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Although Canada's direct cash and services foreign aid to developing countries receives a good deal of attention, our indirect foreign aid through what's called "tax sparing"—or tax forgiveness—is less obvious.

Tax sparing involves forgoing tax revenues that would otherwise be payable to Canada, as opposed to direct budget expenditures or cash paid out from taxes collected. For example, the government might collect $100 and pay out $10 in foreign aid. Alternatively, it might collect only $90 and forgive the other $10 as foreign-aid incentives. Both involve real dollars, but paying aid directly is more obvious than tax forgiveness.

Tax forgiveness occurs though negotiated international tax treaties. A multinational enterprise's (MNE) country of residence spares the corporation taxes that it might have had to pay on income it earned in a foreign country, but which the foreign country forgave because of special tax concessions. Thus it is a credit for unpaid taxes, whereby both countries lose tax revenues. The source country loses revenue by forgiving taxes; the residence country loses by granting credits for phantom taxes. It's a win-win for the MNE and an economic incentive for it to invest in the foreign country.

The source country is prepared to lose revenues in the interests of attracting foreign investors in order to stimulate economic investment and development. The residence country loses revenues by giving the MNE a credit for notional taxes that it never paid to anyone and, in effect, subsidizes the source country in the latter's economic development. Thus, tax sparing is essentially a non-transparent form of foreign aid.

For example, the Canada-Brazil Tax Treaty provides that the Canadian government will provide a credit of 25% for withholding taxes on dividends and interest remitted from Brazil to Canada, regardless of whether the tax payer in Brazil actually paid withholding taxes at those rates. Since the normal withholding rate on dividends and interest under the Treaty is set at a maximum of 15%, an MNE investing in Brazil gets a credit for an incremental 10% that its Brazilian subsidiary never actually paid, which clearly boosts its return on equity.

Since the cost of the aid is buried in the loss of tax revenues (“tax expenditures”) to the resident country, the cost is hidden from public scrutiny.

Understandably, tax sparing is controversial. Countries enter into income tax treaties with developing countries for political and economic reasons. Some use tax sparing as part of their foreign-aid policy to promote industrial, commercial and scientific development in developing countries. They are also concerned that if they do not agree to tax-sparing provisions, their MNEs may be at a competitive disadvantage with other countries that do provide for such arrangements.

Thus, competitive economic considerations pull in countries that might otherwise not accede to tax-sparing provisions for principled tax-policy reasons.

Tax sparing encourages MNEs to artificially inflate their profits in the source country by moving revenues to where they will escape taxation. To be sure, transfer pricing rules attempt to prevent such abuses in related party transactions by requiring transfers at fair market values. The rules, however, require efficient tax administration and have substantial costs to enforce effectively. Transfer-pricing litigation makes civil litigation look like a Ferrari on steroids.

Tax sparing first emerged after the Second World War, following recommendations by a British Royal Commission that the United Kingdom adopt the concept in its treaties. Since then, national positions on tax sparing have changed in compassion with shifts in political and economic power. Even the United States, now an ardent opponent of tax sparing, once supported the idea. For example, in 1955, President Dwight Eisenhower addressed Congress on his foreign economic policies and said: “Under proper safeguard, credit could be given for foreign income taxes which are waived for an initial limited period, as we now grant a credit for foreign taxes which are imposed. This would give maximum effectiveness to foreign tax laws that are designed to encourage new enterprises.”

The Senate Committee on Foreign Relations, however, rejected the novel concept and the United States has never returned to tax sparing to support foreign aid.

As with all economic doctrines, the policy arguments on tax sparing range from avid opposition to complete support for the concept. The opposition to, or support of, the concept ebbs and flows as economies develop and global trade and investments shift. Economics is a strong counterweight to theoretical principles in contentious matters such as wealth transfers.

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