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Corporate Tax Centre - In this article, Vern Krishna discusses the concept of tax sparing regarding foreign corporate taxes, tax concessions in a foreign country and details the economics of tax sparing.

Tax Sparing (Vern Krishna)

Date: November 3, 2014

Tax Sparing—Vern Krishna

Canada's direct economic foreign aid to developing countries receives a good deal of attention from policy wonks and politicians. Less obvious—because it is less understood—is Canada's indirect foreign aid through international tax treaties through tax sparing. Tax sparing is an economic concept that allows a country to grant foreign aid through the tax system instead of direct parliamentary budget expenditures.

Under tax sparing, a multinational enterprise's country of residence spares the corporation taxes that it might have had to pay on income that it earned in a foreign country, but which the foreign country forgave because of special tax concessions. Thus, tax sparing 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. A win-win for the MNE.

The source country is prepared to lose revenues in the interests of attracting foreign investors to it in order to stimulate economic investment and development. The residence country loses revenues by giving the MNE a credit for notional taxes never paid, but gets nothing in return. Thus, the residence country subsidizes the source country in the latter's economic development—an indirect and non-transparent form of foreign aid.

For example, the Canada- Brazil Tax Treaty provides that the Canada will provide a credit of 25 percent for withholding taxes on dividends and interest remitted from Brazil to Canada, regardless whether the payer in Brazil actually paid withholding taxes at those rates. Since the withholding rate on dividends and interest under the Treaty is set at a maximum of 15 percent, the Canadian parent corporation gets a credit for an incremental 10 percent that its Brazilian subsidiary never paid in taxes. Clearly, an incentive for Canadian MNEs to invest in Brazil

The concept of sparing emerged in the 1950s 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 political and economic shifts. Even the United States, now an ardent opponent of tax sparing, supported the idea in the early 1950s. For example, in 1955, President Eisenhower spoke to 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.

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 is essentially a non-transparent way of providing foreign aid. 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.

Tax sparing distorts capital markets and the allocation of resources between domestic and foreign investment decisions. For example, an MNE that can take advantage of tax sparing in a foreign country has a competitive advantage over domestic enterprises in the residence country. Clearly, a policy that rewards an MNE for its foreign investments compared with domestic enterprises is neither neutral nor economically efficient for the residence country.

Tax sparing also promotes avoidance corporate conduit structures in international business and is a magnet for treaty shopping. Thus, the best route for Canadian corporations into India is through Mauritius.

Tax sparing also allows MNEs to inflate their profits in the source country through transfer pricing mechanisms. To be sure, transfer pricing rules attempt to prevent such abuses in related party transactions. The guidelines, however, require efficient tax administration and have substantial costs to enforce effectively. Transfer pricing disputes involve prolonged litigation.

There is, however, an alternative view of tax sparing. As with all “tax expenditures,” tax sparing incentives are equivalent to direct grants or subsidies. Many countries have systems in which they provide direct grants and subsidies to businesses for certain types of operations in certain locations. These grants and subsidies are a cost. Forgiveness of tax through a tax holiday is nothing more than an economic cost to the source and residence countries. The only difference between a direct grant and forgiven taxes is in the manner of delivery of tax benefits. Just as it would be inappropriate for the residence country to seize the direct grant that a business received in the source country, it would be equally inappropriate for the residence country to “claw back” tax incentives provided by the developing country.

As with all economic doctrines, the policy arguments on tax sparing range from complete opposition to complete support for the concept. Further, the opposition to, or support of, the concept evolves and changes as economies develop and global trade and investments increase. Pragmatic economics is a strong counterweight to theoretical tax principles.

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