

Mr Baillie
Southern European Department

POSSIBLE TAX TREATY WITH SPAIN

Further to our discussion by telephone this morning I return your file WSS 20/1.

2. May I suggest, as a follow-up Mr Goodison's letter of 9 March, that the Inland Revenue should be asked to consider negotiating a limited tax sparing agreement with Spain. As stated in my minute of 7 March, there is a second competitive handicap to British banks which would not be overcome even if instant double tax credits are provided. But a limited tax sparing agreement could take care of both the cash-flow and tax sparing problems, and should be much simpler and quicker to conclude than a comprehensive tax treaty.

3. This device of a limited tax sparing agreement was in fact suggested by the Working Party on Private Overseas Investment. For your reference I attach the relevant extract (paragraphs 53 to 55) from the final report of this Working Party.

4. In this connection I should mention that the ODA recently asked the Inland Revenue to report progress with tax sparing under treaties with developing countries, and a reply is awaited. Spain is generally classified as a developing country (eg in the DAC list) but because it ranks very low in UK aid priorities the ODA has been pressing for tax treaty priorities for other countries such as Brazil and Indonesia. So it would be necessary for other departments concerned to press the case for Spain on the separate grounds of UK commercial interest.

12 March 1973

B A Tarlton
Economists Department

Copies to:

~~Mr~~ Kerr (FRD) }
Mr Burns (TRD) } FCO
Mr Ballentyne (EPD) }
Mr Goulden (PS) }

Mr A H K Slater (CRE3) } DTI
Mr J Gill (IC2/1) }
Mr I H Harris (ODA) }

B. A. Tarlton

REC
REGIS.
13 MAR 1973
MFA/3/2r
18/3

CONFIDENTIAL

Reference

(3)

Mr Kerr (FRD) —

c.c. Mr Burns (TRD)
Mr Ballentyne (EPD)
Mr Baillie (SED)
Mr Tarlton (Economists)

TAX TREATIES

1573

1. Do we yet have any means of deciding which of the various candidates for tax treaties deserve priority support from the FCO? I am concerned that Inland Revenue - not a notable outward-looking Departmentally - may be unduly influenced by the developmental motivated men of ODA. It is doubtful how far of FCO. are entitled to press on Inland Revenue a set of priorities which have not been discussed with the FCO. This is not, after all, an area where developmental criteria should be allowed to prevail.

2. I wonder therefore whether we should get together, first among ourselves and later perhaps with ODA, to determine a list of priorities for Inland Revenue based on the broadest foreign policy considerations. It should not be difficult to decide which candidates are the most important from the commercial, investment and general political points of view. If two countries appear to be of roughly equal importance according to this criteria, then other yard-sticks - including the developmental one - might be introduced to decide the issue. But it seems highly undesirable that the developmental factor should receive prominence simply because ODA are better organised than we to decide their priorities and press them on Inland Revenue.

3. Without knowing what other candidates are in the running for tax treaties, it is difficult to comment on Mr Talton's minute of 12 March about the possible tax treaty with Spain. It seems, prima facie, to deserve a higher priority than even the most substantial developing countries (eg Nigeria or Brazil). But I think it would be useful to consider all the candidates together and give the Geographical Departments concerned a chance not only to argue their case but also to help to put their clients into perspective.

14 March 1973

P J Goulden
Planning Staff

John Goulden

File 1573

Mr Kerr (FRD)

*These are Tom
minutes of 21 March
proposed. We
need an opportunity
for late treaties as
for countries as
the harmonisation
for EEC of similar
treaties. My view is
that many of the
key information
of the
negotiations -
the USA -
is this -
the pressing
point is*

Mr Tarlton

*What do you think? The
Planners have come to life again.*

John Kerr



THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

Our Ref: PS 3888/1970

Your Ref: SPD 209/202/01

I H Harris Esq
Foreign and Commonwealth Office
Overseas Development Administration
Eland House
Stag Place
LONDON SW1E 5DH

Dear Mr Harris

MATCHING TAX ADVANTAGES IN DEVELOPING COUNTRIES

You wrote to me about this on 12 February.

I cannot really add anything of substance to my letter of 20 December. So far as we are concerned, negotiations can go ahead quickly; but progress also depends of course on the attitude of the other country, both on timing and content. At the present moment especially, a high degree of confidentiality attaches to the progress of our negotiations with particular countries. I am afraid I must ask you to accept our assurance that our sense of urgency as regards renegotiation of new agreements is no less than yours.

On the point in the third paragraph of your letter, it was not, until recently, our policy to take the initiative in offering matching credit; we included it only if we were satisfied that there was a reasonable balance of concessions in the agreement as a whole. As you know, this restrictive approach has been abandoned in the current round of negotiations as we are now taking the initiative in offering matching credit to all developing countries, and we are not seeking any alterations in the balance of existing agreements on that account. This was the change I had in mind in referring to our more liberal approach to pioneer relief in my letter of 31 July.

As regards the scope of the relief which we are prepared to match, it is very much a question of looking at each piece of legislation the partner country wants matched on its merits. We must ensure that the legislation falls within the enabling power (Income and Corporation Taxes Act 1970 Section 497(3)); we also want to be sure that the United Kingdom tax given up will encourage new investment rather than accrue mainly to

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REGISTRY No. 47
26 APR 1973

MFAR3/2
MFAR2/528/1

15 March 1973

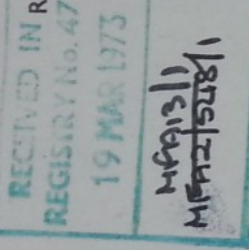
the benefit of investors in existing projects, and that the relief granted in the developing country is reasonable having regard to its purpose. As a practical exercise, you might like to examine some of our agreements which include matching credit to see whether those countries have any provisions which you feel should have been matched but which were not.

Copies of this go to the recipients of your letter.

Yours sincerely

Aime Smallwood

Mrs A H Smallwood



Eda
8/19/73

Mr Webb
Mr Holland

TAX TREATIES WITH DEVELOPING COUNTRIES

As you know, it has been extremely difficult to get information out of the Inland Revenue about the progress made with tax sparing through bilateral treaties. Last month (see Mr Harris's letter of 12 February) the ODA asked the Inland Revenue for a detailed progress report.

2. The reply from Somerset House (see Mrs Smallwood's letter of 15 March) must be regarded as highly unsatisfactory. The information requested is apparently to be withheld because "a high degree of confidentiality attaches to the progress of our negotiations with particular countries".
3. The question of confidentiality can surely be covered if the Inland Revenue gives an appropriate classification to their reports. It cannot serve as an excuse for withholding information from the FCO/ODA. Our various geographical departments need to be properly informed about tax treaty negotiations affecting their territories. They should also be aware of the likely impact of key provisions on British investment and other interests abroad, on foreign investment in the UK and on intergovernmental relations. FCO and ODA functional departments have also expressed views on the policy objectives to be achieved under tax treaties and need to be kept informed (if not consulted) about progress/lack of progress on this front. There is also the general question, referred to in Mr Goulden's minute to Mr Kerr of 14 March 1973, of laying down country to country priorities for tax treaty negotiations.
4. In short the FCO and ODA are concerned with the timing, direction, progress and substance of tax treaty negotiations. Full and regular reporting to us by the Inland Revenue needs to be established as a minimum condition for coordination and consultation within Whitehall.

B. A. Tarlton

19 March 1973

B A Tarlton

Copies to: *Mr* Kerr (FRD)
 { Mr Burns (TRD)
 { Mr Balentyne (EPD)
 { Mr Goulden (PS)

(With copy each of ODA letter of 12.2.72 and IR letter of 15.3.73).

and IR

Mr Webb

FCO INTEREST IN TAX TREATY QUESTIONS

Thank you for your minute of 22 November. I agree generally, subject to a few qualifications.

2. I agree that it is right in principle and practice that geographical departments should take the lead on bilateral tax issues. But I have some doubts on the extent that it will be feasible to equip those departments "to deal with tax questions". There are a lot of desk officers, they do not serve at the desk for all that long, and tax matters must be a very small part of their work. Inevitably, it seems to me, we have to accept that much of the technical expertise will have to rest with us. Our interest, I think, is to get out of the front line. We stand ready, as always, to help geographical departments; but basically it is for them to make the running on bilateral matters with the BIR or whomever. On such bilateral matters, I think that we should gently withdraw towards a more advisory role; and see what happens.

3. I tend to attach more importance than you may do to the creation of some central action point somewhere in the economic departments, with FPAD to my mind being the obvious location. There is, as you say, a range of issues (and they may be the most important issues) which cannot appropriately be handled by geographical departments. General issues of tax policy and practice with broad implications for external relations fall into this category; as do questions of which countries should receive priority in tax negotiations. On this latter point, I think that we ought to be concerned at a situation in which (if I read the minuting rightly) the FCO has had no voice on the order in which tax treaty negotiations take place. The ODA appear to have got their bids in; FCO bids seem to have been brushed aside. We need not imply that any formidable expertise has to be developed by FPAD; in any case, with FPAD a sufficient expertise soon follows active involvement. I notice that Mr Marshall has not been involved in this burst of minuting; perhaps the next step would be for you to take his views.

4. Which brings me to the question of the proposed letter to BIR. Given the abysmal way in which BIR seem to conduct themselves in Whitehall, I think that a letter is a good idea. I wouldn't myself think it necessary to mobilise Mr Bottomley at this stage: perhaps Mr Keeble could be stimulated to write. But my view is that we should, before writing, be clear on how we are to handle these matters in the FCO, and in particular what arrangements can be made to

/create

create a central point responsible for representing FCO views on other than strictly bilateral issues. There is little point in explaining to BIR what our interests are, and why we need to be consulted, until we know how we are going to pursue those interests.

D. G. Holl

D G Holl and

24 November 1972

cc Mr Marshall (FPAD)
Miss Harvey (Economists)
Miss Pestell (FPAD)
Mr Goulden (Planning Staff)
Mr Tarlton (Economists) ✓

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Mr Holland

cc Miss Harvey
Miss Pestell
Mr Goulden
Mr Tarlton

FCO INTEREST IN TAX TREATY QUESTIONS

I have discussed this question, to which you referred in your minute of 10 November, with Miss Pestell.

2. I think that there are two separate problems here. The first concerns the point raised by Mr Tarlton in paragraph 12 of his minute of 30 October, namely that the FCO should insist that the BIR inform us of any negotiations which they are about to undertake with other countries and consult us where UK interests are involved. As both Mr Tarlton's minute and Mr Baillie's minute of 1 November make clear, the BIR are not doing this at the moment. The best way of dealing with this problem would surely be for Mr Bottomley to write to the senior official responsible for the BIR's external activities, explaining the FCO interest in such matters and making clear that in future we expect the BIR to consult us about them.

Flag F

Flag J

3. The second problem concerns the organisational arrangements within the FCO that are most appropriate for dealing with tax questions. Mr Goulden believes that what is needed is a desk officer in one of the functional departments "who could take an overall view of taxation/ investment questions and provide a political equivalent to Mr Tarlton's expertise", and has suggested FPAD as the functional department best suited for this purpose. Mrs Radice has supported this suggestion on the grounds that tax questions are a highly technical subject beyond the grasp of desk officers in geographical departments.

Flag K

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4. I must admit that, having myself generally found questions of company taxation, when I have had to deal with them, both tedious and difficult to grasp, I have a good deal of sympathy with Mrs Radice's point of view. However, I am not convinced that hiving off responsibility for this subject, lock, stock and barrel onto FPAD, as she appears to envisage, is really the answer. You will recall that one of the conclusions reached by the Inspectors when they inspected the economic departments of the FCO earlier this /year,

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Year, was that too much of the responsibility for economic questions had been shifted off the shoulders of the functional Geographical departments and on to those of the functional departments. They recommended - and their recommendation seemed then and still seems to me to be sensible - that Geographical departments should take on more responsibility for bilateral economic relations with their respective countries. Tax treaty negotiations seem to me to be precisely the kind of bilateral economic issue where Geographical departments should take the lead - drawing on Mr Tarlton for expert advice when necessary, but not leaving him to carry the load virtually single-handed.

5. It is true that there are some things in the tax field that geographical departments cannot do. They are not, for example, well suited to fill the co-ordinating role envisaged by Mr Goulden, when it comes to deciding questions such as the priority to be given to various countries in the negotiation of tax treaties. Neither is this role a suitable one for Economists Department, since political considerations, in which we make no claim to have any particular expertise, would be involved in such decisions. FPAD might be able to fulfil this role, but I understand from Miss Pestell that, given their present workload and the resources available to deal with it, they are in no position to provide anyone who would be able to give enough time to the subject to become a taxation/investment specialist. Unless, therefore, their establishment was to be increased, their involvement in these issues would remain somewhat peripheral. However, so long as the geographical departments were prepared to undertake the lion's share of the work in this field, as I think they should, this might not matter.

6. There remains the legitimate point made by Mrs Radice that geographical desk officers are not at present well equipped to deal with tax questions. One way of handling this might be for the FCO, possibly in conjunction with CSD, to organise a short course on company taxation in the UK and elsewhere with particular emphasis on the implications of tax policy for investment flows, earnings of UK companies overseas (and foreign-owned companies in the UK), remittances etc. I am sure that Mr Tarlton, who is extremely knowledgeable about these issues, would be willing to help organise such a course and ensure that it was designed to meet the FCO's needs.

7. Briefly then, I think that the organisational set-up at which we need to aim is one in which:

(i) geographical desk officers would be trained to play a fuller and more effective part in handling bilateral tax questions;

(ii) they would continue to draw upon Mr Tarlton's expertise when necessary - without expecting

/him

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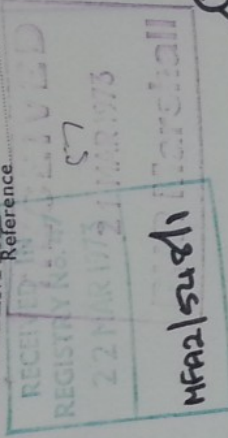
(iii) him to hold their hands all the time;
co-ordinations of views between departments
within FCO, where this was called for, would
be handled by FPAD.

GR. Webb.

T R Webb

22 November 1972

CONFIDENTIAL
Reference



Mr Marshall (FRD)

TAX TREATIES

I refer to Mr Goulden's minute of 14 March to Mr Kerr on this subject. ③

2. This raises once again the question of whether we need a central action point somewhere in the economic departments for dealing with broad general questions of tax policy of a kind that cannot appropriately be handled by geographical departments. The task of working out a list of priorities for the conclusion of tax treaties "based on the broadest foreign policy considerations" seems to me to be an excellent example of precisely this kind of question.
3. You may remember that we discussed this problem a few months ago (for convenience I attach copies of minutes by Mr Holland and myself on the subject). Mr Holland and I had suggested that FRD might provide the "central action point", but at that time the economic departments were in the process of being reorganised and you were reluctant to undertake further commitments until you had seen how the new set-up was working out.

4. In the meantime Mr Kerr's side of FRD has in practice been fulfilling to a large extent the kind of function which we had in mind and has been actively involved in those aspects of taxation policy which concern our relations with developing countries. However, the kind of issue raised by Mr Goulden concerns developed as much as developing countries, and I think that we need to decide whether responsibility for this whole area of tax relations with foreign countries is one which FRD would be prepared to accept. I have in mind here, of course, only questions relating to direct taxation; those relating to indirect taxes, excise duties, tariffs and the like are at present, I think, dealt with by TRD and would presumably continue to be dealt with there.

21 March 1973

T R Webb
Economists Department
G 72/G Ext G 791

Copied to:

Mr Holland
Mr Burns (TRD)
Mr Kerr (FRD)
Mr Ballentyne (EPD)
Mr Goulden (Planning Staff)
Mr Tarlton

T R Webb.

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DD 897261 2301

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Reference

Mr Kerr (Financial Relations Department)

Mr. Nashhill
Tosa. As you know,
I think there is much
force in this; but we
need more staff.
JMK
5/4

TAX TREATIES

MF413/2

1. Please refer to Mr Goulden's minute of 14 March on this subject. I attach a copy of my minute of 1 November 1972 supporting the case for a coordinating point within the FCO to deal with the Inland Revenue on taxation questions.
2. I now see from the communiqué following President Numeiri's recent visit that "HMG have agreed to consider the possibility of negotiating a double taxation agreement with the Sudan Government." The plot thickens.
3. The fact is that geographical departments within the FCO (Whitehall wing and ODA independently) and within the DTI are separately hammering away at the Inland Revenue. The success of these efforts seems to depend on circumstances like the extent of keenness of overseas governments to conclude double taxation agreements with us. There is no comparative assessment of British interests. This must be wrong.
4. In SED's last letter to the Inland Revenue (dated 9 March) we asked what negotiations were in the pipeline and how the Inland Revenue saw their priority in comparison with possible negotiation with Spain. We have not yet had a reply.
5. UK finance houses and business interests are adamant that we are losing a significant amount of business in Spain because there is no double taxation agreement. I have no doubt that there are also cogent political and commercial reasons for negotiating agreements with other countries. It may well be that it would be cost-effective for the Inland Revenue to recruit special teams and to conduct a crash programme to get rid of the backlog.
6. But without a central point we cannot influence the Inland Revenue in a direction that meets FCO interests.

A T Baillie

A T Baillie
Southern European Department

4 April 1973

cc (with encls)

Mr Goulden (Planning Staff)
Mr Ballentyne (EPD)
Mr Tarleton (Econ. Dept)
Mr Burns (TRD)
Mr Wogan (NENAD)

Letter to make up
file
re 14

Mr. Baillie
see. We
must aim to
discuss this next
week. Will you
tell Mr. Kerr and
myself down to
a date please?
JMK
16/4

CONFIDENTIAL



Foreign and Commonwealth Office
London SW1

Telephone 01- 839-8866 Ext 45

I H Harris Esq

Private Investment Consultancies Dept
Overseas Development Administration
R E 608

Eland House

Stag Place SW1E 5DH

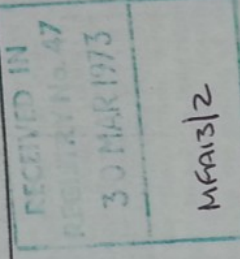
Your reference

MMG 68/3

Our reference

29 March 1973

Date



Dear Sir

SCOPE OF MATCHING RELIEF

Further to my letter of 27 March I attach an extract from the Times of 27 March entitled "investment in Singapore secures Rollei's future". Here is a practical example of how a major German manufacturing concern has successfully met the threat of Japanese competition head-on by investing in a developing country. In so doing it has apparently maintained employment in Germany whilst restoring the international competitiveness and profitability of the Group. This example is contrasted sharply with the lame duckery of BSA.

2. You will see that Rollei's success depends on its capacity to exploit not only the labour cost advantages of Third World production but also two major tax advantages offered by the host country. The first tax advantage - the five year pioneer tax holiday - is available also to British companies under a tax sparing provision in the UK/Singapore tax treaty. But the second tax advantage of a negligible rate of tax on export profits will still be frustrated by countervailing UK tax.

3. Here then is a specific example of how the range of UK matching relief might be expanded under an existing treaty.

4. I am copying this letter to Mr A Adams (Inland Revenue) and to Mr Gill (DTI) as well as to FCO desks.

Copies to:

Mr Kerr (FRD)

Mr Ballentyne (EPD)

Mr Clark (TRD)

B A Tarlton

Economists Department

Mr Goulden (PS)

Mr Paul (SWPD)

oni

Miss Pestell, FPAD

TAX TREATY NEGOTIATIONS

MFAR3/2

1. I would like to add my pennyworth in support of Mr Tarlton's proposal (paragraphs 12 and 13 of his minute of 30 October) that an FCO department should on approach the Inland Revenue on behalf of the Office on the lines suggested.
2. Lack of a coordinating point in the FCO on taxation matters has led us in SED into a dispiriting and unfruitful confrontation with the Inland Revenue. In brief, (and we believe that there is a good commercial (and political) case for negotiating a double taxation agreement with Spain. Both the Inland Revenue and the Spanish Ministry of Finance are in principle willing to resume the negotiations which broke down in 1968 because of technical difficulties which, we think, have now largely disappeared. The Inland Revenue however maintain, irrefutably, that priority must be given to the revision of existing agreements with our major trading partners to fit the new system of corporate tax which comes into force in April 1973. We naturally accepted this but have been aggrieved to learn, quite fortuitously, that the Inland Revenue are currently negotiating double taxation agreements with Indonesia and Brazil - there may well be others.
3. We have tried, unsuccessfully, to find out how the Inland Revenue assesses its priorities. I was told on the telephone that negotiations are under way with Indonesia and Brazil because approaches were made to us by those countries. This may well be a good reason, but seems hardly sufficient. I was told by Mr Lightfoot in IC(2) of the DTI that the ODA had pressed for double taxation agreements with Indonesia and Brazil; he told me with understandable abruptness, that the FCO should set its own house in order if we wished to have a say in determining the Inland Revenue's priorities.
4. I think, therefore, that there is indeed a case for informing the Inland Revenue officially of the FCO's interest and that we should ask them for details about the re-negotiations/negotiations in the pipeline, about order of priority, and an estimate of when the negotiations in each case are likely to be concluded.

1 November 1972

Copies to:

Mr Burns, TPD
Mr Davies, NAD
Mr Holland
Mr Webb
Mr Kerr, FPAD

A T Baillie
Southern European Department

Mr Tarlton, Economists Dept
Mr Goulden, Planning Staff
Miss Rycroft, LAD
Mr Norey, WAD

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WSS 20/1

Mr Marshall

RECEIVED IN
REGISTRY No. 42
25 APR 1973

MF013/2

TAX TREATIES

gs A &
B

1. Mr Goulden's minute of 14 March and Mr Webb's minute of 21 March discuss again the question how FCO should organise itself to deal with broad general questions of tax policy. Mr Webb's minute of 22 November 1972 to Mr Holland is also very relevant.
2. Inevitably fingers are pointed at us. And I think rightly so. Certainly some of these taxation issues - difficult though they are to follow - impinge upon the totality of our economic relationship with individual countries. I do not feel it is right to leave geographical departments to fight their battles unaided with experts in other Ministries. If FCO is to have a voice in these areas - and I think we must - the Office should be so organised as to be capable of producing a co-ordinated view of taxation policy. This to my mind, implies that there should be within the Office a "central action point" as suggested by Mr Webb, which could both take an overall view and give advice to geographical departments. If the logic of this is accepted, I fear I cannot see how we in FRD could escape becoming that "central action point". No other department seems to deal with the type of related subjects which would make it natural for them to undertake this work. But the subject is difficult and mastering it is undoubtedly time-consuming. I have been able to give Mr Tarlton a little help on some taxation matters related to developing countries and the Irish Republic but I am conscious of the need to have a desk officer who would have this as part of his portfolio of subjects. In principle, if it is the general wish of the Office that FRD should take on additional subjects, they really must be prepared to provide us with the necessary additional resources. At the moment we are undoubtedly overstretched. I certainly cannot afford the amount of time which I think is desirable to give Mr Tarlton the policy assistance to which I feel he is entitled.
3. As you will know, however, Miss Pestell does not share my view of this. She feels that we already have more than enough subjects with which to deal and that the geographical departments

should themselves, advised as necessary by the Economists, cope with such tax matters as come up. But it is, I think, significant that it is the Economists themselves who most feel the need for this "central action point" and who are pressing us hardest to provide it.

4. Perhaps you might like to discuss this question with the two of us when Miss Pestell returns.

D. L. Kerr

D M Kerr
Financial Relations
Department

27 March 1973

Copied to:

Miss Pestell

Mr. Marshall.

*I am ready.
Miss Pestell Office*

I agree we should discuss.

2. You will know that the Chancellor has been provided with briefing on specific tax points for his Washington visit.

11/23/3



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London SW1

Telephone 01- 839 8866 Ext 45

I H Harris Esq
Private Investment & Consultancies
Overseas Development Administration
E608
Eland House
SW1E 5DH

Your reference

Our reference *14174 68/3*

27 March 1973

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REGISTRY No. 47

27 MAR 1973

14174 68/3

SCOPE OF MATCHING RELIEF

In paragraph 4 of her letter of 15 March Mrs Smallwood has commented on the general issue of which particular tax advantages in developing countries are to be matched by corresponding reliefs against UK tax.

2. The practical exercise suggested by Mrs Smallwood could provide a useful focus for discussion. The exercise might well be extended to include certain countries to which it is considered desirable to give priority in tax treaty negotiations.
3. There are also three further aspects touched on by Mrs Smallwood :
 - (a) the scope of the enabling power of Section 497(3),
 - (b) the encouragement of 'new' investment, and
 - (c) the 'reasonableness' of host country incentives.

As far as I am aware, there is no agreed Whitehall view on these three questions. Regarding (a), for example, it is understood that no matching of ldc export incentives has been permitted although a developmental (and commercial) case for such matching could be made out. Regarding (b) one wonders if it is practicable (or desirable) to discriminate in favour of incentives which favour 'new' investment whilst countervailing incentives which appear to benefit 'existing' investment.

4. Question (c) above is perhaps still more contentious. Few would disagree that 100-year tax holidays are excessive. But it is not so clear where one should draw the line in recognising (and therefore not countervailing) foreign tax advantages. Should HMG take a more tolerant view of the incentives offered by say, the 'least developed' countries, which may need to offer more attractive tax incentives to compensate for poorer resources or an inferior infrastructure? Or should the host countries be left entirely free to decide for themselves what investment incentives are necessary or appropriate? Should HMG encourage ldc cooperation of the host countries to restrain competition in offering investment incentives?

5. In this connection I understand that the subject of tax incentives and their reciprocation by tax sparing or other methods of investment assistance has been under discussion by the UN Ad Hoc Group of Experts on Treaties between Developed and

/Developing



Developing Countries. The Fourth Session of this Group was held in Geneva in December 1972 and the Group's report is to be considered at the UN ECOSOC's 54th Session next month.

Yours sincerely
Brian Tarlton

B A Tarlton
Economists Dept

Copies to:

Mrs Smallwood (Inland Revenue)
Mrs Boothroyd (Treasury)
Mr J Gill) DTI
Mr Treble)
Mr Ryan (B of E)
Mr Reynolds (ECGD)

FCO

Mr Kerr (FRD)
Mr Burns (TRD)
Mr Ballentyne (EPD)
Mr Wenban-Smith (UND)
Mr Goulden (P. Staff)



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RECEIVED
27 MAR 1973
Your reference SPD 209/202/01
Our reference MFA 13/2
Date 27 March 1973

MATCHING TAX ADVANTAGES IN DEVELOPING COUNTRIES

1. We spoke briefly earlier this week about Miss Smallwood's letter of 15 March to you.
2. I must say I find her second paragraph profoundly unsatisfactory. As I see it, the FCO/ODA is primarily responsible for the totality of Britain's relations with developing countries. We cannot discharge that responsibility unless we know what negotiations other Departments in Whitehall are conducting with these countries and "knowing" entails more than the acceptance of general assurances that experts know best. We cannot accept such assurances. We have a right to be informed and consulted about the priority list the Inland Revenue propose to follow for their tax negotiations. We also have a right to be informed how tax negotiations with individual countries are progressing. We should as a matter of course be consulted whenever negotiations run into difficulties. It is after all not inconceivable that we might on occasions be able to advise the Inland Revenue how such difficulties might be surmounted given our knowledge of the internal politics of the country concerned. If negotiations go smoothly, of course there is no difficulty. But should negotiations result in major differences of opinion they can have an impact upon our general relationship with the developing country concerned. We have a right to know and we need to exercise that right, both in relation to the tax treaty negotiations and to other activities of the Inland Revenue on the international scene.
3. I think the time has come for the points I have made in the preceding paragraph to be put formally to the Inland Revenue at an appropriate level. The two wings of our Office see this matter in exactly the same way and feel equally strongly about it. I should of course be quite content to accept your judgment on who might best sign the letter.
4. Perhaps

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4. Perhaps you will permit me a final thought, that I find the Inland Revenue's attitude and behaviour quite extraordinary. I cannot imagine that any other Department in Whitehall would behave in this way. Nor that we would have allowed any other Department to get away with behaviour like this for so long. I am quite clear we must call a halt now.

D M Kerr
Financial Relations
Department

Copied to:

Mr Tarlton (Economists Dept)
Mr Goulden (Planning Staff)
Mr J Gill (DTI)

CONFIDENTIAL



Foreign and Commonwealth Office
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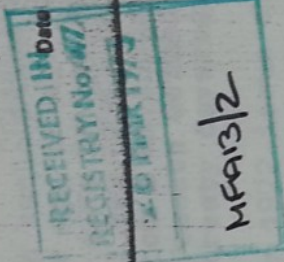
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Your reference

Our reference MMG 68/3

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MATCHING TAX ADVANTAGES IN DEVELOPING COUNTRIES

In your letter to the Inland Revenue of 15 February you expressed concern at the loss of commercial opportunities because foreign competitors seem better placed to enjoy the tax advantages which developing countries offer. The Inland Revenue's reply of 15 March maintains that tax sparing arrangements by the UK compare fairly well with those of the USA, Germany and Japan.

2. But tax sparing by treaty is only a small part of the picture. Indeed, as UK experience has shown, tax sparing by treaty has severe practical limitations. If we look at the overseas tax regime as a whole, including all treaty provisions, the competitive situation is far from reassuring.

Germany

3. Take the case of Germany. The primary 'matching' device in Germany tax treaties is not tax sparing but exemption. Because overseas investment income is exempted from domestic tax German companies can benefit fully from all foreign tax advantages, including low or nil rates, which remain frustrated under UK/sparing provisions. This corporation tax relief may be supplemented by a tax sparing credit against German income tax eg as in the German/Spanish treaty (not listed in the IR's letter) to match reductions of foreign withholding tax. But I am **not aware of any UK arrangement for income tax sparing.**

/tax

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4. Secondly, the German authorities are keenly aware of the incomplete coverage and delays of a purely tax treaty approach. So they give German companies income. tion of a low flat rate of tax (25%) on overseas income. As the attached extract from a UN document* shows, (more option is designed to compensate German investors (more or less) for gaps in tax treaty coverage.
5. Thirdly, the January 1972 issue of "European Taxation" reported a new German measure to apply tax sparing generally for all developing countries whether or not a tax treaty exists. Moreover the tax sparing credit was potentially more generous than anything similar in the UK because the 'deemed' level of foreign tax paid was to be the German domestic rate instead of any lower foreign rate. But I am not sure if this measure has since passed into German law.

Japan

6. Let us now consider Japan. Britain, Japan and the USA are the only major investing countries which do not exempt overseas investment income from domestic tax (whether by treaty or unilaterally) and which therefore refrain from using the most effective tool for matching foreign tax advantages. We must therefore see how far the techniques of double tax relief and tax sparing are applied so as not to frustrate foreign tax advantages.

7. But the level of domestic tax is also relevant. Indeed the picture looks very different when one considers the actual rates of Japanese corporation tax:-

• Pages 32 to 35 from UN Secretariat paper ST/SG/ACA/R31 of 16.9.71 for the Ad Hoc Expert Group on Tax Treaties between Developed and Developing countries.



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Company tax rates in Japan

| <u>Tax rates</u> | <u>Standard</u> | <u>Small income*</u> | <u>Special*</u> |
|------------------------------|-----------------|----------------------|-----------------|
| (a) on distributed profits | 26% | 22% | 19% |
| (b) on undistributed profits | 36.75% | 28% | 23% |

Presumably the overseas income which Japanese parent companies redistribute as dividends is taxable only at the lower (a) rates above. So at a stroke it appears that Japanese investors, regardless of tax treaties, can take the benefit of much lower foreign tax rates, while British investors are confronted by the domestic tax hurdle of a 40% rate of corporation tax - which is expected now to go up to 50%.

United States

8. American investors also face a relatively high domestic rate (48%) of corporation tax. The USA has also taken the paternalistic view that tax sparing is undesirable because it encourages lds to cut each other's throat with tax concessions to attract foreign investors.

9. But in practice the USA goes much further than the UK through its generous system of unilateral relief for foreign tax. Under this system - referred to as the 'overall limitation' of the US tax credit - all foreign income and all foreign taxes can be aggregated before the US domestic tax rate is applied. US-based multinationals can then take the benefits of low taxation in some countries as an offset to higher taxation (or losses) incurred in other countries. But UK companies are taxed slice by slice on their overseas income and so can not gain on the swings what they lose on the roundabouts.

/10. Even

* The small income rates apply to annual income not exceeding ¥3 million while the special rates apply to 'cooperative associations' and 'corporations in the public interest'.



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10. Even so, I would not like to see this aggregation system adopted by the UK. The system distorts international capital flows, it promotes unfair competition and has the perverse effect of transferring revenue from low tax countries to high tax countries. My own preference is for the exemption method.

Other countries

11. The competitive situation abroad, tax-wise, looks still worse if we consider the overseas investment regimes of other major investing countries. Comparison with France, with its imputation system, would be especially relevant. But I have written more than enough for one letter.

12. I am copying this letter to the recipients of yours.

Yours sincerely
Brian Tan

B A Tarlton
Economists Department

Copies to: ✓ Mr Kerr (FRD/FCO)
Mrs Smallwood (Inland Rev)
Mrs Boothroyd (Treasury)
Mr Ryan (B of E)
Mr Treble (CRE2/DTI)
Mr Reynolds (ECGD)

C. Flat rates of German tax on foreign income and foreign assets

1. German law enables the tax authorities to remit German tax on foreign income and foreign assets in whole or in part or to fix a flat amount if this is advisable for economic reasons or if the application of tax credit is "unusually difficult".

These powers have been used to take special cognisance of the fact that German double taxation treaties provide for extensive tax relief which is not enjoyed by investments in countries with which no such treaty exists. In order to go at least halfway toward the situation which would be created by the conclusion of a double taxation treaty, German tax on direct investments, which would normally be exempted from German tax by a double taxation agreement, is cut by about half; Income Tax and Corporation Tax are fixed at 25% of income; Net Worth Tax is reduced from 1% to 0.5%.

2. Flat rate taxation replaces tax credit. A taxpayer has to make a special application for it. In doing so, the taxpayer must include all income from a specific foreign country and all assets in that country.

3. The flat rate applies to

(a) profits of foreign permanent establishments and their assets; also to profits from investments in foreign unincorporated associations and to the value of such investments because investment in an association is regarded as the investor's direct business activity.

(b) dividends from investments by a German commercial entity in a

foreign commercial entity, as well as the value of the investment itself, provided that the investment has amounted to at least 25% of the share capital and registered capital of the foreign company since the beginning of the year; this reflects the concept of the affiliation privilege.

4. Moreover, application of the flat rate requires that the foreign permanent establishment (or unincorporated association) or the foreign subsidiary should

be exclusively or almost exclusively engaged in the manufacture or supply of goods abroad, with the rendition of services abroad or with the importation of merchandise into Germany. The preference is therefore only granted to investments serving the actual conduct of a business in a foreign country. Investments in subsidiaries set up for holding purposes are excluded from the benefit.

5. The flat rate tax is of practical significance only in respect of developing countries because it has little relevance to industrialized countries in view of existing German double taxation treaties. It is therefore meant especially to facilitate direct investments by businessmen as part of development aid, so long as a double taxation treaty has not yet been concluded with the developing country concerned. This can only be justified if the investment entails a genuine business engagement in the developing country. The above-mentioned prerequisite takes this into account.

IV. THE ROLE OF DOUBLE TAXATION TREATIES

A. The Treaties in German Law

1. Double taxation treaties play an important role in shaping tax conditions for foreign investments made by the German economy. They lay down fundamental restrictions on the German taxation of foreign income and assets.
2. As a result, it goes without saying that tax conditions for German investments in developing countries are greatly influenced by double taxation treaties where they exist. The taxation laid down by national law in over-ridden by such agreements over wide areas. The treaties are therefore just as important as domestic law in assessing the fiscal consequences of investments abroad. The picture of tax conditions for investments in countries with which double taxation treaties have been signed, would be completely distorted if the treaty provisions were not taken into consideration.
3. To avoid double taxation, the treaties restrict German taxation. This is done not only through foreign tax credit - as provided for in German domestic law as a unilateral measure - but double taxation treaties in the first place use tax exemption (modified by the so-called "exemption with progression") as a method of avoiding double taxation. Insofar as exemption operates, German tax liability for foreign income is lifted (disregarding the effect of the "exemption with progression" on the other income). In addition to tax exemption, German double taxation treaties also use tax credit. In this respect, the treaties do not provide additional relief when compared to German domestic law. The tax credit already operating as a unilateral measure to avoid double taxation is merely established formally in the treaty. All limitations laid down by domestic law for tax credit also apply to credit on the basis of the double taxation treaties.
4. In respect of developing countries, tax credit is often modified by so-called tax-sparing credit. This is designed to prevent tax relief granted

by a developing country to a German investor from being nullified by the mechanism of tax credit. For any tax reduction in a developing country that decreases the amount to be credited against German tax, with the result that there remains a correspondingly higher residual German tax. Tax-sparing credit makes it possible to credit those amounts of tax which in fact were not payable in the developing country. This lightens the tax burden on the German investor, enabling him to benefit directly from the developing country's tax concession.

5. All this means that double taxation treaties for investments of the German economy in developing countries provide for considerable tax relief beyond the tax credit laid down in German domestic law, by granting tax exemption and tax-sparing credit. From the German point of view, the treaties are therefore an important instrument for the fiscal promotion of investments in developing countries.

6. On 1 September 1970, the following double taxation treaties were in force between Germany and developing countries:

Africa:

United Arab Republic

America:

Argentina

Asia:

Ceylon

India

Iran

Israel

Pakistan

Thailand

Europe:

Spain