Policy Statement

Tax sparing in tax conventions

Prepared by the Commission on Taxation

National tax systems often seek to attract investment through tax concessions. Such measures reduce the tax otherwise imposed on income derived from specified activities, or on the distribution of earnings to the foreign investor, through special tax holidays, credits, deductions or exemptions. However, the economic benefit of such tax-based incentives may be reduced or eliminated by the tax regime of the investor's home jurisdiction. This particularly occurs where that country provides recognition for the taxes paid to the host country under the credit system.

Some bilateral tax conventions preserve the benefit of host country tax-based incentives through "tax sparing". These treaty provisions generally stipulate the granting of a credit for taxes that have not actually been collected.

Tax sparing is found most often in conventions with developing economies and is of particular concern to those economies. The purpose of this policy statement is to consider and evaluate the current international practice regarding tax sparing and provide recommendations for future action.

The purpose of tax sparing

Assume ParentCo, a company resident in country A, decides to establish business operations in country B, either through a subsidiary corporation (SubCo) or a branch. Country B provides tax-based incentives for certain activities.

If country A provides recognition for foreign taxes through the full exemption method, and this exemption is applicable without restriction to the distributed earnings of SubCo or the country B branch, then the tax-based incentive provided by country B benefits ParentCo. The tax payable to country B is reduced by the incentive, and the tax payable to country A is unaffected.

If, however, country A provides recognition for the relevant foreign taxes through the credit method, or if it establishes restrictions regarding the application of its exemption method, the tax-based incentive provided by country B may be effectively recouped, in whole or in part, by country A. In practice, tax credit systems are complex so that the impact of the tax-based incentive will depend on many factors, including the manner in which the country A foreign tax credit is computed (e.g., per country or worldwide calculation).

A similar result may occur where country A generally adopts the exemption method but adopts a tax credit for the particular taxes to which the tax-based incentive applies, such as dividend or royalty withholding taxes. An exemption country may also deny or restrict the benefit of its exemption in certain circumstances (e.g., under a low tax threshold or similar mechanism).

For example, suppose that country B establishes a 3-year tax holiday for income related to natural resource extraction and also reduces the otherwise applicable rate of withholding tax on distributions of such income from 25% to 5%. Country A adopts the credit method for the recognition of foreign taxes. SubCo earns qualifying resource profits in country B that, at the end of the 3-year period, distributes its accumulated profits to ParentCo. While other factors may intervene (such as the impact of any other foreign activities of ParentCo), the tax imposed on the repatriated earnings may attract full country A taxation with a credit only for the 5% withholding tax on dividends. The impact of the country B incentives, both the tax holiday and the reduction in withholding tax, will have been reversed.

To choose another example, suppose that country B imposes a 30% withholding tax on interest and royalties. A special tax incentive applies to such payments where the local activity is of a prescribed type. This may be an attempt by country B to attract the transfer of capital or technology. The incentive will be recouped if country A imposes the receipts of interest and royalties by ParentCo and provides recognition for these country B taxes only by allowing a credit for taxes actually remitted, even though country A may otherwise adopt the exemption system.

To preserve the permanent benefit of the country B tax incentive, countries A and B may agree in their bilateral tax convention that all or a portion of the tax relief provided under the particular incentive system is considered to have been paid by SubCo or the country B branch of ParentCo for purposes of determining the taxes owing in country A. In this way, the tax benefit realized by the enterprise in respect of its activities in country B is not offset by a corresponding increase in taxation in country A.

Current treaty practice

The practice of developed countries is not consistent. Many accept tax sparing in their bilateral conventions. Others rarely or never do. One can find examples of recent bilateral tax conventions in which tax sparing has been extended and others in which existing tax sparing measures have been terminated. Thus, the economic benefit of a particular tax incentive established by a developing economy may be preserved or reversed, depending upon the treaty policy or practice of the country of residence of the foreign investor.

In 1997, the OECD Committee of Fiscal Affairs adopted a report, “Tax Sparing: A Reconsideration”, that was generally critical of tax sparing provisions and practices. This report also highlighted the inconsistencies in international practice and made various recommendations regarding the design of tax sparing provisions in those circumstances in which countries chose to adopt these measures.

Paragraphs 75-78 of the OECD commentary to article 23 of its Model Tax Convention on Income and on Capital reflect the concerns expressed in the tax sparing report. However, paragraph 78.1 suggests not that states should necessarily refrain from adopting tax sparing, but rather that such provisions should be limited to the circumstances of less developed economies, and that care should be taken in drafting taking into account best practices.

Policy issues

It is beyond the scope of this policy statement to address the choice between the exemption and the credit method for the recognition of foreign taxes.[1] Nor does this statement consider the desirability, design or efficiency of tax-based economic incentives, a matter on which public finance economists and tax policy experts hold varying views. However, the policy issues raised by tax sparing necessarily demand sensitivity to both of these broader debates.

Tax sparing is sometimes defended by reference to the concept of "tax expenditures". Most tax-based incentives are economically equivalent to grants or subsidies and rely upon the tax system merely for efficient delivery of the incentive. Therefore, it can be argued that it would be equally inappropriate to recoup the value of tax incentives as it would be for the residence state of a multinational enterprise to insist on repayment by the parent of grants and subsidies received by its foreign subsidiaries.

Developing countries often contend that tax sparing is an effective and appropriate means of supporting local government policies designed to stimulate the economy. Presumably, country B has made a determination that this expenditure of public funds is appropriate to generate wealth and well-being for its citizens. It is unfair, following this line of reasoning, for country A to recoup this incentive through higher taxes imposed on ParentCo. Such a system effectively transfers resources from the treasury of country B to the treasury of country A – from the developing to the developed country – and nullifies the sovereign right of country B to adopt industrial policies.

On the other hand, it has been argued that tax sparing is inappropriate, or perhaps more accurately, unnecessary, since credit systems rarely impose tax on the undistributed business profits of foreign subsidiaries (or even, in many exemption countries, foreign branches). Thus, the recoupment by Country A of the tax concession offered in Country B is deferred, perhaps indefinitely. Indeed, some commentators maintain that tax sparing has the perverse effect of promoting repatriation of profits from Country B, contrary to the interests of local economic development. However, the permanence and, in some cases, the effectiveness of the tax concession may nonetheless be adversely affected by the lack of tax sparing.

[1] See ICC policy statement "Tax Exemption versus Tax Credit Systems for Foreign Dividends: Comparison and International Trends", 3 October 2003 for a discussion of some of these issues.

The most common argument made against tax sparing is that the foreign tax credit system is intended to provide relief to ParentCo only for taxes actually paid. If those taxes are reduced, for whatever reason, so should be the credit. According to some, the contention that Country A is required by comity or some other general principle to recognize for credit purposes tax not imposed by Country B is tantamount to accepting the exemption system as the only appropriate method for the recognition of foreign taxes. Naturally, countries that espouse the credit system disagree.

A very practical argument often raised against the inclusion of tax sparing in conventions is that, even if conceptually appropriate, tax sparing is difficult to design and may have undesirable and unintended economic and fiscal effects. The incentive measures protected by tax sparing may themselves be counterproductive. In addition, taxpayers may find means to exploit the tax-based incentive in an inappropriate manner, and may be encouraged in this behaviour by the presence of tax sparing.

Recommendations

ICC, therefore recommends that:

a. Developed economies should, in principle, accept tax sparing in bilateral conventions with developing economies. This is relevant if the developed country adopts the credit method exclusively, resorts to the credit method for certain forms of income (dividends, interest or royalties) or restricts the availability of its exemption in various ways.

b. However, considerable care should be taken in the design of such tax sparing provisions. This may include limitations on duration, careful delineation of the incentive measures and anti-abuse provisions.

c. Greater consistency in tax sparing practice by developed countries is desirable. Developed countries often seek consensual approaches to foreign economic aid and similar considerations should apply to tax sparing.

Where tax sparing is adopted in a bilateral tax convention, consideration must be given to its scope and design. For example, it is understandable that treaty partners are reluctant to extend tax sparing without a clear definition of the domestic incentive to which it applies and the types of activities to which the incentive is available. Although it is not appropriate for one treaty partner to dictate economic policy to the other, there are likely to be circumstances in which tax-based incentive measures are unacceptably broad, open-ended or poorly defined.

It is legitimate for the developed country treaty negotiators to ensure that incentives qualifying for tax sparing are intended to promote substantial and beneficial economic activity in the host country.

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