**TAX SPARING**
**A Reconsideration**

*(adopted by the OECD Council on 23 October 1997)*

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## FOREWORD

The changes in the international setting have lead both OECD Member and non-Member countries to reconsider their attitude towards including tax sparing provisions in their tax treaties. This re-consideration has in particular been provoked by the realisation that tax sparing provisions in treaties offer wide opportunities for tax planning and tax avoidance.

This report explains why Member countries have become more reluctant to grant tax sparing in treaties. It also provides a set of suggestions ("best practices") on the design of tax sparing provisions to minimise abuse.

In approving the Report by the Committee on Fiscal Affairs on "Tax Sparing: A Reconsideration, on the 23rd October 1997, the OECD Council adopted a Recommendation to the Governments of Member countries and instructed the Committee to pursue its work on issues pertinent to tax sparing and to develop a dialogue with non-Member countries that request tax sparing, with the aim of developing a more coherent position on the granting and design of tax sparing provisions (see Annex VIII).

# I. INTRODUCTION

## a) The changing global economic framework

The removal of capital controls and the continuing liberalisation of the financial markets have increased the flows of cross-border investment and accelerated the pace of integration of national economies. Improved global communication technologies have enabled large corporations and financial institutions to develop global strategies. Whilst these developments have lead to a rapid expansion of cross border activities, which in turn has increased the wealth of nations, they have also increased the geographical mobility of national tax bases and the scope for tax avoidance and evasion.

Globalisation has also contributed to the integration of non-OECD economies into the world economy. Many Asian and Latin American countries are today major players in the world economy and account for an important part of global trade and investment. They are amongst the largest trading partners and recipients of inward investment from OECD Member countries. This rapid economic growth in the Asian and Latin American regions has created a more balanced distribution of trade and investment flows between OECD Member and non-Member countries.

The move from planned to market economies by the former Soviet bloc countries has brought new actors into the international economic arena and already some of these economies, particularly Russia, are playing an increasingly important role in international trade.

These developments have blurred a number of traditional distinctions which underlie existing international tax arrangements. Outside of the OECD area there are an increasing number of countries which have a high per capita income and a developed and diversified industrial base. Many of these countries are rapidly developing their service and high technology sectors. A number of them (*e.g.* Argentina, Chile, Singapore, Chinese Taipei) have a higher per capital income than some of the less developed Member countries.

Similarly, the assumption that all OECD Member countries are major exporters of capital and all non-Member countries are major importers of capital is increasingly being questioned. Australia, the Czech Republic, Canada, Hungary, Mexico and Poland, for example, are major importers of capital, whilst non-member countries such as Chile, Chinese Taipei, Singapore are now major sources of foreign direct investment.

Many OECD Member countries share the tax policy concerns of non-Member countries which rely on the extraction and processing of natural resources. Australia, Canada, Norway, the UK and the US are all major natural resource producers.

Today's world is far too complex and diversified to allow traditional and potentially misleading distinctions to influence approaches to negotiating tax treaties. A reassessment is required recognising that whilst there are many countries outside of the OECD area which remain developing countries (most African countries for example), a growing number of non-Member countries are now rapidly catching up with Member countries in terms of their level of economic development.

This increasing commonality of interest between OECD Member and certain non-Member countries needs, however, to be put in perspective. Whilst investment flows between OECD Member and non-Member countries are now becoming more balanced, most developing countries continue to rely heavily on capital imports for their development and this is unlikely to change in the immediate future.

Many countries provide incentives to encourage domestic and foreign investment. These can take the form of cash grants, in-kind advantages (*e.g.* free land), favourable access to government contracts and tax incentives. This note is concerned with the issues that arise when subsidies are delivered by means of the tax system.

Whilst recognising the right of source countries to structure their tax systems in accordance with their own objectives, the purpose of this report is to promote a collective reconsideration of tax sparing provisions and to assist in the development of a more coherent approach by both OECD Member and non-Member countries to tax sparing.

At the outset, it may be useful to provide a brief description of what is "tax sparing". To encourage foreign investment, many countries grant different kinds of tax concessions to foreign investors. When such a country concludes a convention with a country that applies the exemption method (see Article 23A of the Model Tax Convention), no restriction of the relief given to the taxpayer arises, because the other country must give exemption regardless of the amount of tax, if any, imposed in the country of source. The exemption method usually applies to direct investments (*e.g.* investments made through subsidiaries or permanent establishments). But where the other country applies the credit method (see Article 23B of the Model Tax Convention), the concession may be nullified to the extent that such other country will allow a deduction only of the tax actually paid in the country of source. This may be seen as frustrating the other country's tax incentive legislation.

Box I

EXAMPLE

Company A that is a resident of country X establishes subsidiary S in country Y. S derives 100 in net income during its first year of operation. The income tax rate in country Y is 30 per cent. Because of applicable tax incentive legislation in country Y, S pays no income tax during the first five years of operation. Accordingly, the taxes spared in year 1 by S in country Y amount to 30.

In year 2, S pays 50 of its net income in dividends to A in country X. The corporate income tax rate in country X is 40 per cent. There is no tax at source on outward dividends in country Y. Country X taxes foreign dividends at the full corporate income tax rate, but allows a credit for foreign taxes paid, including corporate income tax paid by foreign subsidiaries on income out of which the dividends are paid (the "underlying tax" on the income distributed). Since no tax has been levied in country Y on the distributed income, A will pay 20 in corporate income tax on the dividends in country X (40 per cent out of 50).

To avoid that result, some countries have agreed to include "tax sparing" provisions in treaties with developing countries. In the case of a credit country, tax sparing provisions basically enable the investor to obtain a foreign tax credit for the taxes that have been "spared" (*i.e.* not actually paid) under the incentive regime of the source country. Similarly, to the extent an exemption country applies the credit method, *e.g.* in respect of portfolio dividends or interest (see Article 23A of the Model Tax Convention), a tax sparing provision will enable a crediting of the tax that has been spared in the source country.

Box II

EXAMPLE

Following the example above, the tax sparing provision in the tax treaty between country X and country Y would require country X to grant A a credit for the taxes that would have been paid by S on the distributed income in the absence of the incentive legislation in country Y. The tax due on the dividends in country X amounts to 20 (40 per cent out of 50). However, A is now granted a credit of 15 (30 per cent out of 50), constituting the tax that would have been paid in country Y had S not benefited from the incentive legislation. Because of the tax sparing provision in the treaty, A will pay only 5 in income tax in country X on the dividends.

### b) Tax sparing - a time for reconsideration?

The new global environment has encouraged, and in some cases even compelled, countries to re-examine established tax structures and the policies upon which taxation arrangements are based. Tax sparing arrangements have not escaped this scrutiny. Tax sparing provisions have more than four decades of history in bilateral tax treaties, including treaties between OECD Member countries, but the world of today is quite different from that when the positions of Member and non-Member countries towards tax sparing were developed.

The large majority of the OECD Member countries are of the view that the provision of tax sparing in treaties is not an effective way to promote foreign investment and to promote national economic goals. These views have been reinforced by the overall disappointing experience of most Member countries and many economies in transition with the use of tax incentives: a trend well documented in a recent OECD publication entitled “Taxation of Foreign Direct Investment” (1995). Furthermore, recent experience shows that tax sparing provisions offer ample opportunities for tax planning and tax avoidance which undermines the tax bases of both the residence and source country.

There are also many misconceptions of the views of foreign investors to tax sparing. Investment decisions taken by international investors resident in credit countries are rarely dependent on or even influenced by the existence or absence of tax sparing provisions in treaties. This is supported by the experience of the international business community which encourages countries to conclude treaties regardless of whether tax sparing can be obtained.

At the same time, some non-Member countries are becoming concerned about the concessions that they have to make to obtain tax sparing when negotiating tax treaties. These concessions may take the form of lower withholding tax rates or stricter permanent establishment rules. These countries are questioning whether the price of obtaining tax sparing is too high given the limited benefits of such provisions.

This report presents a brief overview of the historical background of tax sparing provisions (section II) and of the traditional country views on tax sparing (section III). A review is provided of the reasons behind the changing Member country attitudes to tax sparing (section IV). It further provides an analysis of recent trends and current Member country practices (section V), and some best practices in regard to the design of tax sparing provisions (section VI). Finally, some recommendations are made in section VII. Annex I reproduces in alphabetical order the Member country tax sparing provisions referred to in this report and Annexes II and III provide charts of existing tax sparing provisions in treaties between OECD Member countries and between OECD Member countries and selected non-Member countries. Annexes IV and IV contain examples of tax avoidance schemes detected in Member countries. Annex VI reproduces examples of Member country model tax sparing anti-abuse provisions and Annex VII reproduces the section on tax sparing in the OECD Model Tax Convention. The recommendation of the OECD Council on the granting and design of tax sparing in tax conventions is reproduced in Annex VIII.

For the purposes of this report, the term “resident country” refers to the country that grants tax sparing in a tax treaty. The terms “host country” and “source country” refer to the country to which tax sparing is granted.

## c) The growing importance of the Model Tax Convention outside the OECD area

The changing global economic framework and increasing economic strength of many non-Member countries in both Asia and Latin America have led to a reconsideration of non-Member countries attitudes to tax treaties.

Many advanced non-Member countries are today in the process of expanding and up-dating their tax treaty network. Some, particularly in the Latin American Region (following the lead of Mexico and taking into account the development of regional trading blocs), are re-assessing their policy of not negotiating tax treaties. Since several of these countries are both capital exporters and capital importers, they have begun to look to their policy interests as both source and residence countries rather than as one or the other. This has led to an emerging recognition among many advanced non-Members that tax treaties which follow the OECD Model Convention provide a favourable tax climate to promote cross-border flows of investment and trade, although they will not always wish to follow all of the provisions of the Model.

Most of the 1500 or so bilateral tax treaties currently in force world-wide are based on the Model Tax Convention. The Model is widely used not only in treaty negotiations between Member and non-Member countries, but also in negotiations between non-Member countries. The importance of the OECD Model is further evidenced by the fact that about 90 per cent of the text of the UN Model Tax Convention is based upon the OECD Model. The growing interest among non-Members to become more closely associated with the work of the Committee on Fiscal Affairs in this area also supports this view.

## II. THE HISTORICAL DEVELOPMENT OF TAX SPARING PROVISIONS

One early reference to tax sparing can be found in the 1953 report of the British Royal Commission (referred to by Prof. Surrey at the US Senate hearings on 9 August 1957). The Commission examined the question of aiding British investment abroad through tax policy and recommended adoption of the concept of tax sparing. The Parliament debated the issue in 1953 and a second time in 1956. The Commission proposal was finally rejected by the Chancellor of the Exchequer in 1957. However, the debate on the issue continued in the following years and, in 1961, legislation was enacted enabling the UK to give relief to developing countries for taxes spared under foreign incentive programmes tailored to promote industrial, commercial, scientific, educational or other development.

Tax sparing appeared in a treaty context for the first time in 1957 in a treaty negotiated between the United States and Pakistan. The tax sparing provision of the US-Pakistan treaty is reproduced in box III below:

Box III

Pakistan-US (1957) - Article XV

For the purposes of this credit there shall be deemed to have been paid by a United States domestic corporation the amount by which such Pakistan taxes (other than the business profits tax) have been reduced under the provisions of section 15B of the Income Tax Act, 1922 (XI of 1922) as in effect on the date of the signature of the present Convention: Provided, that any extension made by law of the period within which an industrial undertaking may be set up or commenced in order to obtain the reduction provided in section 15B shall be deemed to be in effect on the date of the signature of the present Convention. [...]

As regards the scope of benefits covered, the Pakistan-US treaty (1957) provided for temporary tax sparing on business (permanent establishment) income, derived by specified enterprises established during 1958 which were partially or fully exempt from tax by a certain Pakistani statute. As regards limitations, tax sparing was applied only to tax reductions or exemptions granted under the specified law that was in force at the date of the signature of the treaty. The tax sparing credit was available only for investment that earned no greater than a 5 per cent return.

The US Senate, however, firmly rejected the tax sparing provision in the proposed US-Pakistan treaty and refused to ratify the treaty in its original form because of the inclusion of the tax sparing provision. The United States has ever since steadfastly opposed the inclusion of tax sparing provisions in their treaties.

Notwithstanding the consistent US opposition to tax sparing, the inclusion of tax sparing provisions in treaties by other countries increased world-wide throughout the 1960s and 1970s. Furthermore, the tax sparing provision of the non-ratified US-Pakistan treaty (as well as other tax sparing provisions in US treaties that were negotiated in the late 1950s but that never entered into force) came to influence the design of tax sparing provisions in other treaties, notably with respect to the scope of benefits covered and to limitations.

In some cases, the provisions were broader than the original proposals in the US treaties. For example, formulations that would allow continuation of tax sparing after amendment to the incentive provisions were added in a number of treaties (a) clarifying the continued application in the case of minor modification of the specified measures [*e.g.* Pakistan-UK 1961], (b) allowing the possibility to agree bilaterally to extend tax sparing to subsequent substantially similar measures [*e.g.* Pakistan-UK (1961)] or (c) allowing broad possibilities for expansion [*e.g.* Italy-Zambia (1972)].

The benefits of tax sparing were also expanded to include reduction of tax in a source country by agreed treaty rates applicable to the payments of dividends, interests and royalties [*e.g.* France-Israel (1963), Japan-Korea (1970)].

Another development was that the amount of withholding tax "deemed paid" on the payment of dividend, interest and royalties was fixed in a number of tax treaties [*e.g.* Germany-Indonesia (1977), Brazil-Japan Protocol (1976)].

Time limitations were also introduced, generally in one of the following two types: *a)* limiting the application of tax sparing benefits to a specified number of years in respect of a particular source [*e.g.* UK-Indonesia (1974)] or *b)* limiting the effect of the tax sparing provisions ("sunset" clause) by providing for the expiration of the provision [*e.g.* Sweden-Philippines (1966)] or by applying mandatory review [*e.g.* the Australia-Singapore treaty signed in 1969 would have expired in 1974 had there been no agreement by the governments in the form of an Exchange of Notes]. The issue of introducing "Sunset" clauses was raised relatively early, but their use did not seem to spread until the mid-1980s.

A discussion of the tax sparing issue was inserted in the Commentary on Article 23 of the 1963 Draft Double Taxation Convention. This discussion was expanded in the 1977 Model Tax Convention. The Commentary refers to various formulations by a brief description of their nature. (paragraphs 72-78 of the Commentary on Article 23 of the Model are reproduced in Annex VII).

## III. TRADITIONAL COUNTRY POSITIONS ON THE ISSUE OF TAX SPARING

Many OECD Member countries that have been critical to or opposed the inclusion of tax sparing provisions in treaties apply the credit method to avoid double taxation. These countries generally take the view that the overall tax system of a particular country should be neutral so that the tax consequences of investment decisions ought to be the same regardless of whether the investment is made at home or abroad. Tax considerations should not influence investors' decisions to invest domestically or abroad.

To satisfy this objective, many such countries apply the foreign tax credit method in taxing foreign source income. Tax sparing provisions are incompatible with the policy behind the credit method in that they preserve the effectiveness of foreign tax incentives, making it more favourable, with respect to taxation, to invest abroad than at home.

With the exception of the United States, developed countries have nevertheless granted tax sparing to developing countries in treaties. The reasons are several.

Most Member countries have traditionally viewed tax sparing as part of the foreign aid policy and granted it with a view to promoting industrial, commercial, scientific, or other development in developing countries. Some Member countries have granted tax sparing as a matter of tax policy. This policy has partly been prompted by a fear that a consistent application of the credit method would put their resident investors at a competitive disadvantage compared to local or other foreign investors able to fully benefit from tax incentives in the host country.

Tax sparing is also frequently used as a bargaining chip in treaty negotiations. Some Member countries are prepared to offer tax sparing in exchange for other benefits; for example, lower withholding taxes on dividends, interest, and royalties. Furthermore, some developing countries simply refuse to conclude treaties unless tax sparing is granted. Many OECD Member countries have therefore accepted the necessity of granting tax sparing in order to have treaties with certain developing countries (however, see Section II, paragraph 5 for the position of the United States).

Tax sparing is also an issue for countries that are usually categorised as "exemption countries" to the extent that these countries still apply the foreign tax credit method to certain categories of foreign income, typically passive, portfolio income, and/or operate a general exemption system which provides for the possibility to switch-over to the credit method in particular situations (anti-avoidance rules may provide that foreign direct investment dividends or business income are exempt only if the income has been subject to a certain minimum taxation in the foreign country).

The exemption-oriented countries usually attach more importance to creating a tax environment where their MNEs can operate on equal terms with local investors in foreign markets than creating a tax neutral environment in relation to other resident investors. This is particularly so for smaller countries that have small domestic markets, but relatively large numbers of companies operating globally. In these countries, foreign investment tends to supplement rather than constitute a substitute for domestic investment, as the domestic markets provide few investment opportunities for their resident MNEs.

These countries have often been more willing to grant tax sparing to developing countries. In part, they have been influenced by the considerations mentioned in paragraphs 4 and 5 of this section. In part, it has simply been considered consistent with their overall tax policy objectives to grant tax sparing.

## IV. TAX SPARING: AN EMERGING CONSENSUS ON THE NEED FOR A RE-EVALUATION

A re-evaluation of the benefits of tax sparing is underway in many countries, both within and outside of the OECD area. This re-evaluation has been prompted by the trends referred to in Section I of this paper, by a greater awareness of the potential for abuse of tax sparing provisions and a greater awareness on the ineffectiveness of tax incentives to promote economic development.

### a) The new global economic framework

***The increasing economic strength of non-Member countries***

Over the years, the primary policy rationale for granting tax sparing has been the necessity to promote economic development in developing countries. Some countries which were developing countries in the 1960s and 1970s, are now economically much more sophisticated. Certain non-Members have today reached an economic level which is equivalent or even superior to that of some Member countries. These developments have made many OECD Member countries more reluctant to grant tax sparing provisions in new or renegotiated treaties.

*The repercussions on the resident countries of granting tax sparing*

The tax sparing device was developed at a time when the size of global trade and investment was relatively modest, national markets were heavily regulated and where there were extensive controls on inward and outward investment. As globalisation has radically increased the amount of cross-border trade and investment and lowered or eliminated traditional barriers on such activities, the potentially adverse effects on the resident country economy of granting tax sparing have become more evident in recent years. Because of the difficulty of limiting tax sparing to typically domestic activities, parts of the industry of the resident country may inadvertently end up competing with enterprises falling under incentive legislation in the host country (indirectly) benefiting from tax sparing (as regards economic distortions and abuse, see below).

## b) Tax sparing as an instrument of foreign aid

As can be seen from the criteria used by countries to grant tax sparing, foreign aid considerations are taken into account.

Direct foreign aid is a relatively transparent means of providing assistance to developing countries. The recipient(s), the amount, and the anticipated use of the foreign aid can generally be established in relatively precise terms. Many of the control mechanisms associated with foreign aid are missing from tax sparing. The resident country is not usually involved in the identification, assessment, design, implementation, monitoring and evaluation of tax spared projects. Tax sparing viewed as aid is also subject to the traditional criticism attached to any form of tied aid; the assistance is linked to companies resident in the country providing the tax sparing. Generally speaking there are no limits on the amount of tax sparing provided. The only limit is the amount of income generated by investors in the host country. Often, it is impossible for the home country to assess accurately the tax revenue cost of its tax sparing arrangements. Furthermore, tax treaty negotiators mostly grant tax sparing without considering the nature and extent of other direct aid flowing to that developing country. The value of the tax sparing to the investors fluctuates with the rates of tax in the host and home country. Some commentators have agreed, however, that tax sparing has the advantage of being an automatic transfer of resources and one which promotes directly private sector development (for a more general discussion on the advantages and disadvantages of assistance provided directly or by means of the tax system, see Section IB of the 1984 OECD report, “Tax Expenditures. A Review of the issues and Current Practices”).

## c) Tax Sparing may encourage an excessive repatriation of profits

The purpose of tax incentives for which tax sparing is typically required is to attract foreign direct investment. Tax sparing provisions may have a counterproductive effect in this regard in that they provide an encouragement for foreign investors to repatriate an excessive percentage of their profits rather than to re-invest these profits in the source country to consolidate or to expand the original investment, and thereby further promoting that country's economic development. Indeed, in the case of foreign investment through a local subsidiary, which is by far the most common form of foreign direct investment, tax credit countries typically defer tax on subsidiary profits until those profits are distributed. When those distributed profits bring with them a tax sparing credit, the effects of tax sparing are perverse since it encourages the return of profits to the residence country rather than the re-investment of these profits in the country of operation. Consequently, source countries, particularly those wishing to encourage re-investment, need to give careful consideration to achieving a proper balance between the need to attract new investment and the need to encourage re-investment of profits made by existing foreign investors. Tax sparing risks upsetting this balance.

Box IV

In renegotiating expired tax sparing provisions, OECD Member countries are often presented with figures of the actual flows of dividends and other income out of the host country to illustrate the amounts that would be immediately taxed in the residence country in the absence of the tax sparing provision. However, these figures are often necessarily inflated, because they are premised on the existence of a clear incentive (the provision of tax sparing relief) to repatriate profits early. Regardless of the existence of any tax sparing provision, it is recognised that companies operating in countries with high rates of inflation tend to have their profits from those operations repatriated as quickly as possible.

### d) The basic assumption underlying tax sparing is invalid

The preceding comments also point to a deficiency in the basic assumption underlying tax sparing, *i.e.* that without tax sparing, the tax foregone through the granting of a tax incentive will accrue to the treasury of the country of residence of the investor. This assumption requires that the income that has benefited from the tax incentive be taxed also in the country of residence of the investor. However, companies tend to maximise the tax benefits derived from incentives even in the absence of tax sparing. Taxation in the country of residence may either never occur or may occur only after a number of years.

First, as already noted, in the case of foreign investment through a local subsidiary, which is by far the most common form of foreign direct investment, tax credit countries will not tax the subsidiary's profits until those profits are distributed as dividends.[1] Yet a large part of profits of companies are never distributed as dividends, but re-invested in the country of origin or abroad.

Also, since dividends may be paid only many years after the underlying profits are earned, if one wanted to determine to what extent the tax imposed in the country of residence offsets the tax foregone in the source country through the tax incentive, one would need to discount the amount of residence tax to reflect its present value at the time the income is earned.

Finally, one should also take account of the particular features of foreign tax credit systems. When tax sparing is not granted and the foreign profits which have not borne local tax because of a tax incentive provision are repatriated (or included in the tax base currently in the case of branch operations), it is not the case, as if often assumed, that the residence country will automatically increase its share of tax revenues from the local investment. Almost all credit-based residence countries allow a broad "averaging" of income and income tax rates for active business income. Thus the repatriation or accrual of low-taxed or untaxed foreign income will often simply allow the investor to utilise credits for "excess" taxes already paid with respect to other higher-taxed investments. As a result of the general lowering of tax rates in OECD Member countries in recent years, the large majority of corporate investors appear to be in "excess" credit positions and can thus effectively utilise tax-free foreign income. As a result, in most cases, the investor and not the residence country in effect benefits from the local tax incentive.

The foregoing point may be illustrated by the experience of the United Kingdom. The UK allows credit for foreign tax paid on an item of income only against the UK tax otherwise payable on the same item of income. Foreign tax that cannot be credited in this way cannot be relieved in another year. Many UK groups seek to circumvent these restrictions by using so-called "mixer companies". The mixer company will be the immediate subsidiary of a UK company and it will in turn hold investments in a number of other companies.

Some of these will be in high tax jurisdictions and others in low tax jurisdictions. The mixer company may, for example, receive from one subsidiary gross dividends of 100 in respect of which no foreign tax is paid and gross dividends of 100 from another subsidiary in respect of which foreign tax (underlying or indirect tax as well as withholding tax) of 66 is paid. Out of those two separate streams of income the mixer company will pay a single gross dividend of 134 to the UK. If the mixer company is resident in another EC Member State, no withholding tax will be deducted from the dividend paid to the UK company. The latter will be regarded for UK tax purposes as having received a gross dividend of 200 in respect of which credit relief of 66 is available. This is exactly the amount required to cancel UK tax liability on the dividend at 33 per cent. In the Finance Act 1997, the UK Parliament enacted legislation to counter avoidance schemes that took the abusive use of mixer companies beyond acceptable limits, for example by buying-in highly-taxed foreign income from a previously unconnected group.

Box V

The US business community, established in foreign countries that have been unwilling to conclude tax treaties with the US without tax sparing, has in recent years encouraged those countries to enter into treaty negotiations with the US, notwithstanding the consistent US opposition to granting tax sparing. Many US companies have acknowledged that they do not need tax sparing to invest in a developing country. These companies recognise that it is rather the absence of a tax treaty, not the absence of tax sparing, that deters further investment.

## e) Effectiveness of tax incentives

As discussed below, another reason for the growing opposition to the use of tax sparing is the overall disappointing experience of OECD Member countries and other countries with the use of tax incentives. Tax incentives are viewed by a growing number of countries as distortive and as an inappropriate tool for economic development (see the 1995 OECD report, "Taxation and Foreign Direct Investment. The Experience of the Economics in Transition"). During the past decade, the policy of most OECD Member countries has therefore been to move away from the use of tax incentives and instead broaden the income tax base and reduce the tax rates. While developing countries are of course free to set their own policies regarding tax incentive devices, Member countries are also free to question the effect that such devices can have on their own tax base through tax sparing.

Whilst all OECD Member countries continue to use some form of tax incentives, these incentives are increasingly focused on specific areas, particularly where there are significant externalities. Thus many countries provide specific tax incentives for Research and Development and for environmental purposes. Nevertheless the general trend has been to move away from general tax incentives to promote economic development. The following paragraphs summarise the experience of OECD countries and of the former Socialist countries with the use of tax incentives. These experiences may also apply to other countries. A full description of these experiences can be found in the 1995 OECD report referred to in the previous paragraph.

***Costs and gains***

The direct cost of a tax incentive is the resulting foregone tax revenues. The expectation is that a small contribution of public funds will induce a substantial increase in private sector funds for investment. However, most empirical evidence suggests that the foregone tax revenue exceeds the increase in the desired investment (*e.g.* the Canadian experience suggests that a dollar of revenue foregone yields only 80 cents of new investment that would not have been undertaken in the absence of the incentive). The reason is that it is very difficult to target exclusively incremental investment. Therefore, a substantial amount of the incentives generates investment that would have occurred in any event.

***Targeting***

It is difficult to ensure that the companies which are intended to use the incentives are able to do so with any degree of confidence. But it is even more difficult, as most developing countries have found, to ensure that taxpayers who are intended to be excluded are effectively precluded from taking advantage of the incentives. Taxpayers naturally arrange their affairs to qualify for the incentives. For example, where tax concessions are available only to foreign investors, domestic investors may, to become eligible for the tax concessions, establish a foreign subsidiary and then route purely domestic investments through that foreign company. The negative impact of tax planning alone may neutralise the public benefits otherwise flowing from the incentives. Anti-avoidance rules are therefore often required. These rules are inevitably complicated and frequently work against the certainty that is required if there is to be any positive effect from the measure.

Furthermore, because foreign investors have difficulty in knowing how long tax incentives will be maintained, the incentives tend to attract companies engaged in sectors such as the retail trade and the service sector. These categories of activities are, however, highly mobile ("footloose" companies). Therefore, when the incentives expire, the activities often move to other jurisdictions offering the same type of incentives. The mobility of the activity that makes the company responsive to the incentive also acts to limit the benefit to the host country. This uncertainty sometimes also induces companies established in the host country to extract profits from the country rather than re-invest them there.

***Complexity***

Another problem with incentives is the complexity they introduce into the tax system. Incentives require definitions of the eligible activities. This in itself complicates the tax legislation. This is particularly so where the incentives attempt to attract special classes of activities, such as high technology or R&D activities. The legislation must be sufficiently precise to allow taxpayers to predict accurately whether or not they qualify for the provision. If it is not, taxpayers cannot plan their affairs on the assumption that they will receive the incentive. In this case its receipt is simply a windfall to them, with no positive impact on their behaviour.

***Tax competition***

The use of tax incentives has also the potential of triggering competition, particularly among countries in the same region or among countries having similar industry structures. For example, a country may be tempted to use tax incentives to attract so called footloose manufacturing companies or to offer substantial tax cuts to global companies willing to establish a regional base (including Headquarters companies) in its country for manufacturing and supply. The response of the country that views itself as being in competition with the country offering incentives is to introduce some form of off-setting incentive. In the end, the tax incentives offered by the countries do nothing to alter the relative incentive to invest between the two countries. The only result of the competition is that both countries receive lower tax revenues.

### *Non-tax factors versus tax factors*

When planning and making investment decisions, enterprises base their decisions on a wide range of different factors, such as political stability, size and location of markets, profitability, security of tenure, availability and cost of skilled labour and of raw materials, exchange control regulations, availability of roads, railways, harbours and other transport facilities, a trained and efficient civil service and the tax consequences of the investment. Thus, taxation is only one of many factors affecting the investment behaviour of enterprises. To the extent that companies do take tax factors into account, they generally attach greater importance to the overall structure and administration of the tax system than to the existence of tax incentives.

### *Lobbying*

Another general problem with incentives is that their adoption into a tax system leads to pressure from other deserving sectors for special treatment. Whenever incentives are provided to one type of activity there will be other activities which are closely related to the preferred activity that do not qualify for the incentive. They will be able to argue that they are disadvantaged in competing with the companies receiving the incentives. A similar argument is often raised where incentives target only foreign investors. The question is then asked why the government should disadvantage domestic companies relative to foreign-owned companies? This kind of lobbying is very difficult to withstand once some targeted incentives have been given. The general experience is that incentives over time spread to other activities and that it is politically difficult to remove them, notwithstanding the reason for their introduction may be gone long ago. While any one targeted incentive may not involve a significant revenue cost, the total for all the resulting incentives can sharply erode government revenues from the business sector.

### f) Abuse of tax sparing provisions

A growing criticism raised against tax sparing is based on the realisation that tax sparing provisions in treaties in themselves offer wide opportunities for tax planning and tax avoidance. Not only may residents inappropriately exploit tax sparing provisions, but the residence country may also be used as a conduit by third country residents (treaty shopping). The cost of such tax avoidance schemes to the residence country may be huge - particularly where the country is being used as a conduit. The source country may also find that its revenue base is eroded in unintended ways.

The most common tax avoidance schemes involving tax sparing provisions may be divided into four different groups:

#### *Transfer pricing abuse*

Tax sparing provisions provide an inherent incentive to affiliated companies in the residence country (or third countries) to inflate the profits in the host country through transfer pricing abuse. This leads to a loss of tax in the residence country and requires valuable resources to be devoted to identifying and investigating such cases. Although the OECD Transfer Pricing Guidelines (OECD 1995) are intended to limit the scope for such abuse, the effectiveness of counteracting measures very much depend on the efficiency of the administration. Furthermore, although transfer pricing and expense allocation rules are tailored to deal with such avoidance schemes, they are unlikely to act as an effective counter in all cases.

#### *Conduit situations*

In a typical conduit situation, a third country investor attempts to exploit the existence of tax sparing in the treaty between the resident country and the source country. The third country investor, wishing to invest in the source country, establishes a company (or several companies) in the resident country with a view to channelling the investment to the source country through the resident company. The conduit company thereby becomes eligible for the tax sparing benefits granted in the treaty (for an example of conduit scheme, see annex IV).

***Routing***

Routing is particularly common in situations where the resident country has agreed under a tax treaty to spare withholding tax on interest or royalties. For example, a resident bank making a loan to a foreign investor may be tempted to route the transaction through a financial institution in a developing country to benefit from tax sparing granted in respect of withholding tax on interest in the treaty between the resident country and the developing country (for an example of a routing scheme, see annex V).

***Potential government abuse of tax sparing***

Tax sparing provisions also create an incentive for host countries to maintain artificially high rates of tax. In some cases "special" tax rates appear to have been designed primarily to secure greater tax sparing credit benefits for foreign investors of credit countries .

**g) Administrative difficulties**

Many OECD Member countries have encountered administrative difficulties in applying tax sparing provisions. For example, where the tax sparing provision refers to particular sections of the law of the host country under which that country's tax is waived or reduced for the purpose of promoting economic development, it is often difficult, if not impossible, to establish whether the taxpayer has really benefited from the incentives identified in those sections. Often, the taxpayer is unable to verify it, and the competent authority of the host country is unwilling or unable to provide assistance.

## V. RECENT TRENDS IN TAX SPARING PROVISIONS

Over the past 15 years, the number and variety of tax sparing provisions have increased considerably. In an attempt to deal with some of the problems described above, the provisions have generally become more targeted.

Some of the new features found in tax sparing provisions in recent years relate to the categories of taxpayers, countries or income eligible, the limits on the deemed paid tax, the period of availability, and the need to combat abuse.

### a) Categories of taxpayers

Where the scope of taxpayers is not limited and the tax sparing includes interest and dividends, purely private loans and investment would also be covered, *e.g.* income received by individuals [*e.g.* Canada-Thailand (1984)]. A number of recent treaties therefore limit the application of tax sparing to companies and/or to investments made by taxpayers with substantial holdings [*e.g.*, Canada-Argentina (1993)].

### b) Categories of income

The categories of income covered by tax sparing provisions vary between different treaties. References are often made to the relevant provisions of the law of the source country. Typically, the scope of the tax sparing provision is limited to income derived from tax incentives designed to promote economic development in the host country. Many countries now add additional conditions, for example, to prevent investment income (*i.e.* interest and capital gain) from being included in the business income [*e.g.* Denmark-Poland Protocol (1994)].

Income from corporate activities do not generally require a tax sparing provision to avoid taxation in the residence country insofar as the corporate earnings are re-invested in the host country. When tax sparing is given also on corporate income, dividends paid by foreign subsidiaries out of eligible income are exempt from residence taxation to preserve the effect of the host country exemption from or reduction of tax.

Tax sparing on interest income has posed a number of problems, perhaps because funds are highly mobile and the amount of "deemed withholding tax paid" is calculated on the gross amount of interest, not all of which is necessarily attributable to the host country. A number of different approaches have been adopted to reduce or eliminate such problems. Apart from not extending tax sparing to interest income [*e.g.* the provisions in Japan-Bulgaria (1991) and Japan-Vietnam (1995) provide for tax sparing on dividends and royalties, but not on interest income], many countries limit tax sparing to interest income that seem unlikely to attract abuse [*e.g.* scope of lenders and borrowers limited to non-financial enterprises, *i.e.* manufacturers, *e.g.* Argentina-Canada (1993)].

**c) Limitation of the "deemed paid tax"**

The overall benefit of tax sparing obtainable by taxpayers resident in countries applying the credit method in their tax treaties is determined by the combination of the scope of the provision and the amount of "spared" tax. Whilst the former is generally specified in the treaty, the latter could be increased by unilateral changes of the general tax rate in the host country. A number of safeguards have been inserted in recent treaties to restrict the ability of the host country from unilaterally changing the rate of deemed paid tax.

Such safeguards may, for example, limit the benefits under the tax sparing provision to the tax incentives available on the date of signature of the treaty. This might, however, be difficult to administer in practice.

Another way is to fix in the treaty the percentage amount of deemed paid tax. For example, the treaty may specify the applicable percentage rates [*e.g.* Canada-China (1986)]. The rate may be fixed at (a) the ceiling rate provided for in the treaty [*e.g.* Germany-Indonesia (1977) and this is also the effect of the tax sparing provisions in UK treaties], (b) above the treaty rates [*e.g.* Brazil-Japan Protocol (1976] or (c) below the treaty rates [*e.g.* Japan-Bangladesh (1991)].

Other safeguard provisions of this kind ensure that the amount of "deemed paid tax" fixed in the treaty does not exceed the amount of tax under the general tax regime by incorporating rules that limit the amount of deemed paid tax to the level of taxation under the general taxation law of the source country [*e.g.* France-Turkey (1987) and Bangladesh-Netherlands (1993)].

### d) Duration of tax sparing

Many treaties limit the availability of the tax sparing relief for each source [in UK treaties]. As mentioned previously, a time limitation may also be applied to the tax sparing provision itself. It has become more common in recent years to insert "sunset" clauses in the tax sparing provisions [*e.g.* Bulgaria-Japan (1991), Australia- China (1988), Denmark-Poland (1994), and Mongolia-UK (1996)].

### e) Types of countries

Many OECD countries that agreed to insert tax sparing provisions in treaties concluded in the 1960's and 1970's with non-Member countries, which have now reached a certain level of economic development, wish to remove or renegotiate the tax sparing provisions considering that the economic justification for such provisions has ceased. In certain cases, these countries have repealed the tax sparing provisions by agreeing to treaty changes. In other cases a "sunset" clause has been added. Some countries have begun to use objective criteria to define countries eligible for tax sparing. Only countries the economic level of which is below a certain benchmark is considered for tax sparing. For example, Japan uses the graduation standard of the World Bank as a reference to define eligible countries.

### f) General anti-abuse provisions

Some recent treaties also contain a specific anti-abuse provision to reduce the potential of abuse [*e.g.* New Zealand-Singapore (1993)]. Section IV and Annex VI provide more details.

## VI. BEST PRACTICES IN DESIGNING TAX SPARING PROVISIONS

The following paragraphs describe a number of additional features that have been used in the design of tax sparing provisions and which may help the countries that decide to use tax sparing to achieve a better targeting of the provision and reducing the potential for abuse in both the residence and source country.

### a) Definition of tax incentives

Many countries have determined that the tax incentives covered by the tax sparing provision should be defined precisely - typically through a specification of eligible incentives - to ensure that tax sparing is granted only for agreed concessions. These countries have concluded that general references to *"special incentive laws designed to promote economic development"* provide the host country with too much discretionary authority to determine the kind and size of the tax sparing aid to be provided by the residence country. This is commonly done through a direct reference to domestic legislation. The reference is typically "static" (*i.e.* a reference is made to domestic legislation as drafted on the date of signature) to avoid the host country from subsequently extending the scope of the tax sparing provision. To avoid the risk, however, that such limitation would prevent minor amendments being made to the tax incentive provisions, some treaties permit minor modifications of the incentive legislation to be made provided that its general character is not affected. Many of those treaties also include a clause that accepts new incentives of a substantially similar character [*e.g.* Article 25(4) of Spain-India Convention (1993)]. The competent authorities of the Contracting States must sometimes agree that the new incentives are substantially of the same character [*e.g.* Article 23(5) of the Australia-Vietnam Convention (1992)].

Yet another possibility would be to ensure that tax sparing not be given to general and widely applicable incentive features such as broadly based tax holidays.

As noted in Section V(b) above, tax sparing provisions often do not apply to passive income such as interest and royalties and relatively few provisions give a “matching credit” (*i.e.* providing that a foreign tax credit will be granted at a fixed rate specified in the treaty regardless of the actual rate of withholding tax levied in the source country). This seems to reflect concerns about tax incentives directed at passive investment as well as concerns about the potential for abuse (see section IV (f) above) involved with these forms of tax sparing.

### b) Definition of activities

Where particular tax incentive legislation is defined in broad terms or where the incentive legislation might conceivably apply to inappropriate activities, it has sometimes been found necessary to limit the applicability of the tax sparing provision to certain specified activities, *e.g.* enumerated *active* business activities, excluding financial intermediation activities such as banking and insurance, or activities that assist in the development of the host country's capital base, such as public infrastructure, plant, equipment, skills, and knowledge [*e.g.* Article 24(2) of the Norway-Mexico Convention (1995)]. Furthermore, to avoid that export-oriented businesses in developing countries compete on “no tax” terms with businesses in other countries which have to pay tax at full rates, tax sparing relief has been given only to typically domestic-oriented activities [*e.g.* Article 23(3)(b) of the United Kingdom-Papua New Guinea Convention (1991) and Article 22(2) of the Sweden-Malta Convention (1995)].

### c) Tax rates

Where tax sparing credits are based on the host country’s *domestic tax rate*, it has in some cases been agreed to limit the maximum domestic rate that could apply for tax sparing credits in order to prevent increases of tax with limited application aimed at increasing the value of the tax spared credits [*e.g.* Article 23(4) of the Australia-Vietnam Convention (1992)].

Similarly, in some cases where the Contracting countries have agreed on a maximum tax rate or a deemed paid tax rate that the host country may impose on particular types of income, it has been found inappropriate to allow these rates, for the purposes of calculating tax sparing credits, to be higher than those set under domestic law. In some cases, it has been clarified in the treaty that the domestic rate applies where this rate is lower than the specified treaty rate [*e.g.* Article 23(1) of the German-Turkey Convention (1985)].

Tax sparing credits may also be based on maximum treaty rates. For example, where the Convention limits the withholding tax on dividends to 5 per cent, and the host country gives up its withholding tax on dividends entirely under incentive legislation recognised under the Convention, the rate of tax for which the residence country will give tax sparing credit is then limited to 5 per cent.

### d) Income exempt under domestic law or treaty

Some OECD Member countries apply the credit method to only particular types of income. For example, while the credit method may be used on income derived by resident companies through foreign permanent establishments; dividends paid by foreign subsidiaries may be exempt under domestic law or under the treaty. Tax sparing should never be considered in regard to the latter type of income. The most a country can do is to exempt foreign income from taxation. No additional tax sparing credit should be granted in such a case.

### e) Anti-abuse clause

Recent experience has shown that tax sparing provisions are very vulnerable to abuse (see Annexes IV and V). A number of treaties now include a tax sparing anti-abuse clause [*e.g.* Article 23(1) of the Spain-Argentina Convention (1992), Article 23(7) of the Australia-Vietnam Convention (1992), see also Annex VI]. Alternatively, where the resident country has an existing anti-abuse rule within its domestic tax law, the Contracting countries may expressly agree to make the tax sparing provision in the treaty subject to that domestic anti-abuse rule.

### f) Time limitation

#### *Investor level*

Tax incentives are generally intended to encourage the start-up of new operations. It has therefore been found appropriate in some treaties to place a time limit on the availability of the tax sparing relief for each taxpayer, thereby preventing tax sparing from becoming a permanent concession [*e.g.* Article 21(3) of UK-Indonesia Convention (1993)]. Furthermore, to prevent taxpayers from abusing this rule by simply transferring the activity to a different legal entity before each time limit expires, it may be appropriate to provide that the duration should be measured having regard also to associated entities undertaking the same or similar activities. As previously noted, many tax sparing provisions today also contain traditional sunset clauses applicable to all taxpayers [see *e.g.* Article 25(5) of Mongolia-UK Convention (1996), see also Section V(d) above].

***Country's economic development level***

Tax sparing is primarily an instrument to encourage economic development in developing countries. Where the developing country has reached a certain degree of development, countries have sometimes agreed to have the tax sparing provision removed from the treaty at a certain date [see Article 22(5) of Japan-Vietnam Convention (1991)] . Many countries have found it more effective, however, to grant tax sparing only for limited periods ("sunset" clause), for example, for 5 or 10 years [*e.g.* Article 25(5) of the Spain-India Convention (1993), see also Section V(d) above] which may facilitate the removal of the clause once its original purpose has been fulfilled.

However, provision of tax sparing for defined periods may raise additional practical problems. When tax sparing commences there is the possibility that contracts could be rewritten to bring the income within the tax sparing period. Furthermore, when tax sparing is expiring, contracts (particularly loan agreements) could be drafted so that income is derived before the date of expiry by, for example, by use of prepayments or cancellation fees. An interpretative provision could be included in tax treaties to ensure that the tax sparing period relates only to income accrued during the period, or the domestic law of the residence country could possibly contain rules for allocation of income to the tax sparing period.

## g) Controlled foreign company legislation

Controlled foreign company (CFC) legislation has been enacted by fifteen OECD countries in response to regulatory reform and the growing use of tax havens and preferential tax regimes to defer or avoid taxation.[2] While foreign investment that is targeted by CFC legislation generally is excluded from the scope of applicable tax sparing provisions, CFC and tax sparing rules may in certain instances apply concurrently. The rules of the CFC legislation may then conflict with those of the tax sparing provisions. To remove any doubt, an interpretative provision could be included in the treaty providing that CFC legislation will prevail in these situations.

## VII. RECOMMENDATIONS

This report has identified a number of concerns that put into question the usefulness of the granting of tax sparing relief by OECD Member countries. These concerns relate in particular to:

– the potential for abuse offered by tax sparing;

– the effectiveness of tax sparing as an instrument of foreign aid; and

– general concerns with the way in which tax sparing may encourage countries to use tax incentives.

The Report has shown that tax sparing is very vulnerable to taxpayer abuse, which can be very costly in terms of lost revenue to both the residence and source country. Experience has shown that this kind of abuse is difficult to detect. In addition, even where it is detected, it is difficult for residence countries to react quickly against such abuse. The process of persuading treaty partners of the necessity to remove or modify existing tax sparing provisions to prevent such abuses may be slow and cumbersome.

The emerging change in attitude among countries towards tax sparing has to be seen also in the context of the increasing problem with harmful tax competition. The continued, and in recent years accelerating, integration of national economies has made many segments of the national tax bases increasingly geographically mobile. These developments have induced some countries to adopt tax regimes that have as their primary purpose the erosion of the tax bases of other countries. These types of tax incentives are specifically tailored to target highly mobile financial and other services that are particularly sensitive to tax differentials. The potentially harmful effects of such regimes may be aggravated by the existence of ill-designed tax sparing provisions in treaties. This is particularly so where a country adopts a tax regime subsequent to the conclusion of treaties and tailors this regime so as to ensure that it is covered by the scope of the existing tax sparing provision.

This report has also shown that tax sparing is not necessarily an adequate tool to promote economic development. Countries that have traditionally sought to obtain tax sparing benefits in treaties may have good reasons to reconsider their position on the issue. The report not only challenges the assumption generally underlying tax sparing, but it also suggests that tax sparing, by promoting the repatriation of profits, provides an inherent incentive to the foreign investor to engage in short-term investment projects and a disincentive to operate in the source country on a long-term basis.

The argument that tax sparing is needed to prevent that the granting of a tax incentive by a host country merely results in a transfer of tax revenues to the country of residence of the investor ignores the fact that this revenue transfer will occur only to the extent that profits are repatriated. No nullification will occur if there is no repatriation. But, even if profits are repatriated, the features of foreign tax credit systems, which all allow some form of pooling of foreign income, may be structured in such a way that tax may not necessarily be levied in the country of residence notwithstanding that no or low tax is imposed in the country of source.

The analysis of this report does not suggest that OECD and other countries which have traditionally granted tax sparing should necessarily cease to do so. In bilateral negotiations between Member and non-Member countries, some countries will, for what they see as legitimate reasons, continue to press for such provisions. But the strength of their case will need to be assessed in the course of their negotiation or renegotiation of bilateral treaties. In addition, it may now be an appropriate time to consider how OECD Member countries working together with non-Member countries can develop a more coherent position towards the granting of tax sparing. This may enable Member countries to reassess the need to give tax sparing, particularly to countries that have reached a certain level of economic development. In judging whether there is a case for continuing to provide tax sparing, countries will need to balance the considerations discussed in the preceding sections, particularly the scope for abuse and the role which tax sparing has played in encouraging tax competition. This would also assist countries that chose to grant tax sparing to achieve a better targeting of the provisions and to reduce the potential for abuse. Non-Member countries that have traditionally requested tax sparing should reconsider whether this is an appropriate instrument to promote economic development and whether tax sparing serves their long-term economic interests.

The Committee on Fiscal Affairs recommends that if a Member country chooses to give tax sparing credits, tax sparing should be considered only in regard to countries the economic level of which is considerably below that of OECD Member countries. Member countries should employ objective economic criteria to define countries eligible for tax sparing. Where countries agree to insert a tax sparing provision, they are encouraged to follow the guidance set out in Section VI of this report. The use of these "best practices" will minimise the potential for abuse of such provisions by ensuring that they apply exclusively to genuine investments aimed at developing the domestic infrastructure of the source country (see Section VI (b) above). A narrow provision applying to real investment would also discourage harmful tax competition for geographically mobile activities.

*Annex I*

## MEMBER COUNTRY TAX SPARING PROVISIONS REFERRED TO IN THE REPORT

Below is reproduced in alphabetical order the Member country tax sparing provisions referred to in the report.

**Australia - China (1988)** Article 23

4. For the purpose of paragraphs 2 and 3, Chinese tax paid shall include an amount equivalent to the amount of any Chinese tax forgone.

5. In paragraph 4, the term "Chinese tax foregone" means, subject to paragraph 6, an amount which, under the law of China relating to Chinese tax and in accordance with this Agreement, would have been payable as Chinese tax on income but for an exemption from, or reduction of, Chinese tax on that income in accordance with:

*a)* Articles 5 and 6 of the Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign Investment and Article 3 of the Detailed *Rules* and Regulations for the Implementation of the Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign Investment;

*b)* Articles 4 and 5 of the Income Tax Law of the People's Republic of China concerning Foreign Enterprises;

*c)* Articles I, II, III, IV and X of Part I, Articles I, II, III and IV of Part II and Articles I, II and III of Part III of the interim provisions of the State Council of the People's Republic of China on reduction in or exemption from enterprise income tax and the consolidated industrial and commercial tax for special economic zones and fourteen coastal cities;

*d)* Articles 12 and 19 of the State Council Regulations for the Encouragement of Investment in the Development of Hainan Island;

*e)* Articles 8, 9 and 10 of the State Council Regulations concerning the Encouragement of Foreign Investment; and

*f)* Articles 1, 2 and 3 of the interim provisions of the Ministry of Finance of the People's Republic of China regarding (reduction in or exemption from) enterprise income tax and industrial and commercial consolidated tax for encouraging foreign investment in the coastal open economic areas; insofar as they were in force on, and have not been modified since, the date of signature of this Agreement, or have been modified only in minor respects so as not to affect their general character and any other provision which may subsequently be made granting an exemption from or reduction of tax which the Treasurer of Australia and the Commissioner of the State Taxation Administration of China agree from time to time in letters exchanged for this purpose to be of a substantially similar character, if that provision has not been modified thereafter or has been modified only in minor respects so as not to affect its general character.

6. In the application of paragraph 5 in relation to dividend, interest and royalty income to which Articles 10, 11 and 12 respectively apply, the amount of Chinese tax shall be deemed to be the amount equal to:

*a)* in the case of dividends, 15 per cent of the gross amount of those dividends;

*b)* in the case of interest, 10 per cent of the gross amount of that interest; and

*c)* in the case of royalties, 15 per cent of the gross amount of those royalties, but only where the rate of tax levied under the law of China, other than a provision specified in paragraph 5, is not less than 15 per cent.

7. Paragraphs 4, 5 and 6 shall apply only in relation to income derived in any of the first ten years of income in relation to which this Agreement has effect by virtue of sub-paragraph (a)(ii) of Article 27 and in any later year of income that may be agreed by the Treasurer of Australia and the Commissioner of the State Taxation Administration of China in letters exchanged for this purpose.

**Australia - Vietnam (1996)** Exchange of Notes

The Exchange of Notes refers to Article 23 of the Convention (1992).

4. paragraphs 5 and 6, the total amount which, under the law of Vietnam relating to Vietnamese tax and in accordance with this Agreement, would have been payable as Vietnamese tax on income but for an exemption from, or reduction of, Vietnamese tax on that income (which total amount shall be deemed to be no greater than 20 per cent of the Vietnamese taxable income that relates to the income the subject of the exemption or reduction), less the actual amount of Vietnamese tax payable on that income.

5. Paragraph 4 shall apply only in respect of exemptions or reductions resulting from the operation of:

*a)* *i)* Articles 26, 27, 28 or 32 of the Law on Foreign Investment in Vietnam 1987; or

*ii)* Articles 66, 67, 68, 69 or 72 of Decree N° 18-CP on implementing regulations of the Law on Foreign Investment in Vietnam dated 16 April 1993; or

*iii)* Circular N° 48-TC-TCT on Profits Tax Rates and Exemption from and Reduction of Profits Tax dated 30 June 1993; or

*iv*) Part A of Part II of Circular N° 51-TC-TCT on Taxation of Foreign Investment in Vietnam dated 3 July 1993; or

*v)* Decree N° 87-CP on Build-Operate-Transfer (BOT) Contracts dated 23 November 1993 and the regulations issued with that Decree, to the extent those provisions were in force on, and have not been modified since, the date of this Note, or have been modified only in minor respects so as not to affect their general character; or

*b)* any other provision which may subsequently be made granting an exemption from, or reduction of, Vietnamese tax which the Treasurer of Australia and the Minister of Finance of Vietnam determine from time to time in letters exchanged for this purpose to be provisions to which this paragraph applies. Subject to its terms, such a determination of applicable provisions shall be valid for as long as those provisions are not modified after the date of that determination or have been modified only in minor respects so as not to affect their general character.

6. Paragraph 4 shall apply only to the extent that the exemption or reduction is granted in respect of Vietnamese tax on income from the following activities:

*a)* construction of infrastructure facilities including communications, power production and supply, construction of infrastructure facilities for the export processing and industry intensive zones and information and telecommunication facilities in mountainous areas in which natural and socio economically difficult conditions exist; or

*b)* plantation of new forests for commercial exploitation; or

*c)* extremely important activities listed in the investment portfolio announced by the Vietnamese State Committee for Co-operation and Investment for each period; or

*d)* exploitation of natural resources except oil, gas or rare and precious natural resources; or

*e)* heavy industry projects including metallurgy, mechanical engineering production, base chemical production, cement production, electrical and electronic materials manufacturing, fertiliser manufacturing and anti epidemic medicines for use in animal production or forestry; or

*f)* plantation of long term industrial crops; or *g)* activities in mountainous areas in which naturally and socio economically difficult conditions exist including hotel undertaking projects; or

*h)* any project satisfying at least 2 of the following criteria:

*i)* employing at least 500 Vietnamese; or

*ii)* applying advanced technology which satisfies the requirements listed in Article 4 of the Ordinance on the Transfer of Foreign Technology dated 5 December 1988, subject to the approval of the Ministry of Science and Technology and Environment; or

*iii)* exporting at least 8 per cent of the products manufactured by the project itself; or

*iv)* the prescribed capital or contributed capital for the implementation of the business co-operation contract is at least US $ 10 million dollars; or

*i)* projects carrying out infrastructure activities within a definite time period in which the foreign partner transfers the infrastructure to the Vietnamese Government without any compensation.

7. Notwithstanding the operation of paragraph 4, Vietnamese tax forgone shall not be deemed to have been paid in respect of income derived from:

*a)* banking, insurance, consulting, accounting, auditing and commercial services of any kind; or

*b)* the operation of ships or aircraft, other than ships or aircraft operated principally from places in Vietnam and used solely in carrying on a business in Vietnam; or

*c)* any scheme entered into by an Australian resident with the purpose of using Vietnam as a conduit for income or as a location of property in order to evade or avoid Australian tax through the exploitation of the Australian foreign tax credit provisions or to confer a benefit on a person who is neither a resident of Australia, nor of Vietnam.

8. Paragraphs 4, 5, 6 and 7 shall not apply in relation to income derived in any year of income after the year of income that ends on:

*a)* 30 June 2003; or

*b)* any later date that may be agreed by the Treasurer of Australia and the Minister of Finance of Vietnam in letters exchanged for this purpose.

whichever is the later in time occurring".

**Canada - Argentina (1993)** Article 23

2. For the purpose of sub-paragraph (a) of paragraph 1, tax payable in Argentina by a company engaged primarily in the manufacturing or natural resources sector which is a resident of Canada in respect of:

*a)* interest, other than interest which is exempted in Argentina in accordance with paragraph 3 of Article 11, or

*b)* industrial royalties referred to in paragraph 3 of Article 12 paid by a company engaged primarily in the same sector which is a resident of Argentina shall be deemed to have been paid at the rate of 12.5 per cent in the case of interest and at the rate of 15 per cent in the case of royalties. The provisions of this paragraph shall apply for the first five years for which the Convention is effective, but the competent authorities of the Contracting States may consult with each other to determine whether this period shall be extended.

**Canada - China (1986)** Article 21

2. For the purposes of paragraph 1(a), tax payable in the People's Republic of China by a company which is a resident of Canada shall be deemed to include any amount which would have been payable as Chinese tax for any year but for an exemption from, or reduction of, tax granted for that year or any part thereof under any of the following provisions of Chinese law:

*a)* Articles 5 and 6 of the Income Tax Law of the People's Republic of China concerning Joint Venture with Chinese and Foreign Investment and Article 3 of the Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's

Republic of China concerning Joint Ventures with Chinese and Foreign Investment;

*b)* Articles 4 and 5 of the Income Tax Law of the People's Republic of China concerning Foreign Enterprises;

*c)* Articles I, II, III, IV and X of Part 1, Articles I, II, III and IV of Part II and Articles I, II and III of Part III of the interim provisions of the State Council of the People's Republic of China concerning reduction or exemption from enterprise income tax in special economic zones and coastal cities; so far as they were in force on, and have not been modified since, the date of signature of this Agreement, or have been modified only in minor respects so as not to affect their general character; or

*d)* any other provision which may subsequently be made granting an exemption or reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character;

**Canada - Thailand (1984)** Article 22

3. For the purposes of paragraph 1(a), the term "tax payable in Thailand" shall be deemed to include any amount which would have been payable as Thai tax for any year but for an exemption or reduction of tax granted with a view to promoting industrial, commercial, scientific, educational or other development in Thailand, for that year or any part thereof under:

*a)* the provisions of the Special Incentive Laws designed to promote economic development in Thailand so far as they were in force on, and have not been modified since, the date of signature of this Convention, or have been modified only in minor respects so as not to affect their general character; or

*b)* any other provision which may subsequently be made granting an exemption or reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not affect its general character. Provided that relief from Canadian tax shall not be given by virtue of this paragraph in respect of income from any source if the income arises in a period starting more than ten years after the exemption from or reduction of Thai tax was first granted in respects of that source. Provided further that any deduction from Canadian tax granted in accordance with the provision of this paragraph in respect of dividends or interest paid to an individual shall not exceed 15 per cent of the gross amount thereof; and in respect of dividends paid to a company, other than a company referred to in paragraph 3 of Article 10, or in respect of interest paid to a company shall not exceed 20 per cent of the gross amount thereof.

**Denmark - Poland (1994)** Protocol

Article III

After Article 23, paragraph 2, subparagraph (c), the following subparagraphs shall be inserted:

"*d)* where in accordance with the laws of a Contracting State a reduction of tax on the profits of an enterprise is granted for the purpose of encouraging economic development in that State, the references in paragraph 1 and paragraph 2, subparagraphs (a) and (b) of this Article, to "taxes paid" or "income tax paid" shall be deemed to include any amount which would have been payable as tax in accordance with this Agreement for any year but for a reduction of tax granted for that year, provided that such an enterprise (being a permanent establishment) is engaged in the manufacture or sale of goods or merchandise or services (other than services in the financial sector) and that no more than 25 per cent of the enterprise's income arises from interest and gains from the alienation of shares and bonds;

*e)* where dividends are paid by a company which is a resident of Poland to a person (being a company) which is a resident of Denmark, and which owns directly or indirectly not less than 25 per cent of the share capital of the first-mentioned company then such dividends shall be exempt from Danish tax, provided that the company paying the dividends is engaged in the manufacture or sale of goods or merchandise or services (other than services in the financial sector) and that no more than 25 per cent of the company's income arises from interest and alienation of shares and bonds;

f) the provisions in subparagraphs (d) and (e) shall apply for the first five years for which the Protocol amending the original Agreement between Poland and Denmark is effective. The competent authorities shall consult each other in order to determine whether this period shall be extended. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures."

**Germany - Indonesia (1977)** Article 22(1)

*c)* If in the cases (aa), (bb) and (cc) of subparagraph (b) above, Indonesian tax on dividends on interest, or on royalties is wholly relieved or reduced below the rates of tax provided for in Article 9 paragraph 2, Article 10 paragraph 2, or Article 11 paragraph 2, by special incentive measures under Indonesian Law designed to promote economic development in Indonesia, there shall be allowed as a credit against German income tax and corporation tax, including the surcharge thereon, on such dividends, interest or royalties, an amount corresponding to the rate of tax provided for in the foregoing mentioned provisions of this Agreement. The credit allowed under the foregoing sentence, shall, however, not exceed the amount of Indonesian tax which would have been payable but for such reduction.

**Germany - Turkey (1985)** Article 23(1)

(d) Where dividends, interest and royalties mentioned in subparagraph (b) are taxed under special measures introduced in Turkish law for the purpose of promoting the economic development of the Republic of Turkey, at rates of tax which are reduced below 10 per cent, there shall under the conditions provided in subparagraph (b) be allowed as a deduction from the tax paid in the Federal Republic of Germany on such income an amount equal to at least 10 per cent of the gross amount of such income. However, the deduction shall not exceed the tax paid in the Republic of Turkey in the absence of such measures.

**Japan - Bangladesh (1991)** Article 23

3. For the purposes of the credit referred to in subparagraph (a) of paragraph 1 above, where an amount of tax paid in Bangladesh on dividends or royalties to which the provisions of paragraph 2 of Article 10 or paragraph 2 of Article 12, as the case may be, apply, is less than 10 per cent of the gross amount thereof, Bangladesh tax shall be deemed to have been paid at the rate of 10 per cent of the gross amount of such dividends or royalties.

4. For the purposes of the credit referred to in subparagraph (a) of paragraph 1 above, where an amount of tax paid in Bangladesh on interest to which the provisions of paragraph 2 of Article 11 apply is less than 5 per cent of the gross amount thereof, Bangladesh tax shall be deemed to have been paid at the rate of 5 per cent of the gross amount of such interest, if such interest is subject to:

(a) the provisions of paragraphs (a), (b), (c), (d), (e), (f) and (g) of Notification number S.R.O. 417A-L/76 dated 29 November 1976; or

(b) any provision referred to in (a) above as modified after the date of signature of this Convention or any other special incentive measure designed to promote economic development in Bangladesh which may be introduced in future in the Bangladesh tax laws in modification of, or in addition to, the existing measures referred to in (a) above, provided that an agreement is made between the two Governments in respect of the scope of the benefit accorded to the taxpayer by the said provision so modified or the said measure. The provisions of this paragraph shall not apply to interest to which the provisions of paragraph 3 of Article 11 apply.

5. For the purposes of the credit referred to in paragraph 1 above, the term "Bangladesh tax payable" shall be deemed to include the amount of the Bangladesh tax which would have been paid under the laws of Bangladesh if the Bangladesh tax had not been reduced or exempted in accordance with:

(a) the provisions of Notification number S.R.O. 289-L/89 dated 17 August 1989 (relating to exemption from tax for industry set-up in any Export Processing Zone); or

(b) any provision referred to in (a) above as modified after the date of signature of this Convention or any other special incentive measure designed to promote economic development in Bangladesh which may be introduced in future in the Bangladesh tax laws in modification of, or in addition to, the existing measures referred to in (a) above, provided that an agreement is made between the two Governments in respect of the scope of the benefit accorded to the taxpayer by the said provision so modified or the said measure.

**Japan - Brazil (1976)** Protocol

Sub-paragraphs (a), (b) and (e) of paragraph (2) of article 22 shall be deleted and replaced by the following:

(a) (i) Where a resident of Japan derives income from Brazil which may be taxed in Brazil in accordance with the provisions of this Convention, the amount of the Brazilian tax payable in respect of that income shall be allowed as a credit against the Japanese tax imposed on that resident. The amount of credit, however, shall not exceed that part of the Japanese tax which is appropriate to that income.

(ii) Where the income derived from Brazil is a dividend paid by a company which is a resident of Brazil to a company which is a resident of Japan and which owns at least 10 per cent either of the voting shares of the company paying such dividend, or of the total shares issued by that company, the credit referred to in (i) above shall take into account the Brazilian tax payable by the company paying the dividend in respect of its income.

(b) (i) For the purposes of the credit referred to in sub-paragraph (a) (i) above, Brazilian tax shall always be considered as having been paid:

(A) At the rate of 25 per cent in the case of dividends to which the provisions of paragraphs (2) and (5) of article 9 apply, and of royalties to which the provisions of sub-paragraphs (b) and (c) of paragraph (2) of article 11 apply;

(B) At the rate of 20 per cent in the case of interest to which the provisions of paragraph (2) of article 10 apply.

(b) (ii) For the purposes of the credit referred to in sub-paragraph (a) above, Brazilian tax shall be deemed to include the amount of Brazilian tax which would have been paid if the Brazilian tax had not been exempted or reduced in accordance with the special incentive measures designed to promote economic development in Brazil, which are effective on March 23, 1976, or which may be introduced thereafter in the Brazilian tax laws in modification of, or in addition to, the existing measures, provided that the scope of the benefit accorded to the taxpayer by those measures shall be agreed to by the Governments of both Contracting States.

(c) In the application of the provisions of sub-paragraph (b)(ii) above, there shall not, in any event, be deemed to have been paid an amount of tax higher than that which, but for the exemption or reduction of tax due to the special incentive measures, would result from the application of the Brazilian tax laws effective on 23 March 1976."

**Japan - Bulgaria (1991)** Article 23

3. For the purposes of the credit referred to in subparagraph (a) of paragraph 2 above, where an amount of tax paid in Bulgaria on dividends or royalties to which the provisions of paragraph 2 of Article 10 or paragraph 2 of Article 12, as the case may be, apply is less than 10 per cent of the gross amount thereof. Bulgarian tax shall be deemed to have been paid at the rate of 10 per cent of the gross amount of such dividends or royalties.

4. For the purposes of the credit referred to in paragraph 2 above, the term "Bulgarian tax payable" shall be deemed to include the amount of the Bulgarian tax which would have been paid under the laws of Bulgaria if the Bulgarian tax had not been reduced or exempted in accordance with the special incentive measures designed to promote economic development in Bulgaria, provided that an agreement is made between the two Governments in respect of the scope of the benefit accorded to the taxpayer by the said measures.

5. The provisions of paragraphs 3 and 4 shall not apply in respect of income derived by a resident of Japan in any taxable year beginning on or after the first day of January of 2002.

**Japan - Vietnam (1995)** Article 22

3. For the purposes of the credit referred to in paragraph 2, taking into account the stage of economic development of Vietnam, there shall be deemed to have been paid by the taxpayer the amount which would have been paid as Vietnamese tax under the laws of Vietnam and in accordance with this Agreement if the Vietnamese tax had not been reduced or relieved in accordance with the special incentive measures designed to promote economic development in Vietnam, effective on the date of signature of this Agreement or which may be introduced in the future in the Vietnamese tax laws in modification of or in addition to the existing measures, provided that an agreement is made between the two Governments in respect of the scope of the benefit accorded to the taxpayer by the said measures.

4. For the purposes of the credit referred to in sub-paragraph (a) of paragraph 2, the Vietnamese tax shall always be considered as having been paid at the rate of 10 per cent of the gross amount in the case of dividends to which the provisions of paragraph 2 of Article 10 apply and of royalties or proceeds to which the provisions of paragraph 2 or 5 of Article 12 apply.

5. The provisions of paragraphs 3 and 4 of this Article shall not apply in respect of income derived by a resident of Japan in any taxable year beginning after 31 December of the fifteenth calendar year next following the calendar year in which this Agreement enters into force.

**The Netherlands - Bangladesh (1993)** Article 23

4. Where, by reason of special relief given under the provisions of Bangladesh law for the purpose of encouraging investment in Bangladesh the Bangladesh tax actually levied on interest and royalties arising in Bangladesh is lower than the tax Bangladesh may levy according to paragraph 2 of Article 11 and paragraph 2 of Article 12, then the amount of the tax paid in Bangladesh on such interest and royalties shall be deemed to have been paid at the rates of tax

mentioned in the said provisions. However, if the general tax rates under Bangladesh law applicable to the afore-mentioned interest and royalties are reduced below those mentioned in the foregoing sentence these lower rates shall apply for the purposes of that sentence.

The provisions of the two foregoing sentences shall only apply for a period of 10 years after the date on which the Convention became effective. This period may be extended by mutual agreement between the competent authorities.

**New Zealand - Singapore (1993)** Protocol

Article I

Notwithstanding paragraph 3 of Article 19 of the Agreement, a New Zealand resident deriving income from Singapore, being income referred to in that paragraph, shall not be deemed to have paid Singapore tax in respect of such income where the competent authority of New Zealand considers, after consultation with the competent authority of Singapore, that it is inappropriate to do so having regard to:

*a)* whether any arrangements have been entered into by any person for the purpose of taking advantage of paragraph 3 of Article 19 for the benefit of that person or any other person;

*b)* whether any benefit accrues or may accrue to a person who is neither a New Zealand resident nor a Singapore resident;

*c)* the prevention of fraud or the avoidance of the taxes to which the Agreement applies;

*d)* any other matter which the competent authorities consider relevant in the particular circumstances of the case including any submissions from the New Zealand resident concerned.

Article II

Article I of this Second Protocol shall apply to income derived on or after 1 July 1993.

**Spain - India (1993)** Article 25

4. For the purposes of deduction referred to in paragraph 3, the term "income-tax paid in India" shall be deemed to include any amount which would have been payable as Indian tax under the laws of India and in accordance with this Convention for any year but for an exemption from, or reduction of, tax granted for that year under:

*i)* Sections 10(4), 10(15)(iv), 10A, 10B, 32A, 32AB, 80HH, 80HHC and 80I of the Income-tax Act, 1961 (43 of 1961) so far as they were in force on, and have not been modified since, the date of the signature of this Convention, or have been modified only in minor respects so as not to affect their general character; or

*ii)* any other provision which may be enacted hereafter granting a deduction in computing the taxable income or an exemption or reduction from tax which the competent authorities of the Contracting States agree to be of a substantially similar character if it has not been modified only in minor respects so as not to affect its general character.

5. The provision of paragraph 4 shall apply for the first 10 years for which this Convention is effective but the competent authorities of the Contracting States may consult each other to determine whether this period shall be extended.

**Sweden - Malta (1995)** Article 22(2)

*d)* For the purposes of sub-paragraph (a) of this paragraph the term "Malta tax paid" shall be deemed to include the Malta tax which would have been paid but for any time-limited exemption or reduction of tax granted under incentive provisions contained in the Malta law designed to promote economic development to the extent that such exemption or reduction is granted for profits from industrial or manufacturing activities or from agriculture, fishing or tourism (including restaurants and hotels) provided that the activities have been carried out within Malta. For the purposes of sub-paragraph (c) of this paragraph a tax of 15 per cent calculated on a Swedish tax base shall be considered to have been paid for such activities under those conditions mentioned in the previous sentence. The competent authorities may agree to extend the application of this provision also to other activities.

*e)* The provisions of sub-paragraph (d) of this paragraph shall apply for the first ten years during which this Convention is effective. This period may be extended by a mutual agreement between the competent authorities.

**United Kingdom - Indonesia (1993)** Article 21

3. For the purposes of paragraph (1) of this Article, the term "Indonesian tax payable" shall be deemed to include any amount which would have been payable as Indonesian tax for any year but for an exemption or reduction of tax granted for the year or any part thereof under Article 15(5) and Article 16(1) and (2) of Law No 1 of 1967 of Indonesia to the extent that these provisions continue in force by virtue of Article 33(2)(a) of Act No 7 of 1983 of Indonesia. Provided that relief from United Kingdom tax shall not be given by virtue of this paragraph in respect of income from any source if the income arises in a period starting more than 10 years after the exemption from, or reduction of, Indonesian tax was first granted in respect of that source.

**United Kingdom - Mongolia (1996)** Article 24

4. For the purposes of paragraph 1 of this Article, the term "Mongolian tax payable" shall be deemed to include any amount which would have been payable as Mongolian tax for any year but for a reduction of tax granted for that year or any part thereof as a result of the application of the following provisions of Mongolian law:

*a)* sub-paragraph (i) of paragraph 1 of Article 20 of the Foreign Investment Law of Mongolia so far as it was in force on, and has not been modified since, the date of signature of this Convention, or has been modified only in minor respects so as not to affect its general character; or

*b)* any other provision which may subsequently be made granting a reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character.

5. Relief from United Kingdom tax by virtue of paragraph 4 of this Article shall not be given where the profits, income or chargeable gains in respect of which tax would have been payable but for the exemption or reduction of tax granted under the provisions referred to in that paragraph arise or accrue more than ten years after the date on which this Convention enters into force.

6. The period referred to in paragraph 5 of this Article may be extended by agreement between the Contracting States.

**United Kingdom - Papua New Guinea (1991)** Article 23

3. For the purposes of paragraph 1 of this Article, the term "Papua New Guinea tax payable" shall be deemed to include any amount which would have been payable as Papua New Guinea tax for any year but for an exemption or reduction of tax granted for that year on any part thereof under any of the following provisions of Papua New Guinea law:

*a)* Sections 45L, 73(9), 97 or 97A of the Papua New Guinea Income Tax Act 1959 as amended, so far as they were in force on, and have not been modified since, the date of signature of this Convention, or have been modified only in minor respects so as not to affect their general character; or

*b)* Sections 72A(3), 73(3) or 73(7) of the Papua New Guinea Income Tax Act 1959 as amended, so far as they were in force on, and have not been modified since, the date of signature of this Convention, or have been modified only in minor respects so as not to affect their general character: and provided always that the competent authority of Papua New Guinea has certified that any such exemption or relief from Papua New Guinea tax given under these Sections has been granted in order to promote industrial, commercial, scientific, educational or other development in Papua New Guinea and the competent authority of the United Kingdom has accepted that such exemption or relief has been granted for such purpose; or *c)* any other provision which may subsequently be made granting an exemption or reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character. Provided that relief from United Kingdom tax shall not be given by virtue of this paragraph in respect of income from any source if the income arises in a period starting more than 10 years after the exemption from, or reduction of, Papua New Guinea tax was first granted in respect of that source.

*Annex II*

**TAX SPARING PROVISIONS BETWEEN OECD MEMBER COUNTRIES**

| | Aus | Aus | Bel | Can | Cze | Den | Fin | Fra | Ger | Gre | Hun | Ice | Ire | Ita | Jap |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Australia | | | | | | | | | | | | | | | |
| Austria | | | | | | | | | | | | | | | |
| Belgium | | | | | | | | | | X | | | | | |
| Canada | | | | | | | | | | | | | X | | |
| Czech R | | | | | | | | | | | | | | | |
| Denmark | | | | | | | | | | | | | | R | |
| Finland | | | | | | | | | | | | | X | R | |
| France | | | | | | | | | | | | | | | |
| Germany | | | | | | | | | | X | | | | | |
| Greece | | | X | | | | | | X | | | | | | |
| Hungary | | | | | | | | | | | | | | | |
| Iceland | | | | | | | | | | | | | | | |
| Ireland | | | | X | | | X | | | | | | | | X |
| Italy | | | | | | R | R | | | | | | | | |
| Japan | | | | | | | | | | | | | X | | |
| Korea | | X | | X | R | | X | X | R | R | | | R | R | X |
| Luxemburg | | | | | | | | | | X | | | | | |
| Mexico | | | | | | | | X | X | | | | | 1 | X |
| Nederlands | | | | | | | | | | X | | | | | |
| New Zealand | | | | | | | | | | | | | | | |
| Norway | | | | | | | | | | | | | X | | |
| Poland | | | | | R | | | | | | | | | | |
| Portugal | | X | X | | | | X | X | X | | | | | 2 | |
| Spain | | | X | X | | X | | | X | | | | | | X |
| Sweden | | | | | | | | | | X | | | | X | |
| Switzerland | | | | | | | | | | | | | | | |
| Turkey | | X | X | | | X | X | X | X | | | | | R | X |
| U.K. | | | | | | | | | | | | | | | |
| U.S.A. | | | | | | | | | | | | | | | |

| Kor | Lux | Mex | Ned | N.Z. | Nor | Pol | Por | Spa | Swe | Swi | Tur | UK | US | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | | | Australia |
| X | | | | | | | X | | | | X | | | Austria |
| | | | | | | | X | X | | | X | | | Belgium |
| X | | | | | | | | X | | | | | | Canada |
| R | | | | | | R | | | | | | | | Czech R |
| | | | | | | | | X | | | X | | | Denmark |
| X | | | | | | | X | | | | X | | | Finland |
| X | | X | | | | | X | | | | X | | | France |
| R | | X | | | | | X | X | | | X | | | Germany |
| R | X | | X | | | | | | | X | | | | Greece |
| | | | | | | | | | | | | | | Hungary |
| | | | | | | | | | | | | | | Iceland |
| R | | | | | X | | | | | | | | | Ireland |
| R | | 1 | | | | | 2 | | X | | R | | | Italy |
| X | | X | | | | | | X | | | X | | | Japan |
| | X | 3 | X | X | | | | | | X | R | X | | Korea |
| X | | | | | | | | X | | | | | | Luxemburg |
| 3 | | | X | | X | | | 4 | X | X | | X | | Mexico |
| X | | X | | | | | | | | | | | | Nederlands |
| X | | | | | | | | | | | | | | New Zealand |
| | | X | | | | | X | X | | | X | | | Norway |
| | | | | | | | | | | | | | | Poland |
| | | | | | X | | | | | X | | X | | Portugal |
| | X | 4 | | | X | | | | X | X | | X | | Spain |
| | | X | | | | | | X | | | X | | | Sweden |
| X | | X | | | | | X | X | | | | | | Switzerland |
| R | | | | | X | | | | X | | | X | | Turkey |
| X | | X | | | | | X | X | | | X | | | U.K. |
| | | | | | | | | | | | | | | U.S.A. |

## Notes on the Table

*Source*: The International Bureau of Fiscal Documentation

Some of the OECD Member countries listed in the table have not concluded tax treaties with each other.

Unless otherwise noted in the table, the following countries are always the recipients of tax sparing:

| | | | |
|---|---|---|---|
| Greece | Ireland | Italy | Korea |
| Mexico | Portugal | Spain | Turkey |

Keys in table

1 = Italy grants tax sparing to Mexico
2 = Italy grants tax sparing to Portugal
3 = Korea grants tax sparing to Mexico
4 = Spain grants tax sparing to Mexico
R = Tax sparing granted on a reciprocal basis

*Annex III*

# TAX SPARING PROVISIONS IN TREATIES BETWEEN OECD MEMBER AND CERTAIN NON- MEMBER COUNTRIES

## TAX SPARING PROVISIONS IN TREATIES BETWEEN OECD MEMBER AND CERTAIN NON-MEMBER COUNTRIES

| Country | Argentina | Brazil | China | India | Indonesia |
|---|---|---|---|---|---|
| Australia | | | X | X | |
| Austria | | X | X | | X |
| Belgium | | X | X | X | X |
| Canada | X | X | X | X | X |
| Czech Rep. | | X | X (R) | X (R) | |
| Denmark | X | X | X | X | |
| Finland | X | X | X | X | |
| France | X | X | X | X | X |
| Germany | X | X | X | X | X |
| Greece | | | | | |
| Hungary | | X | X | | |
| Iceland | | | | | |
| Ireland | | | | | |
| Italy | X | X | X | X | |
| Japan | | X | X | X | X |
| Korea | | X (R) | X (R) | X (R) | X (R) |
| Luxembourg | | X | X | | |
| Mexico | | | | | |
| Netherlands | | X | X | X | X |
| New Zealand | | | X | X | |
| Norway | | X | X | X | |
| Poland | | | X | X (R) | |
| Portugal | | | | | |
| Spain | X | X (R) | X | X | |
| Sweden | | X | | X | X |
| Switzerland | | | X | X | |
| Turkey | | | | | |
| U.K. | X | | X | X | X |
| U.S.A. | | | | | |

*Source*: The International Bureau of Fiscal Documentation.
*Note*: Some of the OECD Member and non-Member countries listed in the table have not concluded tax treaties with each other.

**TAX SPARING PROVISIONS IN TREATIES BETWEEN OECD MEMBER AND CERTAIN NON-MEMBER COUNTRIES** (CONTINUED)

| Country | Malaysia | Philippines | Singapore | Thailand | Venezuela |
|---|---|---|---|---|---|
| Australia | | X | | X | |
| Austria | X | X | | X | |
| Belgium | X | X | X | | |
| Canada | X | X | X | X | |
| Czech Rep. | X (R) | | | X (R) | |
| Denmark | X | X (R) | X | | |
| Finland | X | X | | | |
| France | X | X | X | | X |
| Germany | X | X | X | | X |
| Greece | | | | | |
| Hungary | X | | | X | |
| Iceland | | | | | |
| Ireland | | | | | |
| Italy | X | X | X | | X |
| Japan | X | X | | X | |
| Korea | X (R) | X | X (R) | | |
| Luxembourg | | | X | | |
| Mexico | | | X * | | |
| Netherlands | X | X | X | | X |
| New Zeal. | X | X | X | | |
| Norway | X | X | X | | |
| Poland | | | | | |
| Portugal | | | | | |
| Spain | | X | | | |
| Sweden | | X | X | X | X |
| Switzerland | X | | | | |
| Turkey | | | | | |
| U.K. | X | | X | X | X |
| U.S.A | | | | | |

® = Tax sparing granted on a reciprocal basis
* = Tax sparing granted only to the OECD country

*Annex IV*

# TAX AVOIDANCE SCHEME I

The conduit-scheme example described below has been reproduced from the New Zealand note SG/EMEF/CFA(96)18 to the EMEF meeting in Paris on 26-27 September 1996.

The following scheme is designed effectively to offset tax sparing credits against tax liabilities that do not relate to the foreign investment which gave rise to the tax sparing credit. The scheme has particular application in situations where the taxpayer has excess tax sparing credits. The scheme came to New Zealand's attention three years ago and precipitated renegotiation of the tax sparing provision in six of New Zealand's treaties to include an anti-avoidance rule to stop the scheme. Two of the schemes discovered involved loans of hundreds of millions of US dollars. More recently, during an audit of an international financial institution, we discovered correspondence confirming that the scheme is being used in Asia.

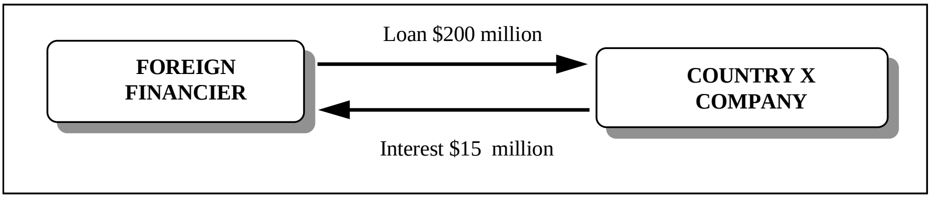
Tax sparing provisions in tax treaties are intended to prevent the home country clawing back a tax incentive by the host country. Where there is no tax liability in the home country in respect of the income that is spared by the host country, the tax sparing credits should not, in principle, be available to offset the tax liability on other unrelated income. New Zealand's tax law does not allow foreign tax credits (including tax sparing credits) to offset liabilities on other non-related income. However, as the examples below will show, this effect may be achieved by allocating the income and expenditure through different legal entities. As a result, this scheme exposes countries that give tax sparing to being used as conduits for loans destined for developing countries. The scheme can erode their existing tax bases by an amount equal to the value of the tax spared by the host country.

The scheme is illustrated using three scenarios. They assume a company resident in a developing country (Country X) requires a loan of $200 million to fund a development project that is approved under that country's various economic expansion incentives. An international financier ("Foreign Financier") agrees to lend the money at a rate of 7.5 per cent per annum.

**Scenario one - direct loan from Foreign Financier to Country X Company**

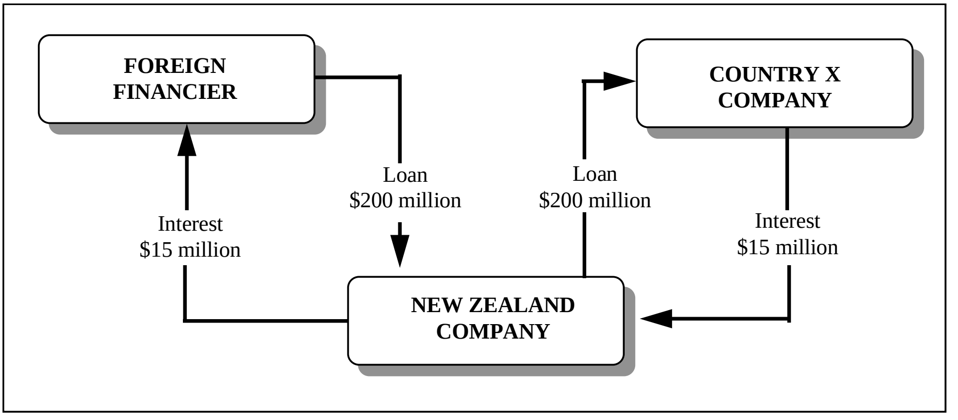
This scenario illustrates the substance of the transactions that are outlined in the examples that follow: $200 million is loaned by Foreign Financier to "Country X Company", a company resident in Country X which offers a number of tax concessions, including a tax exemption for interest paid to non-residents.

Under this scenario $15 million interest is paid by Country X Company to Foreign Financier. No tax is imposed in Country X since the interest is exempt under one of Country X's economic expansion incentives. Foreign Financier may or may not be taxed on the $15 million interest income, depending on the tax system in the country in which it is resident.




**Scenario two - loan from Foreign Financier to Country X Company, but loan is channelled through a New Zealand company**

This is similar to scenario one, except the loan is channelled through New Zealand. The New Zealand part of the transaction is essentially a back-to-back loan arrangement. "New Zealand Company" earns $15 million interest income but is entitled to a tax deduction of the $15 million interest expense that relates to the income. We assume that New Zealand has granted tax sparing to Country X on this interest income at a rate of 10 per cent, being the maximum tax on gross interest typically set under our tax treaties.




The tax consequences are as follows:

– Country X: No Country X tax is imposed because the tax is spared under one of Country X's economic expansion incentives.

– New Zealand: New Zealand Company pays no New Zealand tax since its net profit is nil (interest income equals its interest expenses). Tax credits for tax spared under the New Zealand/Country X tax treaty are not used, therefore, as there is no New Zealand tax liability.

– The interest income paid from New Zealand to Foreign Financier may be subject to either interest withholding tax of 10 per cent to 15 per cent, or a 2 per cent levy.[3]

– Foreign Country: Foreign Financier may or may not be subject to tax, depending on the tax system in the country in which it is resident.

In summary, nothing is gained by using New Zealand as a conduit for a simple back-to-back financing arrangement.

**Scenario three - similar to scenario two, except two New Zealand companies are used - one to soak up the tax sparing credits and the other to accumulate tax losses**

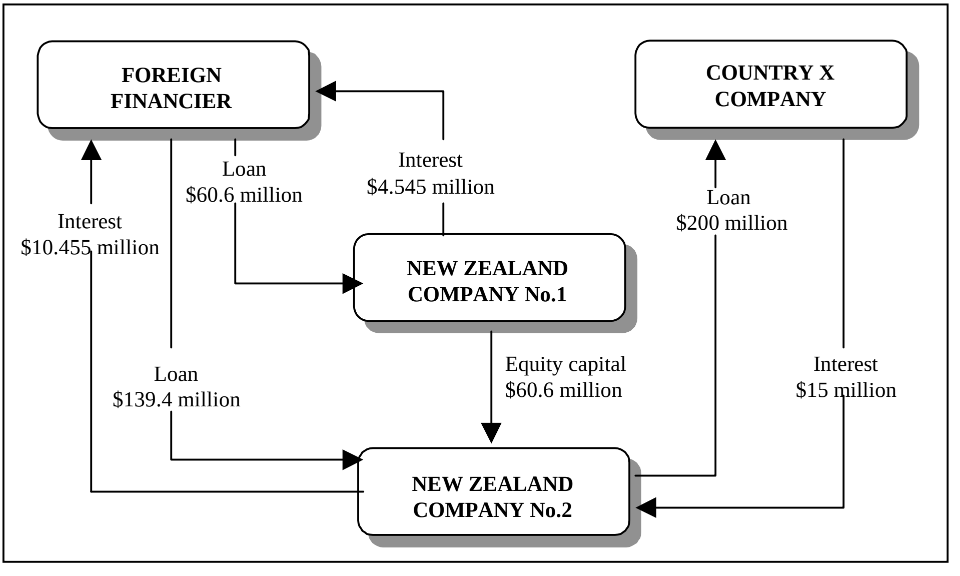
A tax-effective structure ensures that the tax spared credits are soaked up by the recipient company. This is done by splitting the interest expenditure (and loans) between two companies to create a profit in the credit soak-up company. The interest expenses (not required by the tax credit soak-up company) are passed (typically sold) to a profitable New Zealand company that can offset them against other income or accumulate them as tax losses for future use.

As illustrated below, the $200 million loan from Foreign Financier is split between the two New Zealand companies in the following proportions:

– "New Zealand Company No. 1" (NZ Co 1) - $60.6 million; and

– "New Zealand Company No. 2" (NZ Co 2) - $139.4 million.

NZ Co 1 passes the funds that it borrowed ($60.6 million) on to NZ Co 2 by way of an equity capital injection (for example, a purchase of shares in NZ Co 2). NZ Co 2 then lends the full $200 million to Country X Company. We assume again that New Zealand has granted tax sparing to Country X on this interest income at a rate of 10 per cent.



Country X Company pays $15 million interest to NZ Co 2. NZ Co 2 is taxed in New Zealand as follows:

| | |
|---|---|
| Interest income | 15 000 000 |
| Interest expenses | 10 454 545 |
| Net profit | 4 545 455 |
| Tax on net profit (33 per cent) | 1 500 000 |
| Tax sparing credits (10 per cent x $15 million) | (1 500 000) |
| Tax to pay | Nil |

NZ Co 1 has incurred an interest expense of $4,545,455. This translates to a net loss of the same amount on this transaction because it receives no current taxable income from its equity investment in NZ Co 2. This loss can be offset against other income of NZ Co 1 or offset against the income of another company in the same group of companies.

The tax consequences are as follows:

– Country X: No Country X tax is imposed since the tax is spared under one of Country X's economic expansion incentives.

– New Zealand: NZ Co 2 pays no New Zealand tax because its $1 500 000 tax liability is eliminated by a tax sparing credit.

NZ Co 1 is left with a tax loss of $4 545 455 which may be offset against other New Zealand income. The tax benefit of this loss - which is borne by the New Zealand tax base - is $1 500 000 ($4 545 455 x 33 per cent). This is equivalent to the amount of the tax sparing credit.

The interest income paid from New Zealand to Foreign Financier may be subject to either interest withholding tax of 10 per cent to 15 per cent, or a 2 per cent levy

– Foreign Country: Foreign Financier may or may not be subject to tax, depending on the tax system in the country in which it is resident.

By channelling debt investments through a country that grants tax sparing credits, and ensuring that an appropriately tax-planned structure is used to soak up the spared foreign tax credits, a tax benefit equal to the value of the tax spared credits can be obtained. This is contrary to the purpose of tax sparing, which is intended to prevent the home country clawing back the tax incentive of the developing country. It is not there to give a cash subsidy equal to the value of the tax spared by the developing country.

The example has been presented in a simplified form so that the concept can be understood. In the actual schemes that we have encountered, the tax benefit was shared between the foreign financier, a New Zealand company and the company in the developing country (which was to receive a discounted rate of interest). The schemes did not proceed because New Zealand and the treaty partners concerned quickly inserted an anti-avoidance rule in the treaties which permit the New Zealand competent authority to deny tax sparing credit claims if the provision is being abused. This anti-avoidance rule is discussed in more detail later in this paper. We also considered amending New Zealand's domestic law to counter the scheme, but we could not find a suitable remedy. The tax treaty solution appears to have deterred international financiers from using the treaties concerned, although some financiers have advised that they will instead run the scheme through other countries with tax sparing provisions.

We also became aware of schemes that were to use a structure similar to the one outlined above, except the debt funding was to flow from the developing country to New Zealand and then back to the developing country. The sole purpose of this circular flow of funds would be to exploit the tax sparing provision in the tax treaty. We suspect that the lender and borrower in the developing country were either the same entity or associated entities.

*Annex V*

## TAX AVOIDANCE SCHEME II

The routing-scheme example described below has been reproduced from the Australian note SG/EMEF/CFA(96)17 to the EMEF meeting in Paris on 26-27 September 1996.

The largest scheme so far encountered in Australia involves a circular flow of funds. A series of loans were to be purportedly made by an Australian financial institution to a major foreign bank via an intermediary finance company resident in a developing country with which Australia had agreed under a tax treaty to tax spare interest withholding tax forgone by that country under a particular development incentive tax concession. The foreign bank then effectively was to pay the loan moneys back to the Australian financial institution. Interest on such loans were normally subject to 10 per cent interest withholding tax by the developing country. However, the Finance Minister of that country agreed to reduce the interest withholding tax rate on these loans to 1.5 per cent under the relevant development incentive.

Judged against a test of commercial reality, the proposed scheme was artificial and contrived, with the transactions being intended to take place in the space of 30 minutes. Although ostensibly the proposed transactions involved funds of several billion Australian dollars, the transactions were to use only approximately $A 200m, which was to be made available to the intermediary finance company and most of that amount would have been returned immediately to the Australian financial institution in the form of prepaid interest. The scheme would have enabled that financial institution to incur a notional loss which was approximately sufficient in amount to offset the interest income it had earned. The "tax spared" foreign tax credit in respect of the interest withholding tax was to be offset against the tax payable on other foreign income of the financial institution. Over the duration of the scheme the cost to

Australian revenue would have been in the order of $A 100m. It was only by means of strong representations to its treaty partner that Australia was able to prevent the scheme from being implemented.

*Annex VI*

# ANTI-ABUSE PROVISIONS

Country model tax sparing anti-abuse provisions

**New Zealand:** Notwithstanding paragraph (...) of Article ... [tax sparing provision in the Elimination of Double Taxation Article] of the Agreement, a New Zealand resident deriving income from [other country], being income referred to in that paragraph, shall not be deemed to have paid [other country] tax in respect of such income where the competent authority of New Zealand considers, after consultation with the competent authority of [other country], that it is inappropriate to do so having regard to:

*a)* whether any arrangements have been entered into by any person for the purpose of taking advantage of paragraph (...) of Article ... for the benefit of that person or any other person;

*b)* whether any benefit accrues or may accrue to a person who is neither a New Zealand resident nor a resident of [other country];

*c)* the prevention of fraud, evasion, or avoidance of the taxes to which the Agreement applies;

*d)* any other matter which the competent authorities consider relevant in the particular circumstances of the case including any submissions from the New Zealand resident concerned.

**Australia: (**Host country) tax forgone shall not be deemed to have been paid in respect of income derived from any scheme entered into by an Australian resident with the purpose of using [host country] as a conduit for income or as a location of property in order to evade or avoid Australian tax through the exploitation of the Australian foreign tax credit provisions, or to confer a benefit on a person who is neither a resident of Australia, nor of (the host country).

*Annex VII*

## ARTICLE 23B OF THE COMMENTARY TO THE OECD MODEL TAX CONVENTION

C. The relation in special cases between the taxation in the State of source and the ordinary credit method

72. In certain cases a State, especially a developing country, may for particular reasons give concessions to taxpayers, *e.g.* tax incentive reliefs to encourage industrial output. In a similar way, a State may exempt from tax certain kinds of income, *e.g.* pensions to war wounded soldiers.

73. When such a State concludes a convention with a State which applies the exemption method, no restriction of the relief given to the taxpayers arises, because that other State must give exemption regardless of the amount of tax, if any, imposed in the State of source (see Section III, paragraph 3). But when the other State applies the credit method, the concession may be nullified to the extent that such other State will allow a deduction only of the tax paid in the State of source. By reason of the concessions, that other State secures what may be called an uncovenanted gain for its own Exchequer.

74. Should the two States agree that the benefit of the concessions given to the taxpayers in the State of source are not to be nullified, a derogation from paragraph 2 of Article 23 A, or from Article 23 B will be necessary.

75. Various formulae can be used to this effect, as for example:

*a*) the State of residence will allow as a deduction the amount of tax which the State of source could have imposed in accordance with its general legislation or such amount as limited by the Convention (*e.g.* limitations of rates provided for dividends and interest in

Articles 10 and 11) even if the State of source, as a developing country, has waived all or part of that tax under special provisions for the promotion of its economic development;

*b*) as a counterpart for the tax sacrifice which the developing country makes by reducing in a general way its tax at the source, the State of residence agrees to allow a deduction against its own tax of an amount (in part fictitious) fixed at a higher rate;

*c*) the State of residence exempts the income which has benefited from tax incentives in the developing country.

Contracting States are free to devise other formulae in the course of bilateral negotiations.

76. If a Contracting State agrees to stimulate especially investments in the other State being a developing country, the above provisions will generally be accompanied by guarantees for the investors, that is to say, the Convention will limit the rate of tax which can be imposed in the State of source on dividends, interest and royalties.

77. Moreover, time restrictions or time limits can be provided for the application of the advantages referred to in formula *a*), and possibly *c*), above: the extended credit (or the exemption) may be granted only in respect of incentives applied temporarily in developing countries, or only for investments made or contracts concluded in the future (for instance, from the date of entry into force of the Convention) or for a determined period of time.

78. Thus, there exists a considerable number of solutions to this problem. In fact, the concrete effects of the provisions concerned can also vary as a result of other factors such as the amount to be included in the taxable income in the State of residence (formulae *a*) and *b*) above); it may be the net income derived (after deduction of the tax effectively paid in the State of source), or the net income grossed-up by an amount equal to the tax effectively paid in the State of source, or to the tax which could have been levied in accordance with the Convention (rates provided for in Articles 10 and 11) or to the tax which the State of residence agrees to allow as a deduction.

*Annex VIII*

# RECOMMENDATION OF THE COUNCIL ON THE GRANTING AND DESIGN OF TAX SPARING IN TAX CONVENTIONS

THE COUNCIL,

Having regard to Article 5 b) of the Convention on the Organisation for Economic Co-operation and Development of 14 December 1960;

Having regard to the Recommendation of the Council of 23 October 1997 concerning the Model Tax Convention on Income and on Capital C(97)195;

Having regard to the Report on tax sparing: "Tax Sparing: A Reconsideration" [DAFFE/CFA(97)3/REV2], hereafter referred to as the Report;

Considering that the granting of tax sparing in tax conventions may offer wide opportunities for tax planning and tax avoidance;

Considering that the granting of tax sparing in tax conventions may have the effect of provoking harmful tax competition between countries;

Having regard to the need to develop a more coherent approach among Member countries and non-member countries towards the granting and design of tax sparing in tax conventions;

I. RECOMMENDS to the Governments of Member countries that, in negotiating and concluding tax treaties, they follow the recommendations set out in the Report on the use and design of tax sparing provisions, as it may be amended from time to time; and

II. INVITES the Governments of Member countries to inform, as appropriate, the Committee on Fiscal Affairs of any modification in their policy on the use and design of tax sparing provisions;

III. INSTRUCTS the Committee on Fiscal Affairs:

1. to pursue its work on issues pertinent to tax sparing; and

2. to develop a dialogue with non-Member countries that request tax sparing, with the aim of developing a more coherent position on the granting and design of tax sparing.

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# NOTES

1. The current report is focused primarily on foreign investment activities carried on through a subsidiary. Since foreign branches of companies are generally taxed on a current basis in the residence country, some of the arguments raised in this and other sub-sections would not be directly relevant to branch-situations. This fact does not necessarily affect the conclusions of this report. First, the bulk of foreign operations of multinationals are carried out through subsidiaries. Second, the decision to establish foreign activities through a branch is often taken in cases where the resident company anticipates that the foreign operations initially will generate substantial losses. The use of a branch enables the resident company to offset those losses against other income derived by the company. When the branch operations later begin to generate income, the residence company often reorganises the branch into a subsidiary to benefit from deferral.

2. For a general overview of the CFC regimes in the OECD Member countries, see the OECD report, Controlled Foreign Company Legislation, Studies in Taxation of Foreign Source Income (1996).

3. The rate may be set by a tax treaty or domestic law and some instruments are exempt from income tax but subject to a levy.