on taxation matters. The creation of a branch is usually accompanied by certain capital transacions including the acquisition of immovable property, goodwill, leases, etc. When the companies expand their operation outside Egypt the tax treatment depends on the position of the establishment which may be a dependent branch or an independent branch. In the former its result (taxable profit) will be taxable on foreign tax only. On the other hand an independent, branch will be taxable in Egypt and other foreign countries. Egypt, will allow a credit against Egyptian tax on the branch profits. A foreign company operating in Egypt is subject to CT or commercial and industrial profits tax on exactly the same basis as if the principal shareholders were Egyptian nationals. The transfer of profits between associated enterprises gives rise to the classic case of double taxation namely the clash between taxation at source and taxation on the basis of domicile. However, Egypt has an agreement with UK and other countries, as mentioned earlier in chapter five in the research, to alleviate double taxation. The following important aspects should be taken into account in Egyptian corporate tax to meet the tax problems and the methods which multinationals may use to minimize local profits, and to take steps to combat these methods.

a)<u>Business Profits and Transfer Pricing</u>

Business profits will be deemed to have a 'source' in the country to the extent that they arise:
a) from, or through a branch or a permanent establishment in Egypt, b) from a contract entered into or carried out in Egypt, c) from the operations of a dependent agent in Egypt. A double taxation treaty may restrict the circumstances in which business profits are taxable in Egypt only to (a) above.

Tax Law No.157 should have provisions to apply an arm's length test in calculating business profits when local operations are controlled from abroad, and goods or services are supplied from the parent office overseas to local operations. This is a most important problem and certainly in practice, the most difficult aspect of the whole subject of multinationals, namely, transfer pricing. Full support for the Tax Administration should be given by the Central Bank, Department of Trade, and other like departments. Some tax officers should specialize in multinationals and, if possible, receive special training courses.

Transactions within tax havens pose practical problems but the specially-trained officers dealing with multinationals should be on their guard when they see sales or purchases made in what is obviously a tax haven and make the necessary changes to reveal the hidden profits.

b) <u>Excessive charges for head office administration expenses and management fees:</u>

There should be no profit element in a true reimbursement of administrative expenses paid by a subsidiary or branch to a parent company. There may be no need to have specific domestic tax laws to control the deduction of administrative expenses. However, some thought should perhaps be given to limiting the deduction for administration expenses to a set percentage of gross receipts or giving the tax commissioner power to do so. Some multinationals may claim, and be allowed by the local tax administration a deduction for a portion of head office administrative expenses based on a percentage of the local gross receipts.

The approach most favoured is to ask that a certificate by the external auditors of the parent office be supplied giving the following details:

(i) an itemized list of the expenses included in the claim;

(ii) Local receipts and

(iii) Total receipts for the organisations as a whole.

The auditor's certificates would be required to certify that expenses in (i) did not include any capital or other items not normally deductible for tax purposes and did in fact apply to administering operations of the kind carried on in the local country concerned. This approach would favour a deduction based on the proportion that (ii) above bears to (iii).

c) <u>Excessive claims for interest, royalties and knowhow payment</u>

There are attempts by MNCs to minimize their local profits by excessive charges under any of these heading which could be met by adequate provisions in CT. Subsidiary companies should be assessed through the ordinary CT rates on the net income from these payments. Of course, obviously excessive claims could be adjusted by disallowance to the local payer and should be challenged for tax purposes. Interest should be deemed to have a "source" in the country if the loan on which it is paid is used by the borrower in Egypt, irrespective of where the money has in fact been borrowed. Interest payable by the branch on its 'Head Office Account' should be ignored for tax purposes. A portion of the interest payable to an outside lender may need to be allowed against the branch operations.

The domestic tax law should provide also for royal.ties to have a source in the country when deducted by the payer in arriving at the payer's assessable income in Egypt.

12.9 The Tax treatment of multinational companies according to UK tax system

UK Corporation Tax is charged on the world-wide income of UK residents and on income arising from UK sources in the case of non UK residents. Thus UK residents, either individual or corporate, must consider the possible impact of both UK taxes and also overseas taxes on the same income or gains. For instance, a UK resident trading company with a branch in Egypt will be charged to UK corporation tax on its world-wide income and charged to Egyptian corporation tax on income from its branch in Egypt. So once an activity crosses a tax frontier the international as well as national tax dimension must be considered.[35]

After tax, profits of an overseas branch may generally be permitted to a UK resident enterprise without any additional overseas withholding tax. In the case of the subsidiary company, when it is remitted to a UK parent company by way of a dividend it will generally be subject to an overseas withholding tax on the amount of the dividends.

The main provisions of UK tax law applicable to companies resident in the UK will be summarised in the following points:

(1) A company resident in the UK is chargeable to CT on its trading profits wherever arising, whether or not such income is remitted to the UK. Similarly any losses incurred on trading in any part of the world may be set off against profits arising in any other part.

(2) If, however, foreign operations are carried on through subsidiary companies set-up outside the UK, only dividends, and interest and similar payments, paid to the parent company are chargeable to taxes in the UK. Once again, whether or not these dividends are remitted back to the UK is irrelevant. As only distributed profit of an overseas subsidiary are taxable in the UK, any losses incurred by such a subsidiary cannot be set off against other income in computing UK taxes.
(3) A UK resident company receiving a dividend from an overseas company is entitled to a credit for overseas tax on that dividend against its liability to UK corporation tax on the same dividend. But the maximum tax credit cannot exceed the UK corporatin tax on the dividend. To compute the tax credit it is necessary to find out: (i) the overseas withholding tax on the dividend; and (ii) whether, and if so what, relief is available for underlying tax, i.e. tax paid in the country in which the paying company is resident on the profits out of which the dividend was paid.[36]
(4) Double taxation relief is granted in the UK, both unilaterally and under treaties with foreign countries.
(5) Under provisions for unilateral relief, taxation paid in a foreign country on profits or dividends is allowed as a deduction against UK taxes payable on that income.[37]

UK unilatral relief rules provides a credit for underlying tax where the recipient of an overseas dividend is a UK resident company which controls at least 10% of the voting power of the overseas company which paid the dividend. Dividends received are therefore grossed-up in calculating UK corporation tax, the exact procedure however depends on the interest of the UK company in the foreign company. If the UK company has more than 10% of the voting power in the foreign company then dividends are added to all foreign taxes paid on the dividends i.e. withholding tax and other underlying taxes. Double tax relief is then allowed in respect of all underlying tax. If, however, the voting power of the Uk recipient of dividends in the foreign company is less than 10% only taxes paid specifically on the dividend may be added to the dividend and claimed for DTR. The relief allowed in each case is however limited to the foreign tax added to obtain gross dividend or the UK CT on the gross dividends, whichever is the lower. DTR cannot be carried over from one period to another; any foreign tax cannot be relieved in the relevant period is not eligible for set-off against UK taxes of any other year.

(6) The UK has entered into DTR agreements with a large number of foreign countries. These treaties may provide for additional relief over and above that given unilaterally or specify taxes to be included in the definition of underlying tax. Generally, they also provide for the free exchange of information between the tax authorities of the two countries.

(4) Section 485, TA 1970, contains the UK transfer-price rule. Where property is sold between associated companies which might have been expected between independent persons dealing at "arm's length" the Board of Inland Revenue may direct an adjustment to arm's length price. If the sale price is lower than arm's length price the adjustment is made

in computing the seller's profits or losses for tax purposes. On the other hand, if the sale price is higher than arm's length price the adjustment is made in computing the buyer's profit or losses for tax purposes. However in the above two cases there is no adjustment will be made if the buyer or saleler are a UK resident trading in the UK and the price paid for the property, in the first case, is deducted in computing the profits or loses of that trade for UK tax purpose, or in the second case, is brought in as a trading receipt in computing the profit or losses of that trade for UK tax purposes.(38)

(8) A limitation on the recovery of DTR can arise when the UK recipient of foreign dividends in turn pays out its foreign earnings as dividends in the UK. When the dividend is paid by the UK company it has also to pay ACT at a rate determined by the basic rate of personal tax (25%) and this tax is recoverable from CT before computation of DTR. Under such circumstances it is very likely that some DT will go unrelieved. A UK compny may, however, surrender its advance CT relief to 51% owned UK subsidiary thus increasing its ability to receive DTR.

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CHAPTER THIRTEEN

RESEARCH DESIGN AND METHODOLOGICAL CONSIDERATION

Chapter Thirteen

Research Design and Methodological Consideration

13.1 Introduction

The principal findings from the survey are set out in the chapter dealing with the relative area with which the research has been concerned.[1] There are, however some important results which should be set out before the detailed inferences are discussed.

The principal hypothesis which underlies the whole research is that taxation has some effect on the investment decisions of the multinational companies (MNCs) concerned.

The survey contributes to the research in two ways: Firstly, it provides information about the view of management of MNCs, tax officers and management of GAFI, concerning taxation and financial decision making. Secondly, it provides data which can be used in testing the hypothesis in the decision areas.

The main objective of this survey was to obtain independent professional opinion with regard to business response to taxation stimulation. Such opinion in general was expected to (i) provide a secondary source of information on attitudes of business firms, and (ii) provide us with a relatively impartial view on the response of business to taxation.

The survey method was a questionnaire which was sent out to 72 British multinational companies (BMNCs) operating in Egypt. A copy of this questionnaire is to be found in Appendix (A). Of the 72 MNCs circulated, 43 replied to the questionnaire, a response rate of 55%. The postal survey was carried out in 1985/86 and was followed by a personal interview with 20 Tax Officers (Tax Inspectors, Tax Researchers in Research Department, The general Director in Tax Adminstration), 20 experts of GAFI in different departments (i.e. Department of Accounting, the Department of Mathematics, and Fellowship 'adminstrative' Department), and 10 staff and research students for higher degrees in different universities (Al-Azhar, Menofia and Mansoura Universities) who were interested in this subject. This chapter will consider the following important points:

(1) Hypothesis study,

(2) The interpretation of the study and the main results,

(3) Selection of the sample,

(4) Limitations of the research.

The study attempts to combine the theoretical study with the field study e.g. when we research the effect of CT on finance or on profit distributions we try to give more detail about the field study and at the same time to facilitate a comparison between the impirical and theoretical studies. So, in the final chapter , a brief summary of the matters which have been discussed previously is followed by details on matters which have not been discussed before.

13.2 Study Hypothesis

The main hypothesis of the study can be outlined as follows:

(a) In respect of the reasons for Foreign Investment

For most firms, foreign investment (FI) decisions are contingent upon several considerations including specific factors relating to host countries, particularly inducements by the host and home government which can be advantageous to the firm in deciding whether or not to invest. All of these factors are likely to have a significant influence on the firm's decision to invest abroad.

The main reasons for a firm's decision to invest in a host country are, for example, cost factors including labour costs and inducements by host government, investment climate factors such as general attitudes towards FI, political stability, etc. These are in addition to tax attraction and accelerated depreciation.

As far as the present study is concerned, it has been assumed that a British multinational company's (BMNCs) decision to undertake a new FI in Egypt is motivated by a number of reasons related to sales, profits, risk diversification, cost factors and other locational factors in addition to the inducements from the host and home governments.

The reasons related to sales and profit potential are expected to play a considerably greater role when a decision about investment in Egypt is being considered by a BMNC: in order of importance there are reasons related to tax holidays, tax rates, accelerated depreciation, cost factors and also reasons related to host government inducements.

It should be noted that the above assumptions mean that the difference between the reasons given lie in their degree of influence of importance in relation to the FI decision. Thus it is proposed that the reasons related to sales and profits be considered as first in significance.

(b) <u>Problems encountered by BMNCs when implementing tax policies, investment expansion and other activities in Egypt</u>

There are a variety of factors in an economic cultural and political environment in developing host countries, which might influence the implementation of firms' tax treatment and investment growth and activities. Empirical studies[2] provide evidence which list the following factors: that of inefficient infrastructural facilities, communications, tax information, transportation, energy etc., the scarcity of qualified accountants, tax experts and a skilled labour force, government controls and measures imposed over e.g. pricing.

It has also been illustrated that most firms are very concerned about the Egyptian tax rate and exchange rates.

Accordingly, the present assumption seems to be this: The BMNCs operating in Egypt may tend to attach more importance to the influence of infrastructural and communications and transportation problems; government subsidy policies and controls over prices, and lengthy negotiations relating to the implementation of investment policies.

(c) <u>The impact of Foreign Investment on Egypt</u>

The overall effects of foreign investment on Egyptian economic and social development will rely on substantial capital inflows, increasing government revenue, the creation of new jobs, technology and other resource transfers etc. Foreign investment will probably play an increasingly important role.

In order of importance, some of the Egyptian staff will possibly tend to put more emphasis on the importance of technological benefits resulting from FI to Egypt, followed by the economic benefits. But on the whole, it is possible that there are significant differences in the importance of these various benefits as far as Egypt's development is concerned.

In the light of foreign investment theories, there are several factors which may influence a firm before making foreign investment decisions. The number of reasons for a firm's decision to invest in a host country are listed as follows; cost factors including labour costs and inducement by host government, government policies in respect of taxes, tariffs, investment climate factors such as general attitudes toward foreign investment, political stability, etc.

(d)There is a relationship between the incentive tax and investment in Egypt.

(e) There is no trust between taxpayers and tax inspectors. In addition taxpayers have not full knowledge of the rules and regulations of the tax system, bookkeeping principles and classification of documents. Therefore, taxpayers require more information about Egyptian tax and investment laws, especially when such tax information is beneficial to taxpayers as a whole, both individuals and corporate bodies.

On the other hand, the staff of tax offices have enough practical experience which is very important to improve their knowledge, and to acquire the breadth of vision necessary for handling important tax cases.

Moreover, tax inspectors have to achieve a number of tax cases (at least 30 cases every month). Therefore there is a tendency to pursue trivial cases while sometimes neglecting more important matters. This tendency obviously will lead to discrepancies in state revenue. It also creates openings for opportunists to evade tax and amass wealth illegally. In practice, the tax inspector does not generally accept a tax return and makes a personal estimation of taxable profit (random estimation which may be for good or insignificant reasons but he does not attempt to do his best to discover the deficit and cure it). This phenomenon creates distrust between the tax inspector and the taxpayer who thinks the tax inspector will refuse his return whether the tax return is true or not.

13.3 The interpretation of the study and the main results

Before we begin to discuss how the sample for the study was drawn upon it is necessary to clarify that the study depended basically on some important tools of research and empirical studies, such as the use of questionnaires.

The study is divided into two parts. The first part is based on interviews with tax ispectors, tax assessors, tax collectors in the tax administration and with the managers, accountants and clerks in GAFI. The second part is an outline questionnaire designed for use with MNCs in Egypt, inteviewing their management, either foreign or local, and employees, especially clerks and accountants.

Both types of questionnaire were designed to investigate some vital issues related to our study of the impact of MNCs in Egypt as a host country, and to gain basic information about MNCs, the reasons for investment in Egypt, the importance placed by the Egyptian Government on the presence of MNCS, and facilities offered by the government to encourage the MNCs to operate in the country.

The studies were classified as follows:

1)Studies which have tried to trace the impact of MNCs in their host country (Egypt) through a dependence on the statistical analysis of data which is gathered from MNCs responses and GAFI sources.

2) Studies which have attempted to analyse the effect of multinational companies in the host country (Egypt) through assessing the intellectual attitudes and opinions in these

countries, especially Egypt.

3) Studies which have concentrated on the tax treatment of MNCs and their existing implications in the host country (Egypt), as well as the tax problems and difficulties facing the MNCs.

4) Studies which have tried to analyse the impact of MNCs in the host countries, especially looking at specific issues such as creating new jobs,and transfer technology.

5) Studies which chose the period 1974-84 for the following reasons:

a) Attracting foreign investment started in 1971, but was not effective until Law No.43 was issued in 1974 to further organize foreign investment. From 1971 to 1974 there were few investment projects and these were mainly by Arab investors.

b) It was hoped that by the end of the research period that data on foreign investment and its tax problems could be obtained.

The main objective of each interview with the Inspectors and other experts in both Tax Administration and General Authority for Investment and Free Zones (GAFI), other than the filing of information and recording the answers to the questionnaire, was to discuss with the Inspectors, the tax treatment and the effects of investment on the Egyptian economy.

The interviewee was asked to talk about, in general, tax incentives, tax rates, tax exemptions and tax holidays as important factors to attract foreign investment to operate in

Egypt, and in particular the tax problems and tax treatment of MNCs during tax holidays and after tax holidays. During that time, many questions in the questionnaire were answered (without being known to the interviewee) and any points raised or comments made were recorded

During the interview, company records and the feasibility studies of the Egyptian project were seen whenever it was possible, but in some cases, it was not possible to obtain the exact figures of financial structure and expected profits. This data was seen and collected from GAFI.

In addition to interviewing executives, interviews were conducted with a group of staff in Al Azhar, Menofia, and Mansora Universities, research students for higher degrees were also interviewed who are directly or indirectly involved with foreign investment in Egypt and the problems which face the foreign investors.

Egyptian government officials mainly in the offices of the GAFI, were interviewed with the aim of understanding the process of approving an investment proposal and what the problems are which face dealing with foreign investors, and their control of MNCs.

Both types of questionnaire were designed to investigate some vital issues related to our study of the impact of MNCs in Egypt (as a host country); to gain basic information about the tax treatment of MNCs and the effect of MNCs on the national revenue of Egypt, and its labour force; also its effect on technology transfer, employment and training, and its transfer prices.

Moreover important data which includes views about foreign investment, tax problems and other problems which deter investment in Egypt, were obtained from reports, and periodicals by different sources in addition to the literature review of foreign investment.

Finally in the following chapter,[3] while we do not propose to repeat at length data discussed in previous chapters, we wish to make clear the correlation between the theoretical research and the field study. In order to do this I will summarise the results of the field study which have been discussed before, and will deal in great depth with further data resulting from the empirical research.

13.4 Selection of the Sample

When investigating the attitude of large groups of people about specific problems, it may be difficult to interview all these people but it is often be possible to interview a sample of them in order to assess their general attitude. At the same time, it is necessary to represent all these people in the sample of the study to ensure that the results reflect the position of all of them.

It is very difficult to survey and cover all of the MNCs operating in Egypt because of time and cost availability, so we eventually calculated the total number of MNCs operating in Egypt to be about 1637 in 1984 (as shown in table 13.1 in both Inland and Free Zones) which operate in Egypt under Investment Law No. 43 of 1974 as amended by Law 32 of 1977, while British Multinational Companies (BMNCs) operating in Egypt are estimated at 72 BMNCs.

Actually we found that 72 BMCs represent all kinds of activity and in both inland projects and in the Free Zone, as shown on table (13.2).

In collecting the data necessary for the research, three methods were employed:

1) While the researcher was in Egypt on field-study questionnaires were sent to several MNCs operating in Egypt enclosing a stamped addressed envelope for a reply;

2) The help of the researcher's son and daughter and other colleagues in Egypt was engaged in distributing the questionnaires to MNCs and collecting them after completion;

3) In order to generate more information a further number of

questionnaires were sent from Britain to BMNCs in Egypt (S.A.E included).

Table No. (13.1)

All countries participating in the capital of MNCS

Operating in Egypt

value LE.MN.

	No.of Firms	Capital Local	%	Foreign	%	Total of capital
Industrial proj.	547	910.4	45.6	1087.6	54.4	1998.0
Agricultural proj.	99	144.4	48.7	152.3	51.3	296.7
Constructive proj.	197	318.0	58.5	225.4	41.5	543.4
Services proj.	219	338.3	32.7	695.4	67.3	1033.7
Finance proj.	264	853.8	46.7	975.1	53.3	1828.0
Total	1326	2564.9	45.0	3135.8	55.0	5700.7
<u>Free Zones</u>						
Cairo	60	2.5	0.8	313.2	99.2	315.7
Alexandria	126	0.4	0.1	334.9	99.9	335.3
Suez	40	0.4	0.5	78.2	99.5	78.6
Port-Said	85	1.9	2.2	84.4	97.6	86.3
Total	311	5.2	0.6	810.7	99.3	815.9
Grand Total	1637	2570.1		3946.5		6516.6

Source: GAFI, Investment Review, April 1985, Vol.6 No.1

Table No (13.2)

British participation in the capital of MNCs in Egypt

Up to 31.12.1984

Value in LE.1000

	No. of firms	CAPITAL				
		British part.		Other part.		Total of Cap.
		Capital	%	Capital	%	
Industrial proj.	27	29782	48.1	32158	51.9	61940
Financial Proj.	27	33023	48.4	58686	51.6	91709
Construction proj.	10	2520	29.9	5910	70.1	8430
Services projects	8	1447	41.7	2026	58.3	3473
Total	72	66772	--	98780	--	165552

Source: Statistics Informations from GAFI.

13.5 Limitations of the study

The main limitations of this research are:

(1) The analysis provided in this study is based on estimates and not the actual figures. This is due to the fact that some of the foreign investment projects are just approved proposals and have not yet arrived to the operational stage, and data about the tax treatment of the majority of projects that are in the operational stage is not available because they are still in tax holiday periods.

(2) Some of the required data was difficult to obtain either from the tax office or GAFI because, as they said, the information is very confidential and not allowed to be given without permission from the taxpayers or investors. The data includes the cost of production, the value of exports and imports, the transfer price, the statements of profits and losses accounts, balance sheets, repatriation profits, annual reports, tax returns, and other information related to the method of depreciations and stock in trade.

(3) This study is concerned with the effect of CT and tax incentives on distributed profits, foreign investment in Egypt.

(4) The researcher is aware that some important matters are excluded from this study, such as the effects of inflation on CT, shifting tax, the analysis of accounting statements (operating accounts, profit and losses account, balance sheets...) of MNCs have not been taken account because the data relative to these matter is hardly to collect and on

the other hand the time is consntrained.

(5) People usually do not speak frankly about their goals particularly business goals, and that one is more likely to get complete answers.

Chapter Thirteen Reference

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3. Chapter Fourteen.

CHAPTER FOURTEEN

ANALYSIS OF THE FIELD STUDY

Chapter Fourteen

Analysis of the Field Study

14.1 Introduction

In the light of the preceding chapters, it could be generally noted that the study aim was to evaluate the Egyptian tax system in general and company tax system in particular, and also the tax effect on foreign investment in Egypt. An attempt will be made to analyes the data collected using the methodology which was outlined in the last chapter in order to test the hypothesis put forward in this chapter, and also to present the finding concerning the determinations of foreign investment decisions to undertaking FI and choose its form. As discussed earlier the decision of a company to undertake a new FI in a given country occurs on the basis of a number of considerations concerning e.g. the choice of a particular location, the size and form of FI etc. Theories of FI and previous research findings point out a wide range of determinations and reasons behind the companies' decisions for investment. In addition the investing companies can rank these factors according to their influence and importance in the investment decision. Such ranking is important because it can be used to differentiate between investments in different countries. For example, one company may consider the tax incentives as a main factor behind its investment in Egypt, while it considers the availability of raw materials as the main factor for its investment in another country, such as Hong Kong.

In this chapter, while we do not propose to repeat at length data discussed in previous chapters, we wish to make clear the correction between the theoretical research and the field study. In order to do this I will summarise the results of the field study which have been discussed before, and will deal in great depth with further data resulting from the empirical research.

14.2 Reasons for Investment in Egypt

The following analysis represents an examination of factors concerning the reasons for investment decisions as preceived by 43 BMNCs operating in Egypt. It is clear that some factors are more important than others i.e. it appears that there are reasons which tend to play a greater role compared with other reasons in relation to the decision undertaken by the firms surveyed to invest in Egypt. The respondents were asked to state the main objectives and indicate the most important amongst these reasons. The responses are summarised in the table 14.1 ranked according to choice of the most important objective. The table (14.1) shows the reasons for foreign investment which have been taken into account by the MNCs when the decision to invest in Egypt is considered. In order of importance the factors are, first, those related to profit potential followed by a desire to benefit from tax-holidays to maximise profits; the desire to benefit from host government inducements e.g. risk avoidance, labour trouble avoidance, accelerated depreciation

Table (14.1)

The Reasons and Motivation behind the British Multinational Company's Decision to undertake Investment in Egypt

Reasons for Investment	Respon. (Out of 43) According to Rank (1)		Respon. (Out of 43) According to Rank (2)		Respon. (Out of 43) According to Rank (3)		Respon. (Out of 43) According to Rank (4)		Respon. (Out of 43) According to Rank (5)		Missing value	Order of importance
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	No.
Maximum Profit	28	66.7	11	26.2	3	7.1	-	-	-	-	1	1
Tax Holiday	7	16.3	17	39.5	15	34.9	4	9.3	-	-	-	2
Lower Cost Condition	4	9.3	2	14.0	3	6.9	24	55.8	6	14.0	-	4
Tax Rate is Lower	-	-	1	2.4	-	-	5	11.9	36	85.7	1	5
Other Benefits of Host Government according to Law 43 of 1974 such as	4	9.5	10	23.8	18	42.8	10	23.8	-	-	1	3
- To avoid labour troubles; - Non Commercial risk; - Non National Legislation; - Policy stability; - Accelerated Deprecia-:tion												

and policy stability.

Those objectives originally listed in the questionnaire ranked at the top and not many respondents added new items to the list. It is not obvious whether this is because the objectives in the original list almost matched the main objective of the responding firms.

The survey of the activities of BMNCs shows that taxation may not be very important in location decisions but that tax considerations are still relatively important.

A comparison of our results with other results, suggests, similarly, that taxation is not the most important factor which attracts investors. These other results were obtained from a survey[1] of MNCs operating in Singapore which reported that the political and social stability of Singapore was the most important factor attracting foreign investors to that country, although Singapore is well known as a low-tax export platform for MNCs. Also, the Mead Committee in the UK[2] suggests that taxation is probably not the prime consideration in locational decisions and that quite marked differences can exist between national tax burdens without these resulting in extensive movements of capital and persons from high tax to low tax countries. Other studies[3] in South American developing countries have concluded that tax incentives have had little influence on investment area.

Moreover, Table 14.2 below reveals the desire of BMNCs to maximise their profits. It found that 31 BMNCs out of 43 mentioned increasing profit as a main objective for appraising their production. A comparison between the reasons for investment decisions and factors affecting the pricing of the goods sold is shown on tables 14.1 and 14.2. These reveal that factors related to maximising profits are first in order of importance followed by factors related to desire to open new markets (table 14.2) while the covering costs will be in the third stage.

Table (14.2)

Main Objectives of Pricing Productions

	Total of Respond. (out of 43) Rank 1 No %	Total of Respond. (out of 43) Rank 2 No %	Total of Respond. (out of 43) Rank 3 No %	Total Of Respond. (out of 43) Rank 4 No %	Order of Impor--tance
Increasing profit	31 75.6	9 22.0	1 2.4	-- --	1
Cover cost	6 27.3	7 31.8	9 40.9	-- --	3
Open new market	6 16.2	22 59.5	9 24.3	-- --	2
Others	- -	1 100.0	- -	-- --	4

14.3 Attitudes towards the effects of foreign investment in Egypt

Attitudes towards the effects of foreign investment are an initial pre-requisite for measuring and probing the importance of foreign investment(FI) in Egypt. As mentioned earlier in chapter twelve the interview presented by the staff in tax administration, tax offices and the foreign investment authority agree that the overall effects of foreign investment on Egypt's economic and social development is positive. This agreement is evident in table (14.3). This table shows that about 72% of the respondents interviewed considered the effects of foreign investment as generally positive and 8% of the respondents very positive. While about 6% of the respondents do not know and 14% are negative.

Table No. (14.3)

Attitudes towards the effects of FI in Egypt

Very positive Responses		Positive Responses		Do not know Responses		Negative Responses		Total Responses	
No.	%	No.	%	No.	%	No.	%	No.	%
4	8	36	72	3	6	7	14	50	100

Moreover, it has been generally assumed that Egypt will probably have to continue to rely on substantial capital inflows, technology, other resources and social benefits in which foreign investment will play an important role.
Table (14.4) portrays how the sample of Egyptian academic staff in universities, tax offices, GAFI and research students evaluated some of the anticipated benefits of FI to develop the Egyptian economy. From this table, it is clear that respondents considered that the benefits examined as being most important to the development of the Egyptian economy were related to the creation of new jobs, additional sources for government's revenue and technological contributions to direct foreign investment.

Table (14.4)

Contribution of Foreign Investment to Egypt

	Very Important		Fairly Important		Some Important		No Important		Rank
	No.	%	No.	%	No.	%	No.	%	
Create new jobs	30	60.0	14	28.0	6	12.0	–	–	1
Foreign capital inflow	12	24.2	9	18.5	18	36.0	11	22.7	6
New sources for government's revenue	16	32.4	25	50.0	7	14.6	3	4.3	2
Technology transferred	13	26.0	17	34.0	11	22.5	7	14.6	4
Training manpower	15	30.0	19	38.0	8	16.0	8	16.0	3
Providing new production and services	13	26.0	18	36.0	8	16.0	8	16.0	5

14.4 Attitudes toward tax rates

In recent decades reduced tax rates in general and CT rates in particular have become increasingly popular tools of governments, both at the state and national levels, to encourage the location of new firms. For example, in the UK the CT rate has been reduced from 52% to 35%, with the CT rate for small companies reduced from 33% to 25%. In addition, income tax rates have been reduced to 25% in the Budget of 1988 and the higher tax rates reduced from 60% to 40%.[4]

The survey of BMNCs operating in Egypt, as revealed from table (14.5) show that more than 90% of respondents considered the tax rate too high. However, respondents report that the maximization of profit was the most important factor attracting FI to that country.

By comparison with others, the same result was arrived at from the survey of MNCs operating in Signapore[5] which reported that the political and social stability of Singapore was the single most important factor encouraging FI to invest in the country and tax rates were unimportant although Singapore is well known as a low-tax export platform for MNCS.

However, it seems to me the increased tax rates in Egypt in 1983 were one of the important reasons behind the widespread winding up of investment companies in Egypt.

Table (14.5)

Attitudes to Tax Rates

High		Reasonable		Low		Total	
No.	%	No.	%	No.	%	No.	%
39	90.7	3	7	1	2.3	43	100

The figures in table No. (14.6) on the following page indicate that about 31.5% of total inland projects operating in Egypt were wound up between 1974 and 1984. The reasons for this, as we found in discussion with academic staff in GAFI and tax inspectors, are Egyptian tax system problems related to the tax treatment of capital gains during tax holiday and the differential tax treatment between foreigners and Egyptian employees. Additional reasons include, the different tax treatment between foreign and Egyptian shareholders in relation to increasing the capital of companies, problems related to labour conditions, technology transport, local supplies, etc. Finally, the major points can be highlighted in the following:

(1) As mentioned above, table 14.1 shows the reasons for foreign investment which were taken into account by the BMNCs when deciding to invest in Egypt was considered. It is clear that certain factors are important and it appears that there are reasons which tend to play a greater role compared with other reasons in relation to the decision undertaken by

the firms surveyed to invest in Egypt.

(2) In order of importance the factors are, first, these related to profit potential, followed by the desire to benefit from tax holiday to maximise profits; the desire to benefit from host-government inducements e.g. risk avoidance, labour trouble avoidance, accelerated depreciation and policy stability.

(3) The important factors may differ from one country to another according to the position of the countries. For example, if a country has policy stability then other factors will be taken into account in the investor's decision such as tax incentives, maximising profit...

Table (14.6)

Projects Approved, Withdrawn and In Operation

Until 31/12/1984

Sectors	Approved Projects No.	%	Withdrawn projects No.	%	Projects in operation No.	%
Industrial proj.	783	100	261	33.3	522	66.7
Agricultural Proj.	155	100	61	39.3	94	60.7
Construction proj.	252	100	66	26.2	186	73.8
Services Proj.	348	100	127	36.5	221	63.5
Financial Proj.	333	100	75	25.5	258	74.5
Total	1871	100	590	31.5	1281	68.5

14.5 Problems of Foreign Investment

As related to the previous analysis, it was considered appropriate to explore the most common problems which have been experienced by respondents of the BMNCS in Egypt. They were asked to indicate the greatest problems they have encounterd in respect of the implementation of their companies' tax treatment, investment expansion and related activities. In response to these questions, more than 55% answered yes while about 44% said no as shown from table 14.7.

Table (14.7)

Tax problems facing BMNCs

Yes		No		Total	
No.	%	No.	%	No	%
24	55.8	19	44.2	43	100

The table 14.7 above demonstrates that the 24 respondents have tax problems facing their BMNCs in Egypt while 19 BMNCs said no. Table 14.4 illustrates types of problems which can lead to estimated assessments being made by tax inspectors even when returns of profit have been made. These problems include the treatment of capital gains accruing during tax holidays, employee taxation, depreciation percentages and allowable expenses. In addition, the foreign exchange rate was the common problem facing all investors in Egypt. Discussion with a group of investors through GAFI showed that all of them believed the availability of foreign exchange to be vitally important to any investors. This enables them to import their required raw materials, pay for services, repay external debts, and repatriate dividends. The discussion emphasised the lack of foreign exchange and the different exchange rates applying in the transfer of capital into Egypt and the repatriation of profits from Egypt. Also Egypt has insufficient foreign exchange to meet its imports on the one hand and alternatively to provide a favourable climate for foreign investment on the other hand.

The respondents were asked to indicate the common problems they have encountered in respect of the implementation of their companies' tax treatment. In response to this question, the salient problems which were found to have more significant influence can be summarised in the following table (14.8).

Table (14.8)

The Kind of Tax Problems facing MNCs in Egypt

Kind of problems	No. of Respo. Accor. Rank 1 Freq	%	No. of Respo. Accor. Rank 2 Freq	%	No. of Respo. Accor. Rank 3 Freq	%	No. of Respo. Accor. Rank 4 Freq	%	missing value Freq	order of importance
Involving taxable profits	24	55.8	9	20.9	4	9.3	5	11.6	1	1
Employee tax	3	7.0	8	18.6	8	18.6	21	48.8	3	4
Fixed date of beginnig tax holiday	5	11.6	9	20.9	21	48.8	8	18.6	–	3
Taxable gains and movable capital asset	10	23.3	17	39.5	10	23.3	6	14.0	–	2

It was considered appropriate to explore the most common problems which have been added by respondents and these can be summerised as follows:

1. Shortage of finance and credits provided by the Egyptian government
2. Exchange rates and the difficulty of collecting foreign currency from banks.
3. Price control.
4. Lack of skilled manpower at all level.

5. Shortage of technology.
6. Ambiguities which exist with regard to many aspects of the investment policies.
7. The lack of co-ordination between government's departments concerning result in lengthy negotiations and increased costs.
8. The different tax treatment between Egyptians (either shareholders or employees) and foreigners which leads to Egyptians giving up their jobs or being unco-operative with the company
9. Shortage of foreign exchange and change in foreign exchange rates with regard to the Egyptian Pound against other currencies.
10. Inadequate and poor standard of communication facilities in Egypt.
11. Excessive customs procedures in respect of imports and exports.
12. The absence of research in Egypt and of information centres needed to serve investment purposes in general.

Responsibility for solving tax problems

Table 14.9 below was prepared by converting the reported frequencies of problems according to group No.1 and then applying the percentages reported as having been solved by the respondents themselves, by other experts (professional accountants or auditors), negotiation with tax authorities, or by appeals, as shown below.

Table (14.9)

Methods of solving Tax Problems

	Respon. Out of 43 Accord. to rank (1) No %	Respon. out of 43 Accord. to rank (2) No %	Respon. out of 43 Accord. to rank (3) No %	Respon. out of 43 Accord. to rank (4) No %	Missing value	Order of importance
Solved by Respondents	10 28.5	5 14.3	14 40.0	5 14.3	8	4
Referred to Auditors	4 12.1	19 57.6	8 24.2	2 6.1	10	2
Referred to Tax Specialist	1 100	-	- --	- --	42	5
Referred to Courts	7 18.4	8 21.0	16 42.1	7 18.4	5	3
Negotiated with Tax Inspectors	21 77.8	4 14.8	2 7.4	- --	16	1

Table (14.10)

Relation of Funds

Parent Companies No.	%	Internal Finance No.	%	Other Shareholders No.	%
34	79.1	32	74.4	14	32.6

Note: the sum of response does not equal 43 and percentage over 100 because of multiple responses.

From the data in table (14.10) above we see that the funds from the parent company have been counted as a major source of finance for BMNCs following by internal finance. Those in our sample received about 79.1 and 74.4 percent. These sources of finance were large in aggregate terms for the reaons mentioned above and other two reasons:

(1) Tax exemptions will apply for a five year period to the proceeds of the profit which are reinvested in the enterprise.

(2) Tax holiday will apply for a five year period, according to Law 43 of 1974, when an increase in the capital of BMNCs has been issued and the increase of capital has been paid with foreign currency.

Further, from the data in table (14.11) below perhaps reflecting larger need for funds these subsidiaries tended to borrow more and in larger amounts foreign currency from local or foreign sources to benefit from Egyptian investment and tax laws as follows:

(1) Exemption from tax on interest for loans in foreign currency granted to joint ventures,

(2) Loan interest is taken from gross profit as any other expenses, and

(3) Investment Law 43 offers tax free to loan interest if the loan was hard currency in order to encourage the investors to save their requirements of foreign currency.[6]

Table (14.11)

Kind of finance

Increase of capital		Loan		Increase current Account	
No.	%	No.	%	No.	%
14	38.9	27	75	2	5.6

14.7 Effect of CT on Financial Decision

As mentioned earlier, in chapter ten of this research, BMNCs are looking to minimise their global tax-bill. Therefore, a firm choosing between financing by external, internal or retained earnings, takes into account benefits from host countries which can minimise the tax-bill. The Egyptian Investment and Tax Laws provide that interest payable on external loans can be deducted as a tax expense. On the other hand the interest is exempt from tax on movable capital assets. Therefore, parent companies, as shown from table (14.4) prefer to finance the subsidiary by loans instead of issuing new shares for the following reasons:

1. It is quicker to borrow than to issue new capital.
2. Borrowing policy is preferred to fresh equity in order to reduce taxable profit.
3. It is easy to borrow as little as possible.
4. Interest rates, compared with bank interest rates may be lower. and
5. From the viewpoint of the issuing company the cost of equity is potentially more expensive than on equal amount of borrowed capital. Companies are allowed to deduct from taxable income, interest payments on borrowed capital, but there is no corrosponding deduction for dividends paid to shareholders in return for the use of their funds as equity capital.

<u>Chapter Fourteen: Reference</u>

1- Koh G., An Evaluation of The Singapore Government's Policies in Promoting Industrialization, Ph.D Thesis, University of East Anglia, 1975.
2- Institute for Fiscal Studies, The Structure and Reform of Direct Taxation of Commiittee Chaired by Mead J.E., George Allen and Unwin, 1978, P.3.
3- Joel C., Tax Incentives In Central American Development, Economic Development and Cultural Change, Vol. 19, No.2 PP.229,225.
4- Budget Spech March 1988.
5- Koh G., op.cit.
6- Article 18 of Law No 43 of 1974.

CHAPTER FIFTEEN

CONCLUSION

Chapter Fifteen

Conclusion

Taxation today plays a major role in economic acitivity, as the prime source of revenue and as a tool of economic management for government and as a major recurrent outgoing for business firms and investment field.

Theoretical analysis of the impact of any taxation is usually conducted with reference to investors and business firms excercising 'rational' profit maximising behaviour under conditions where all other relevant factors remain unchanged.

This study has been concerned with the tax treatment of company with special reference to MNCs operating in Egypt. The purpose of the research has been to evaluate the importance of tax as a factor in the location decision of MNCs and to study the specific effect of tax exemption.

The different methods of company tax system which have been discussed in part one and part two, gave us an indication about the determination of suitable CT systems in the developed (UK) country and what is suitable to a less developed country (Egypt).

This thesis examined an overall review of CT first in the U.K. involving a discussion of the historical development and the present state of UK corporation tax and secondly in Egypt entailing an examination of the incidence and effects of the present system of CT as well as ranging widely over the various requirements of principle in CT reform is invariably bound to be lengthy. However, in the light of our study in respect of the structure of CT in the UK which has been invaluable for the light it has thrown upon such questions as the most appropriate system of CT that can meet Egyptian needs and objectives, relative effects of the major systems of CT upon economic development generally, the appropriate CT has considering the financial requirements of Egypt, the forestalment of devices which would otherwise permit the avoidance or evasion of CT.

Thus the U.K. experience with company taxation has served in this thesis as an effective basis for the appraisal of the Company Tax system in Egypt..

In the light of this conclusion the research was divided into three parts which are:

(1) UK company tax systems.

(2) Egyptian company tax system.

(3) Foreign investment operating in Egypt and the Egyptian incentives either tax incentive or other kinds for stimulating investors to operate in Egypt.

U.K. Company Tax system

Before 1958 the U.K. taxable profit was liable to profit tax at rates which discriminated against dividends. In addition, income tax was applied to both retained and distributed profits at the standard rate. In the case of the distributed profit, the income tax was credited by the shareholder against his income tax liability on dividend.

Between 1958 and 1965 the same rate of profits tax was applied to both retained and distributed earnings, whilst income tax was levied as before. This system was neutral at company level in the sense that the additional tax on undistributed profits was equal to the withholding tax on dividends.

Between 1965 and 1973 a classical system was in force at rates varying from 40% to 45%. Under this system companies paid CT on their profits regardless of whether they were distributed or not. Distributions out of such profits were then fully taxable in the hands of shareholders with no account being taken of the fact that the source of income had already suffered tax at one level. Dividend was subject to discriminatory double taxation.

Under the imputation system the rate of tax on company's profits rose to 50% and subsequently was raised to 52% while being reduced in 1984 to become 35% from 1986 and 25% for small companies according to the Budget of 1988. Shareholders are now entitled to tax credit of 25/75 of the amount of cash dividend paid. The granting of tax credit to the shareholder is intended to reflect the fact that the underlying profits have already been taxed. The intention is to mitigate the double taxation. To ensure that any credit or refund is matched by CT actually paid, the company, in paying the dividend, must account for advance Corporation tax equal in amount to the imputation credit. This tax is not a withholding tax and cannot be construed or taking in interpreti double tax agreement. It is merely an advance payment of tax which will eventually be due. Provided that the company has a sufficient liability to corporation tax in respect of the profits of the year during which the dividend is paid the effect of the dividend payment would be to bring forward the payment of tax liability.

As mentioned earlier, there are many important resemblances between the three systems, i.e. the company tax, and the tax on the income of individuals which are independent of each other; the CT is imposed on the entire profit of share companies, etc. Also there is a great similarity between the two-rate and the imputation systems: this idea has been demonstrated by Prest who regards the two systems are, as substantially similar in terms of total tax payments, net profit rentions, and net dividends.[1] Also Mr Chon commenting on the choice between the two-rate and the imputaton system said:[2]

> "We are not really being asked to discuss a choice between two systems, but two means for the same system".

As can be seen in EDT, none of the three systems provides for entire avoidance of EDT: the classical system results in EDT. While the other two systems attempt to moderate the EDT and the suggested method attempts to prevent EDT by imposing one only tax, income tax, on distributed profit, and also only one tax (CT) on undistributed profit.[3] According to the classical system, the rate of CT is the same for retained and for distributed profit. Under the two-rate system, the rate of CT applied to distributed profits by a company is lower than that applied to retained profits. With the imputation system, the rate of CT is the same for the retained and the distributed profits.

The dividends received by the shareholders are taxed in the same way as any other income according to the three tax systems.

From the standpoint of finance, the classical system is more disposed to encourage self-finance rather than the distribution of dividends. The other two systems are both neutral as regards retentions and distributions.

The imputation systems for one, presents certain complications regarding assessment and also regarding the payment of dividends out of profits which are exempt from CT, disadvantages which could be troublesome to multinational companies. In the classical system and the two-rate system foreign shareholders automatically enjoy the benefit of the lower rate of CT while the imputation system allows each country to decide whether or not, and under what conditions credits will be given to foreign dividend recipients of third world countries.

The Egyptian Company Tax System

In the light of the foregoing analysis in part two, it will be seen that up to 1981 the taxable profit was subjected to commercial and industrial profits tax at tax rates of 39.7% (17% commercial and industrial profits tax plus additional tax rates 22.7%) according to Tax Law 14 of 1939. Since the promulgation of this law which is still, until now, the essence of tax legislation in Egypt, a number of economic, social and political events have had their impact upon the the taxation system, and its aims and significance. At the outset of the 1952 revolution, the State was interested in economic development, and used the taxation policy as an instrument encouraging national and foreign private investment. But following the nationalization of the Suez Canal and the 1956 war, encouragement was reserved for the Egyptian private sector only, foreign investors were actively discouraged. During this period, the bulk of proceeds from indirect tax remained to be the backbone of the collection system representing two thirds of tax revenue, and may be considered a sign of an incapable taxation system, and an expression of the State's basic reliance on direct methods in bridging incomes.

The apparent feature of the Egyptian tax system up to the issue of Tax Law 157, was the continuance of indirect taxation in raising taxation revenue, even when customs duties declined during the war years (1967-73) because of the contraction in the volume of foreign trade.

Under this system there is no difference in tax treatment for the following activities i.e. partnership taxable profit, sole-trader taxable profits or joint stock company's taxable profits which were subject to the commercial and industrial profits tax. Therefore, it was necessary to reform the Egyptian tax system and a separate tax on corporate income had to be established because of the special privileges and benefits which it receives under its form according to Egyptian laws. The tax is predicated on the assumption that corporations have some tax capacity of their own. In addition the corporation has a separation of management and ownership, thus generating income over which no shareholder can claim any particular economic control.(4) This system was modified in 1981 by the introduction of the new Tax Law 157 which differentiates among finance companies (limited liability company, limited liability company with shares or joint stock company) which are subject to corporation tax at flat rate of 32% for industrial companies, of 40% for commercial company or of 40.5% for petroleum company, and personal companies (general partnership, limited partnership) and sole traders which are liable to commercial and industrial profts tax at progressive tax rates starting from 20%, to 32% for industrial projects, from 20% to 40% for commercial and industrial profits tax and from 20% to 40.55% for petroleum projects.

The study also reveals that the existing taxation system in Egypt has failed to realise some of its objectives, as it encounters several problems which should be tackled and remedied such as tax avoidance, tax evasion and tax arrears. To control tax evasion the tax laws should be constructed in a simple manner without any ambiguity which might pave the way for tax loopholes. This entails the application of penalties relating to tax evasion in its different dimensions.(5) The problem of tax arrears is reflected in the data released by the Tax Adminstration which revealed arrears of LE356.5mn. in 1980/81 in addition to LE230.5mn. for Custom Duties in the same year.[6]

From the foregoing information it is clear that taxation reform would inevitably require a change in the whole system and reconsideration of tax laws. However, a balance should also be maintained between all types of taxes so that the taxation structure would depend mainly on direct taxes and reliance on indirect taxes would be reduced, thereby ensuring a greater degree of equity in the distribution of the national income. The possibility of a unified tax system should also be studied, so that one tax would be applied to the taxpayer's total incomes derived from various sources. Undoubtedly the Egyptian tax reforms become necessary to reach the stage of a unified tax system require careful preparation, new organisational and administrative procedures, as well as legislative amendments of tax laws. The unified tax system is characterized by simplicity in application and the low cost of collecting taxes as compared with the Schedular taxes. It is also characterized by its clarity for the taxpayer and by the greater realisation of social justice, permitting the graduation of the tax in accordance with the taxpayer's ability to pay. However, the application of this system requires a tax collecting mechanism of great efficiency.

Finally, it is important to understand that tax policy cannot be completely isolated from wider economic matters. Therefore, in the less-developed countries, such as Egypt, the classical system is more suitable especially as this system discriminates against the distribution of profit for encouraging investment and saving. However, the retained profit will lead to deficit in the revenue, but in the long run will be caught up for capital gains tax. On the other hand, the government could substitute the deficit of tax revenue by imposing heavy penalties on the income from overseas investment and it can collect specific sums from individuals who may be shareholders, employees, creditors, suppliers or customers.

In respect of international transactions, the Egyptian tax incentive laws require scrutiny. Also, proper methods for allocating taxable profits of foreign corporations conducting activities through their subsidiaries in Egypt should be developed. Finally, steps should be taken to strengthen and reorganize the tax administration. A modern corporate tax in Egypt requires a modern and effective tax administration to collect the amounts due.

In the developed countries, such as Great Britain, which have arrived at the stage of mass production both the two rate and imputation systems are more suitable for promoting the distribution profits which lead to the creation of new purchasing power and to the re-activation of the capital market and the reduction of reliance upon financing out of ploughed-back profits.

The effect of the CT according to the two-rate or imputation systems would, therefore, reduce substanially aggregate investment. But if the government wishes to encourage total investment it can do so more directly by influencing credit conditions; by general budgetary policies; by investment allowances; and by giving direct subsidies or cheap loans on specific investment projects.

Relief For Losses

Under the UK tax system, a company has the right to loss tax relief to set off losses incurred in the course of its trade or business against its taxable profit and the carrying forward of unused losses is unlimited.

Under the Egyptian tax system it is limited to a period of five years. Therefore, it seems that for the time being at least, the tax system should give the right to that company to set off losses incurred in the course of its trade, or business, against its taxable profit until the losses are absorbed, especially to encourage taxpayers to be honest and not to consider making any attempts to avoid the tax by covering any loss which might remain after the specified period (5 years only).

Foreign Investment Operating in Egypt and Incentives

As said earlier, this thesis examines the impact of taxation on business in Egypt, as less developed countries, at the level of multinational companies. The Egyptian government attitude towards incoming direct foreign investment is basically favourable and encouraging. This is reflected in the issue of the Investment Law 43 of 1974 which offers many inducements and incentives to foreign investors including tax exemption, tax holiday, accelerated depreciation, repatriation of profits, and insurance against the nationalisation or confiscation of their capital.

As such, it was necessary that tax legislation mediates between contrasting aims, i.e encouraging local and foreign investment and saving through expanding exemption and privileges, in contrast with the aim of securing social justice; achieving financial aims and adjusting taxation to achieve justice in distributing the burdens of economic development and easing their impact on limited income groups. This situation is reflected in taxation legislation and investment laws during the period after the War of 1973, especially with the promulgation of Laws 43 and 46 of 1978. Approval of a foreign investment under Law 43 involved automatic exemption from taxes on industrial and commercial profits, CT and other kinds of taxes. The exemption specified under investment law is generally for a period of five years but may be extended for a further three years which may be granted by the GAFI for projects which are considered to be of sufficient importance. Also machinery, equipment and transportation equipment necessary for approved projects may be exempt from Egyptian custom duties and taxes on the recommendation of the Authority and the approval of the President. Besides the exemptions granted for taxes and customs duties, an equally important range of concessions applies to exchange controls and repatriation of capital and profits. Under Law 43, companies operating projects approved by GAFI are allowed to set up a special foreign currency bank account with an Egyptian bank. On the basis of the balance of this account, companies will be able to repatriate profits and capital in hard currency. As mentioned in chapter eleven (11.7) the investment in Egypt is very important for creating extra finance for Egyptian government to meet the needs of current expenditure and to help the Government to improve the standard living of the Egyptian people. In addition increasing employment opportunities and increasing the technical and administrative effiiciency through training in modern technology.

Law 43 has two aspects: The first aspect is the principles, regulations and provisions governing the entry of foreign investment. Potential foreign investors have to go through this initial stage if they wish to operate in Egypt. There are four main ministries or organizations involved:

(i) Foreign Investment and Free Zone Authority (GAFI) which is headed by a Deputy Chairman who is appointed by the President,

(ii) The Ministry of Economy from which organisation comes the Chairman of the Board of the Investment Authority,

(iii) Ministry of Industry, and

(iv) The General Organization for Industrialzation (GOFI).

When a foreign investor approches the GAFI, they take an application from him and they examine it. After examination they send copies to the Ministry of Industry and to GOFI to get their opinion about evaluating the scheme, i.e. evaluating it from the point of view of seeing whether such an investment is useful for Egyptian economy or not.

The second aspect is the principles, regulations and provisions governing the operation of the foreign investment when it gets into Egypt.

As stated earlier Egyptian investment law encompasses many aspects, either tax or non-tax incentives, to encourage investors to operate in Egypt. There are a number of non-tax incentive provisions within Law 43, e.g exemptions from exchange controls relating to profit remittances, providing a guarantee against nationalization or confiscation; it also contains exemptions from certain restrictive labour law requirements, and enables operations that are established in Egypt by foreign investors to maintain bank accounts in foreign currencies.

Furthermore Law 43 has two basic objectives. The first, and probably the most important, is to obtain foreign capital, to create exports and thereby create a favourable foreign exchange position, which Egypt does not have at the present time. The second is the need for technology in modern development. Therefore, the tax incentives are designed to accomplish these objectives by bringing and for encouraging foreign investors to invest in Egypt. The tax exemptions are contained in several articles in Law 43: Articles 16, 17 and 18, and Articles 46 and 47. The first three articles create a series of temporary exemptions, while the latter two articles creat a permanent tax exemption, as mentioned in chapter 12 with more detail.

Although the Egyptian government gives more incentives as mentioned above to encourage investors to invest in Egypt, there are still a lot of problems facing these investors. For instance, the investor who operates in free zones has to use foreign currency in all his dealings, he has to pay wages, electricity, water, rent, everything in foreign currency, and it is very hard to have access to enough currency for these purposes. The other problem which arises when anyone considers oporating in Egypt is the infrastructures. Despite the Egyptian government having attempted several times to improve the standard of infrastructures through foreign loans Egypt still has inadequate telephones, inadequate housing, and inadequate transportation.

In addition to the recommendations which are mentioned in this research, there are other suggestions as follows:

(1) The government should have a plan with clear and realistic objectives that will attract foreign investors to invest in Egypt.

(2) GAFI collects the requirements of all districts (about 26 districts in Egypt) and should co-ordinate these to produce

a comprehensive list of required projects. Also GAFI should distribute the investment projects among all or most districts according to their requirements, thus giving more equal opportunities to all Egyptians.

(3) GAFI should keep information and up to date data about a good number of MNCs. Such information would be useful for getting a reasonable assessment on the viability of such companies. For example, if a MNC wound up its project and it wishes to start a new business under a new name, perhaps to avoid and evade tax, or to benefit from a new tax holiday and similar incentives under the new project, the historical background information would be available to help GAFI scrutinise its business record and assess the potential of the newly-proposed project. (4) GAFI should also promote the ODP by advertising in foreign newspapers and magazines the objectives of the policy, and the incentives which are offered by Egyptian investment law. Moreover, the authority should try to give invitations to investors in different countries to visit Egypt and the Authority gives them visibility studies for the projects which are useful for both Egyptian economy and investors.

(5) The Egyptian tax code, as described earlier in chapters four and eight, accepted any method of trade-stock valuation, so, this way created a loophole in the tax by changing the method from time to time, in both depreciations and trading-stock. The consequence of such change is that a taxpayer can avoid tax. It seems to me that the best way for the tax treatment of depreciation and trade-stock are as follows:

(a) Straight line method should be used for Industrial buildings, commercial buildings, hotels, agriculture and foresry buildings and works.

(b) Reducing balance reduction should be used for machinery and plant, cars, vehicles, mines, oil wells.

(c) Depeciation rate should be in line with the nature of assets, their life, e.g. if the plant works one shift the rate of depreciation must be less than the other which works two shifts or more.

(d) The "First-In First Out" should be only accepted by the Tax Authority for valuing trading stock except those cases where the actual cost of the particular item can be directly ascertained, and those (e.g. small items) where the current market value is more suitable for them.

(6) Improving the standards of tax adminstration by implementing the following suggestions:

(a) The scaling up of the training of tax administrative personal with the establishment of more courses in Egypt and other developed countries, especially in the UK and in France because the sources of the Egyptian tax system rely upon the rational basis of tax system of both countries (UK and France), to study the technology and other methods which are used in these countries and attempt to benefit from them.

(b) The introduction of computer technology and its wider use in Egypt.

(c) An increase in co-operation between tax offices in different districts and the Tax Authority.

(d) Encouragement of honest and hard work in the tax administration by awarding more incentives, and the provision of stiff penalties for those who are corrupt or careless.

(7) Setting of a co-ordinated plan for national investments: There is no doubt that when choosing internal ways of financing, particularly when choosing goals of investment, such methods must help create a continuous automatic movement of investment and saving in which every new stage of forming capital leads to additional resources which are stronger than before. Such resources may be devoted to new investments to help raise the levels of income, but such ways achieve no success unless they are used within a coordinated plan of investment.

(8) Filling the gaps in the Egyptian tax system: In the tax system there are gaps from which some citizens benefited and are still benefiting by indulging in 'black-market' which are not subject to taxes. These activities are known all over the country and they need not be mentioned in detail. The government must try to fill the gaps by imposing taxes on these activities. But we must avoid exaggeration in determining the rate scale on these new activities because very high rates may deprive the government of its proceeds. Besides, this may drive people to create new means of fraud, and this will create a vicious circle of tax evasion.

It is therefore suggested that attempts at reform should be just and reasonable, showing no fear nor favour, and should be steady and gradual, as Egypt has suffered much in the past from erratic methods of reform.

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APPENDIXES

APPENDIX ONE
QUESTIONNAIRE LISTS

PART ONE
TO BE COMPLETED BY THE EXECUTIVE MANAGERS OF BRITISH MULTINATIONAL COMPANIES OPERATING IN EGYPT

ERSITY OF GLASGOW

TMENT OF

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Faculty of Law & Financial Studies
5-9 The Square
GLASGOW G12 8QQ
Tel: 041-339 8855
Ext.
Telex. 777070 UNIGLA

Dear Sir,

The Egyptian Tax System and Multinational Business

The questionaire is part of a research project currently undertaken in the Department of Taxation, Glasgow University, and in co-operation with the Egyptian Ministry of Higher Education.

The aim of the questionaire is to find out the main tax and related accounting problems which, in your view, may affect the performance of your company's business in Egypt or may influence decisions regarding business investment in Egypt. This is part of a wider examination of multinational enterprises operating in Egypt and our objective in carrying out the research is to identify any difficulties arising from the present Egyptian tax system as it affects the encouragement, or otherwise, of foreign investment in Egypt. We believe that the result of this survey will be of interest not only for academic purposes but also to the Government of Egypt, investors and businesses operating in Egypt, and to the Egyptian Board of Tax Administration. We would therefore be most grateful if you could complete these forms and return them to the undersigned as soon as possible.

The value of the survey will depend to a great extent on the number of businesses willing to provide information and you can be sure that any information which you supply will be treated in the strictest confidence. A copy of the findings of the survey can be sent to you in due course, if you wish.

Please do not hesitate to contact the undersigned if you have any queries on the questionaire.

We thank you, in anticipation, for your co-operation.

Yours faithfully,

Sayed M.A. El Wahab
Research Student
Department of Taxation
University of Glasgow.

Supervisor:-
Professor Mervyn Lewis
Head of Department of
Taxation
University of Glasgow

Part One

This section is concerned with the nature of your firm's business as part of a multi-national organisation.

Q1 Name of company (or firm)
(please print)

Address ....

Telephone number ....

Q2 Classification of organisation (please ring the number opposite the classification which most closely describes your business).

1. More than one of thos listed below;
2. Agriculture, fishing, poultry projects;
3. Mining and Quarrying;
4. Land reclamation;
5. Food, drink, tobacco;
6. Petroleum products;
7. Metal manufacture;
8. Mechanical engineering;
9. Electrical engineering;
10. Textiles;
11. Leather, leather goods and furs;
12. Clothing and footwear;

13. Other manufacturing industries;
14. Transport and communication;
15. Banking and financial services;
16. Professional and scientific services;
17. Others (please specify).

Q3 What is the type of your Company?

(Please tick one box)

(a) Joint venture

(b) Branch;

(c) Others (please specify).

Q4 Does your Company have its own subsidiary company or branch operating abroad?

(Please tick one box.)

(a) Yes

(b) No

Q5 If yes, is that company (or companies):

(a) and independent branch?

(b) a dependent branch?

(c) a factory producing goods to sell in Egypt?

(d) others (please specify).

Q6 What are the main reasons for your investment in Egypt?

(Please rank in order of importance)

(a) To attain maximum profit;

(b) Egyptian tax holiday period is longer than in other countries;

(c) Cost of production is lower;

(d) Egyptian tax rate is lower;

(e) Others (please specify).

1. Accelerated depreciation

2. Cash subsidy

3. Policy stability

Q7 Do you consider it desirable to:

(a) Increase the length of the tax holiday period;

(b) Decrease the Egyptian tax rate;

(c) Others (please write in your suggestion).

Q8 Do you consider, by reference to other companies in the group, that

your company's profit is:

(a) High;

(b) Reasonable;

(c) Low

Egyptian tax rates are:

(a) High;

(b) Reasonable;

(c) Low

Q9 What are the main pricing objectives of your company?

(Please rank in order of importance.)

(a) Profit maximization;

(b) Covering the fully allocated costs as quickly as possible;

(c) Entering new markets;

(d) Others (please state).

Q10 What are the major factors affecting your pricing strategy?

(a) Competitive price;

(b) Industry leader price;

(c) What customer can pay;

(d) Fixed price by host government pricing authority;

(e) Full cost plus rate of profit;

(f) Fixed price by the parent company;

(g) Others (please state).

Q11 Does your company require extra finance? (please tick one box)

(1) Yes

(2) No

Q12. If yes: please specify

1. Internal finance

2. External finance

3. Others (please state)

Q13 If internal finance is provided from inside the company?

(Please specify the source of funds)

(a) Retained profits (i.e. do not make distribution);

(b) Reserves;

(c) Others (please specify).

Q14 Has taxation been a consideration in your general borrowing policy decisions.

(Please tick one box.)

(1) Yes

(2) No

Q15 The following are some factors that may be relevent in deciding whether external (borrowing) or internal owner finance. Could you specify?

(1) It is quicker to borrow than obtain owner capital;

(2) Internally generated funds are usually adequate for the company methods;

(3) It is policy to borrow as little as possible;

(4) Interest rates are acceptable;

(5) Interest rates are unacceptably high;

(6) Borrowing is preferred to fresh equity in order to reduce taxable profit.

Q16 Has your firm performed its objective in the last 5 years? (Please tick one box)

1. Yes 2. No

Q17 If your answer is No do you think taxation was a discouraging factor.

1. Yes ☐ 2. No ☐

Q18 If your anser is Yes could you state the reasons.

1. Tax rate is high ☐
2. Tax holiday not enough ☐
3. Others (Please specify) ☐

Q19 Are there any differences between the standard and actual achievement?

(Please tick one box.)

(a) Yes; ☐

(b) No. ☐

Q20 Does your firm have a separate accounting system from its parent?

(a) Yes ☐

(b) No ☐

Q21 What is the method of accounting regularly employed in your company?

(a) Cash mehtod; ☐

(b) Actual method; ☐

(c) Hybrid method; ☐

(d) Long term contract method; ☐

(e) Others (please specify). ☐

Q22 What is the method you apply to estimate your inventories?

(Please state.)

(a) Costing methods; ☐

(b) Market value; ☐

(c) Lower of cost or market; ☐

(d) Others (please specify). ☐

Q23 If costing method, what is the method your company uses?

(Please tick one box.)

(a) Average cost; ☐

(b) First in first out; ☐

(c) Last in first out; ☐

(d) Others (please specify). ☐

Q24 Has your company changed its method of valuing inventories in the past five years?

(Please tick one box.)

(a) Yes; ☐

(b) No. ☐

Q25 If yes, what were main reasons behind any change?

(Please explain.)

<u>Q26</u> What depreciation formula is applied by your company?

(Please state.)

(a) Straight-line method; ☐

(b) Declining-balance method; ☐

(c) Sum of the years - digits method; ☐

(d) Unit of production method; ☐

(e) Machine hour method; ☐

(f) Others (please specify). ☐

<u>Q27</u> Has your company changed its depreciation formula during the past five years?

(Please tick one box.)

(a) Yes; ☐

(b) No ☐

<u>Q28</u> If yes, what are the main reasons behind this change?

(Please explain.)

<u>Q29</u> Do you request special reports from accounting organisations?

(a) Yes; ☐

(b) No. ☐

<u>Q30</u> If yes, are they as helpful as you feel they should be?

(Please specify)

Q31 What do you believe is the general attitude of line line management to the use of profit plans as a planning and control technique in your company?

(Please describe.)

Q32 What is the currency used by the company in its accounts?

(Please tick one box.)

(a) Home currency (i.e. the currency of the country where the parent company is established;

(b) Currency of the country where most of the investment capital is going;

(c) Currency of the country where the majority of shareholders reside;

(d) Others (please specify).

Q33 What is the method used in transfer pricing?

(Please tick one box.)

(a) Current and non current methods;

(b) Cash and non cash methods;

(c) Historical method;

(d) Current method;

(e) Others (please specify).

<u>Q34</u> When your Company receives products, raw material or services from its parent company or another subsidiary company, what price would apply?

(Please tick one box)

(a) Cost of product, raw material

(b) Variable cost of product;

(c) Market value;

(d) Others, please state.

<u>Q35</u> If your Company sends products, raw material or services to its parent company or subsidiary company, what price would apply?

(Please tick one box)

(a) Cost of product, raw material;

(b) Variable cost of product;

(c) Market value

(d) Others, please state.

<u>Q36</u> Are the profits of your Company computed according to the requirement of tax law?

(Please tick one box)

(a) Yes

(b) No

<u>Q37</u> Has taxation of your company a relevant consideration in your distribution?

(a) Yes

(b) No

Q38 If your answer is yes please state;

(a) very important consideration

(b) important consideration

(c) minor consideration

Q39 Are your employees salaries paid in foreign currency?

Yes No

Q40 Does your company fill in an annual tax return?

(Please tick one box)

(a) Yes

(b) No

Q41 Do you enclose revenue statements and other documents with your tax returns, as required by the tax office?

(a) Yes

(b) No

Q42 Does the tax inspector approve your tax returns?

(Please tick one box)

(a) Yes

(b) No

Q43 If no, what method would the tax inspector use to determine your taxable profit?

(Please tick one box)

(a) Random estimate;

(b) Gross profit/sale ratio;

(c) Percentage of public expenses;

(d) Using available financial ratio;

(e) Same taxable profit of previous year;

(f) Others please specify.

Q44 Has your company's tax holiday started? If so, when did it start? (Please state)

(a) When the company's assets were first used;

(b) When the company first started to manufacture goods or supply services;

(c) When the company started to sell its goods or services;

(d) When the company made up its first balance sheet or financial statement;

(e) When the company first registered in Egypt;

(f) What other time, if any.

Q45 Has your company suffered tax by deduction or otherwise during its tax holiday period?

(Please tick one box)

(a) Yes

(b) No

Q46 If it has, please state whether, and how, the tax was reclaimed

(a) From supplier/producer ☐

(b) From the tax office ☐

(c) By substitute from another tax credit. ☐

(d) Any other source (please specify). ☐

Q47 Has your company made any business loss, or losses, during its tax holiday period?

(Please tick one box)

(a) Yes ☐

(b) No ☐

Q48 If it has, please state how the company treated the loss.

(a) By carry forward ☐

(b) By transfer to parent company. ☐

(c) By other means (please specify). ☐

Q49 What Egyptian tax, if any, is paid on dividends remitted by your company to its parent company (please explain).

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Q50 Do you think that taxation has been a problem area making it difficult for your company to achieve its objective?

(please tick one box)

(a) Yes

(b) No

Q51 If your answer is Yes, do you think that taxation is

(a) a major problem area

(b) a moderate problem area

(c) a minor problem area

Q52 Please indicate, in percentage terms, the extent to which you

(a) attempt to solve such problems yourself;

(b) refer them to the company's auditors;

(c) refer them to tax specialists;

(d) refer them to the courts;

(e) negotiate with the Egyptian Tax Administration;

(f) use other means (please specify).

Q53 What percentage of such problems are concerned with (please state)

(a) taxes on profits;

(b) taxes on dividends;

(c) other taxes (please specify)

Q54 Please state, in relation to problems solved by yourself, the sources of information used by you.

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In order to receive a copy of the completed survey please give your name and job title.

Name ....

Job title ....

Thanking you for your co-operation.