# The Concept of Tax Sparing

*A General Analys*is, *and an Analysis and Assessment of the Various Features of Tax Sparing Provisions*

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## Preface

This paper was submitted as my Master Thesis at the University of Oslo, to obtain my degree as Master of Laws. Except for some minor lingual corrections, this text is the same as the one submitted.

The paper was written as part of a research project called Sustainable Tax Governance in Developing Countries through Global Tax Transparency (DeSTaT), headed by Professor Frederik Zimmer. While working on the paper I was employed as a research assistant at the Department of Public and International Law at the University of Oslo.

On an abstract level, the paper concerns legal instruments in international tax law, which affects domestic tax measures in developing countries. Herein, more specifically, the topic of the paper is a basic premise in the quite comprehensive policy debate whether tax sparing provisions should be adopted in tax treaties between industrialized countries and developing countries, namely the characteristics of tax sparing as a legal phenomenon.

Seemingly, surprisingly little effort has been devoted systematizing and analyzing tax sparing as a separate legal phenomenon. This discovery was part of my motivation to research this particular topic. Accordingly, this paper is intended to contribute to the understanding of tax sparing as a concept of law.

While working on the paper I received tremendous inspiration and support from colleagues and friends. I would especially like to thank my supervisor Professor Frederik Zimmer for valuable comments and input. For interesting discussions, contributing to my general understanding of international tax law, I would also like to thank Blazej Kuzniacki and Eivind Furuseth.

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## Table of contents

# Part I: Introduction

## 1 General introduction

### 1.1 The general topic

Tax sparing is a regulatory technique predominantly adopted in double tax treaties between industrialized countries and developing countries.[1] Tax sparing provisions generally enable tax incentives granted by developing countries to accrue to foreign investors, rather than being consumed under the system of eliminating juridical double taxation. The overall rationale of enabling tax incentives to accrue to foreign investors is the notion that it will induce an increase of inbound capital flows to the developing country, which may contribute towards economic development.[2]

The objective of this thesis is to provide a comprehensive analysis of the concept of tax sparing. This will be done in two main parts. The first part will address the general characteristics of tax sparing, its rationale and its role in double tax treaties. The second part will provide an analysis and systematization of, and comments on, the different and variable components of tax sparing provisions.

### 1.2 Contribution and context

From a general policy perspective, it is a controversial issue whether tax sparing provisions should be adopted in tax treaties between industrialized and developing countries. Skepticism towards tax sparing is especially reflected in the OECD report of 1998 *Tax Sparing, A Reconsideration*. However, the OECD report does not go as far as to generally discourage

[1] *Tax Law Design and Drafting* (2000) p. 1013.

[2] Knoll (2008) p. 4.

the adoption of tax sparing provisions in tax treaties.[3] Moreover, some industrialized countries have a fairly restrictive policy on adopting tax sparing provisions in tax treaties. On the outer end of the scale is the U.S., which has a consistent policy of not adopting tax sparing provisions in any of its double tax treaties.[4] More recently, Norway has also taken the policy position of not adopting tax sparing provisions in double tax treaties.[5] The United Kingdom has seemingly adopted a more balanced position, and has concluded tax treaties with tax sparing provisions as recently as in 2011.[6] Developing countries tend to be proponents of tax sparing.[7] On the outer end of this scale is the position of Brazil, that refuses to enter into tax treaties unless the treaty includes tax sparing. Because of the incompatible policy positions of the U.S. and Brazil, there is no tax treaty between these States.[8] Moreover, China has also been a strong proponent of tax sparing.[9]

In legal theory, besides very general analysis, it appears that the primary focus is mostly set on the policy debate whether tax sparing provisions should be adopted in tax treaties or not, and the more general issues connected to tax sparing, such as general efficiency and harmful tax competition. Conversely, seemingly little effort is put in analyzing and systematizing tax sparing as a legal concept.[10] Accordingly, presented perceptions of the concept of

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[3] OECD, *Tax Sparing: A reconsideration* (1998) p. 42: The report especially mentions lacking efficiency, tax treaty abuse and harmful tax competition as primary concerns.

[4] *International Tax Law* (2012) p. 224.

[5] Proposal by the Norwegian Ministry of Finance to the Norwegian Parliament, nr. 42 (1996-1997). The proposal was endorsed by the Financial Committee of the Norwegian Parliament and the Parliament adopted a resolution in accordance with the proposal. The proposal primarily concerned the conclusion of a tax treaty between Norway and Nepal.

[6] United Kingdom and Ethiopia 2011 article 22(3).

[7] Arnold (2002) p. 51. See also the reservations in the OECD Commentaries P(23)-1, paragraphs 1-5.

[8] Zimmer (2009) p. 145.

[9] Maugüé (1997) p. 159-160.

[10] A notable exception is Viherkenttä (1991), who gives a nuanced analysis of tax sparing, especially on p. 140-163.

tax sparing appear to lack nuance and especially fail to acknowledge that the implications of tax sparing are heavily influenced by the variable components that may constitute a tax sparing provision. Hence, there is seemingly a void as to the perception of what tax sparing is and what it may be. The objective of this thesis is to contribute toward filling this void, by providing a comprehensive analysis and systematization of tax sparing as a legal concept, which will hopefully contribute to increase the understanding of what tax sparing is and what it may be.

# 2 The methodological approach

## 2.1 General

The perspective of the thesis is tax sparing as a regulatory model and concept. Conversely, it is not an in-depth study of how specific tax sparing provisions are applied on a case to case basis in a specific bilateral context. This section will address the general methodology used to analyze the concept of tax sparing and moreover the basis used to comment on the various features of tax sparing provisions.

## 2.2 Tax treaties

### 2.2.1 Operative tax treaties

The tax sparing provisions referred to are from operative tax treaties. A methodical challenge is the selection of operative tax treaties and tax sparing provisions. In principle, a fully valid analysis of tax sparing entails studying all tax treaties with tax sparing provisions. However, considering the frame and topic of the thesis, and the fact that it is a nearly insurmountable task to find and obtain all relevant treaties, this is considered inapt. Rather, the provisions referred to is a selection of what is considered to be provisions that exhibit generally distinct and representative features. The provisions are selected from a base of provisions found by initially studying legal theory, which provides information on the general types of tax sparing provisions, which States that adopt or have adopted tax sparing provisions in their tax treaties and references to tax treaties with tax sparing provisions.[11] This has served as a starting point for researching the tax treaties of States that frequently have adopted tax sparing provisions, which has resulted in additional findings.

Using an inductive research method, such as this one, it cannot be excluded that there are variations of tax sparing, with significantly distinct features, that have been left out and that may compromise the validity of the conclusions and observations made. Thus, in this respect, a general reservation is made.

It should be noted that not all the tax sparing provisions referred to are in force, because such provisions often "expire" after a certain period of time. Because of the conceptual perspective of the thesis, this is not considered problematic.

### 2.2.2 Model tax treaties and their commentaries

In general, operative tax treaties are heavily based on model tax treaties. By far the most influential model tax treaty is the OECD Model Tax Convention on Income and on Capital. Its provisions are adopted in the majority of operative tax treaties and it is extensively used as a basis for drafting tax treaties not only by OECD countries, but also non-OECD countries. Moreover, it is the basis of the United Nations Model Double Taxation Convention between Developed and Developing Countries.[12] The influence includes both the model provisions and the comprehensive general commentary. Tax sparing is included in neither of the model treaties, but is addressed in both general commentaries.

Many important aspects of tax sparing arise from the interaction with other tax treaty provisions. In these respects, the OECD MTT will be the general reference, unless otherwise

[11] OECD, *Tax Sparing: A reconsideration* (1998) p. 68-69 provides a table of tax sparing provisions between OECD and certain non-OECD countries, which has been a particularly useful starting point when searching for tax sparing provisions. However, other sources have been used as well.

[12] OECD Commentaries I-4 paragraphs 13-15 and UN Commentaries vi paragraphs 1-3.

stated. The UN MTT will be addressed to the extent that it provides for relevant divergences. Overall, the main difference between the provisions in the OECD MTT and the UN MTT is that the latter generally grant the State of source a more extensive right to tax income.[13] The U.S. model tax treaty will not be used as a reference, as it is only used where the U.S. is a contracting State,[14] entailing that there is no tax sparing provision.

### 2.2.3 General rules of interpretation

The Vienna Convention on the Law of Treaties provides general rules for interpretation of treaties. The convention is not ratified by all States. However, its provisions regarding the interpretation of treaties are considered congruent with customary international public law,[15] which is generally binding for all States. It is also generally recognized that these rules apply to tax treaties.[16] Thus, the general rule is that tax treaties shall be interpreted in "good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."[17] The wording of the tax treaty is accordingly the fundamental factor of interpretation. Moreover, the treaty shall be interpreted so that it effectively fulfills it purpose.[18] The general purpose of tax treaties is to avoid juridical double taxation. However, the purpose of tax sparing provisions is to contribute to economic development in the State of source by ensuring that the income is not fully taxed in any of the States.[19] It is not said that these purposes necessarily conflict when interpreting a treaty. However, if they do, the question could be raised which purpose prevails.

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[13] UN commentaries vi paragraph 3.

[14] Holmes (2007) p. 62.

[15] Cassese (2005) p. 179.

[16] Vogel (1997) p. 35.

[17] Vienna Convention art 31(1).

[18] Cassese (2005) p. 179. See also Slovakia v. Hungary p. 79/76. The judgment uses two separate page numerations.

[19] Viherkenttä (1991) p. 141.

The status of the OECD Commentaries as a factor of interpretation under the Vienna Convention is controversial.[20] Nonetheless, most scholars seem to agree that the Commentaries are a significant factor of interpretation.[21] In respect to tax sparing provisions, the issue is not precarious as the Commentaries do not provide meaningful guidance to their interpretation. Where the OECD and UN model treaties are used as a contextual reference, the respective commentaries will be used extensively as the question in that case is not the substance of an operative treaty, but the substance of a regulatory model.

### 2.3 Domestic law

In some contexts a coherent analysis of tax sparing requires references to domestic law. Especially, this includes tax incentive measures in developing countries and the domestic treatment of foreign source income in industrialized countries. In these respects, the analysis is based on regulatory models that may be adopted in domestic law and are perceived to be more or less widespread. The description of these models is primarily based on legal theory. However, for illustrative purposes, references to specific domestic law will also be made. In this case, unless otherwise stated, the legal substance is derived solely from the wording of the respective statutes, except in the case of Norwegian law where generally accepted rules of interpretation of Norwegian law are applied.

### 2.4 Normative comments

Some parts of the analysis, especially those concerning alternative design options, are appropriate to supplement with normative comments. The primary basis for the comments is the normative view that tax sparing provision should provide the greatest possible contribution to the economic development of the developing country whilst counteracting that benefits accrue to investors who behave contrary to this purpose.[22] These aspects are based on the primary critical points addressed by the OECD, which is that tax sparing may be an

[20] *International Tax Law* (2012) p. 170.

[21] For example: *International Tax Law* (2012) p. 170, Vogel (1997) p. 43, Zimmer (2009) p. 78-79.

[22] Weeghel (1998) p. 117.

ineffective contribution to development and that it is prone to abuse.[23] The applied primary basis is in principle different aspects of the same objective, namely to optimize the premises for tax sparing to function according to its object and purpose.

Moreover, separate features and aspects may raise specific issues of a less principal nature. Such issues will be commented continuously as they arise and as is found appropriate.

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[23] OECD, *Tax Sparing: A reconsideration* (1998) p. 41.

# Part II: The General Concept of Tax Sparing

## 3 General characteristics

### 3.1 Introduction

The purpose of this section is to analyze and systematize the principal aspects of the concept of tax sparing.

### 3.2 Basic perceptions

In legal theory, the abstract perceptions of tax sparing provisions are fairly congruent, despite that in operative tax treaties there are numerous and significant variations of the concept. In the OECD report, *Tax Sparing: A reconsideration,* of 1998, the following general characteristic is used on page 11:

> "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."

According to this general description, tax sparing generally entails that the benefit of a special tax reduction or exemption, granted by the State of source, accrues to the investor. Here, the need for tax sparing is limited to the case where the State of residence applies the credit method to eliminate juridical double taxation. A similar characteristic is found in the OECD Commentaries C(23)-30-31, paragraph 73, and the commentary to the UN MTT on page 336, paragraph 73:

> "The purpose of these provisions is to allow non-residents to obtain a foreign tax credit for taxes that have been "spared" under the incentive programme of the source State or to ensure that these taxes will be taken into account for the purposes of applying certain conditions that may be attached to exemption systems."

Here, tax sparing seemingly also includes the case where the State of residence applies the exemption method combined with a *subject to tax clause*.[24] In this case, the technique denoted as tax sparing involves modifying subject to tax clauses so that they do not apply in the case of tax incentives. However, in this thesis, for reasons given in section 4.4.1.1, this is not considered a form of tax sparing.

So far it has been stated that tax sparing is needed for the tax incentive to accrue to the foreign investor. This reflects what would occur in the absence of tax sparing, namely that the tax incentive would not accrue to the investor. Generally, both in the case of the credit method and the exemption method, with a subject to tax clause, the tax foregone by the State of source under its tax incentive measure will be taxed in the State of residence. Thus, the concession made by the State of source effectively accrues to the revenue of the State of residence, rather than the investor. Accordingly the immediate rationale of tax sparing is to prevent the nullification of source country tax incentives and to ensure that the tax benefit accrues to the foreign investor. It should be noted that the nullification effect does not always occur where the source country grants tax incentives to foreign investors. Section 8 will address in which cases tax sparing is necessary for the tax incentive to accrue to the investor.

### 3.3 Outline of the tax sparing mechanism in practice

From a functional perspective, the primary mechanism of tax sparing is to establish a fictional tax paid in the State of source, to fully or partially restrict the consequence on source country tax incentives otherwise induced by the credit method.[25] The taxpayer is provided a credit in the State of residence for tax not actually paid in the State of source, i.e. a credit for “notional tax”.[26] This mechanism may appropriately be illustrated by an example:

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[24] Vogel (1997) p. 361 and 1175.

[25] OECD MTT article 23B.

[26] Vogel (1997) p. 1255.

State A and B have a double tax treaty where State A applies the ordinary credit method to eliminate juridical double taxation. The tax treaty states that dividends may be taxed in the State where the company paying dividends is resident. The company paying dividends is resident in State B, which, as a tax incentive, provides withholding tax relief on dividends. Normally, dividend withholding tax is imposed at a rate of 10 percent. In State A, the dividends are taxed by 25 percent. Pursuant to the credit method, a credit is only granted in the State of residence for tax "paid"[27] in the State of source. Thus, as no tax on dividends is paid in State B, the taxpayer does not receive a credit in State A. Consequently, the dividends are taxed by 25 percent in State A. Thus, the benefit of withholding tax relief does not accrue to the taxpayer. Instead, the benefit accrues to the State of residence, as it does not have to provide a credit. As the investor does not obtain any tax benefit, the purpose of withholding tax relief as an investment inducement is clearly not realized.

Tax sparing provisions may be drafted differently, but the common purpose of such provisions is to fully or partially preserve the tax incentive. Article 25(2)(c) of the France and India treaty of 1992 sets forth that

> "(…) the term "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 within the limits provided for by this Convention, for any year but for an exemption from, or reduction of, tax granted for that year (…)"

Applied to the current example, the cited part of the provision results that the investor, resident in State A, receives a credit in State A equal to 10 percent of the dividends paid, even though no tax is actually paid. Thus, the investor obtains the benefit of withholding tax relief in the State of source. Consequently, 15 percent tax is imposed on the paid dividends, instead of 25 percent.

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[27] OECD MTT article 23B(1)a.

### 3.4 Why the concept of tax sparing is implemented in tax treaties

From the general descriptions of tax sparing it could appear that the concept is reserved the domain of tax treaties. However, in principle, there is no necessity implying that tax sparing has to be implemented in double tax treaties.

An example of domestic implementation of tax sparing is the revoked § 26(3) of the German Körperschaftsteuergesetz (corporate income tax law). It prescribed that a German parent company of a subsidiary in a developing country, under certain conditions, would be granted a credit on distributions from the subsidiary, equal to German tax on the distributions.[28] Thus, if the distributions where subject to full withholding tax relief in the developing country and would be taxed by 20 percent in Germany, the parent company would receive a credit equal to 20 percent tax on the distributions. Accordingly, the host State withholding tax relief would not be nullified by the higher tax on received distributions otherwise imposed on the German parent.

Thus, in principle, the intended consequence could be achieved separately on domestic level, outside the framework of a tax treaty. Nonetheless, the concept of tax sparing is usually implemented in tax treaties.[29] States may have different reasons to adopt this approach rather than implementing tax sparing in its domestic legislation. However, some possible reasons may be identified. First it is the obvious reason that it is common practice to implement the concept in tax treaties. Second, tax treaties are usual bilateral, allowing the State of residence to deploy and draft tax sparing provisions on a State to State basis, rather than generally. A third reason may be that tax sparing is often used as leverage by

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[28] Reference to Körperschaftsteuergesetz § 26(3) is made by Vogel (1997) p. 1257 and Viherkenttä (1991) p. 141. The referred substance of the provisions is based on the interpretation of the mentioned authors and is thus a description of legal theory. In the currently effective Körperschaftsteuergesetz, the § 26(3) provision is removed. Nevertheless, it illustrates that tax sparing may be implemented outside the framework of tax treaties.

[29] Viherkenttä (1991) p. 142.

industrialized countries in tax treaty negotiations with developing countries.[30] Lastly, the credit method is a prerequisite for the consequence that tax sparing is designed to eliminate. Hence, it may be considered appropriate to directly attach the function of tax sparing to the credit method.

### 3.5 Tax sparing credit and matching credit

Subordinate of the general concept of tax sparing, a distinction is often made between "tax sparing credit" and "matching credit", which are considered the main types of tax sparing.[31] The distinction primarily concerns the relevance of domestic law of the State of source when determining the creditable notional tax.

Tax sparing credit, sometimes also referred to as the "contingent relief method", is the more commonly deployed version of tax sparing.[32] It describes the case where the credit for notional tax is set to the general tax liability otherwise imposed in the host State. Moreover, in this case, the credit for notional tax is often limited to special host country tax incentive measures that meet set conditions, which are more or less specified. The very basic operation of this approach was illustrated under the example in section 3.3. An illustrative example of tax sparing credit provision is the first sentence of article 22(2)(d) of the tax treaty between Sweden and Malta of 1995, cited below:

> "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 manufac-

[30] OECD, *Tax Sparing: A reconsideration* (1998) p. 13.

[31] Vogel (1997) p. 1256.

[32] *Tax Law Design and Drafting* (2000) p. 1013.

> turing activities or from agriculture, fishing, tourism (including restaurants and hotels) provided that the activities have been carried out within Malta."

The wording clearly implies that the creditable amount is tax that would otherwise be imposed pursuant to the general tax provisions of Malta. Moreover, the credit for notional tax is limited to tax measures promoting economic development within specific fields.

Matching credit, sometimes also referred to as "the fixed-relief method"[33], differs by providing a fixed credit, regardless of both tax paid under the tax incentive regime and the general level of tax in the source State. An example of matching credit is article 24(4) of the tax treaty between Norway and Brazil of 1980:

> "For the deduction indicated in paragraph 3 Brazilian tax on dividends, interest and royalties shall always be considered as having been paid at a rate of 25 per cent."

Here, the creditable amount is the same, i.e. 25 percent, regardless of the general tax liability imposed on such income in Brazil and thus regardless of the tax actually foregone. Moreover, under this particular provision, no conditions are set as to the characteristics of the Brazilian tax incentive.

Beyond the obvious difference, that the credit for notional tax is computed differently, a principally important difference is that under the matching credit approach, the credit is unaffected by the general level of tax in the State of source. Conversely, under the tax sparing credit approach, the credit is constituted by the tax actually foregone, and is thus influenced by the general level of tax. Moreover, depending on the fixed rate, a matching credit may also have other functions than just ensuring that the tax foregone in the State of source accrues to the investor. This will be addressed under section 8.6.3.

[33] *Tax Law Design and Drafting* (2000) p. 1014.

Although the distinction between matching credit and tax sparing credit is apt to provide a rough classification of two primary types of tax sparing, the distinction is somewhat inaccurate for the purpose of a more in-depth analysis of tax sparing and its features. Firstly, operative tax sparing provisions may adopt combined concepts in its tax sparing provision, applying matching credit for specific items of income and tax sparing credit for other items of income. An example is that the second sentence of article 22(2)(d) of Sweden and Malta 1995, provides matching credit, prescribing that

> "For the purposes of sub-paragraph (c) [certain dividends] 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 reference to the first sentence entails that the matching credit is subject to the same conditions as the tax sparing credit, making the concepts interconnected. Also, some provisions provide a fixed credit limited by tax actually foregone, thus combining both features.[34] Secondly, tax sparing provisions have other important elements than the feature prescribing how the credit for notional tax is computed, which are not reflected aptly in the categorization, such as conditions that the income has to be derived from specific activities. A third problem is that the distinction is used inconsistently in legal theory, making it a distortive element if used as basis for a coherent analysis.[35] For these reasons, the distinction will not be used in the more detailed analysis. However, it will be used where it is sufficient with a very general classification.

### 3.6 The rationale of tax sparing

Having established the general function of tax sparing, what is the basic justification of preventing the nullification of source country tax incentives?

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[34] For example: Netherlands and Bangladesh 1993 article 23(4).

[35] Viherkenttä (1991) p. 156.

The answer to this question is not obvious. To achieve tax equity and avoid economic distortions, the considerations of capital import neutrality and capital export neutrality are paramount.[36] In respect to capital export neutrality, tax sparing is directly counterproductive. The consideration involves that a taxpayer should be treated equally for tax purposes, regardless whether an investment is made where the taxpayer is resident or in any other State. Tax sparing makes it more favorable to invest abroad and may typically involve that it is more favorable to invest in some States than others, assuming that tax sparing is not granted under all the tax treaties of the home State. In respect to capital import neutrality, tax sparing may be counterproductive. This consideration involves that foreign and domestic investors are treated equally for tax purposes. Hence, tax incentives restricted to foreign investors, underlying the tax sparing provision, are contrary to this consideration. Overall, tax sparing may not be justified on basis of these basic considerations.[37] Rather, they oppose the concept of tax sparing.

One approach to justify tax sparing is the moral aspect of industrialized countries increasing their revenue because of tax concessions in developing countries, whilst inhibiting them from granting effective tax benefits to foreign investors with the aim of increasing inbound capital flows. The view of Viherkenttä (1991) on p. 141 is illustrative:

> "The paramount argument for tax-sparing credit is the perceived inappropriateness of the way in which foreign tax credit in some cases negates source country tax incentives."

Here, tax sparing is seemingly justified by what is considered an inappropriate consequence that may occur in the absence of tax sparing. Thus, the asserted rationale focuses on the negative aspects of the absence of tax sparing, rather than the potentially positive aspects of

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[36] Holmes (2007) p. 6 and 11.

[37] Viherkenttä (1991) p. 141.

the presence of tax sparing. Traditionally, the justification of tax sparing tends to focus on the latter aspect. An example is the view of Barker (2008) on p 361-362:

> "Tax sparing is conceived not as a device for accomplishing inter-nation justice, but rather as a device to aid an emerging economy."

How tax sparing could be considered a form of foreign aid is not entirely clear. The asserted justification is apt to create the notion that tax sparing entails a positive contribution from the industrialized country to the developing country.[38] A more appropriate characteristic is that it allows the developing country to grant tax benefits that accrue to foreign investors. Moreover, from the perspective that the developing country would otherwise impose its ordinary tax, the industrialized country does not have to waiver tax revenue to preserve the incentive. Hence, the "contribution" is of a strictly passive nature and the direct cost is incurred by the developing country. Accordingly, the perspective of foreign aid is rather inappropriate.

A third approach is to justify tax sparing as a means to ensure the exercise of developing country sovereignty, allowing it to effectively deploy a specific part of its domestic tax regime. In this respect tax sparing could be viewed as a restriction of the scope of the worldwide income principle, applied by many industrialized countries, extending the territorial tax sovereignty of the developing country. Such a view is adopted by Vogel (1997) on p. 1256. In this respect, Vogel makes a distinction between tax sparing credit and matching credit. As to the former, it involves that

> "(…) the State of residence respects the indirect subsidy given by the State of source."

[38] Some tax sparing provisions provide credit for more tax than may be taxed by the State of source. In this case, the tax sparing provision entails a concession of tax revenue by the State of residence and thus constitutes a "positive contribution". However, this is a more specific case that will be addressed in section 7.6.3.2.

As to matching credit, Vogel claims that

> "It is based on a different philosophy than tax credit, namely respect for the State of source's fiscal jurisdiction."[39]

As discussed above, matching credit, compared to tax sparing credit, generally provides the source State with greater discretion to amend and govern its tax incentive measures and domestic tax laws. Thus, the distinction appears apt. However, in respect to the basic end-result, both tax sparing credit and matching credit have the consequence that host country tax incentive measures are rendered effective, thus expanding the exercise of territorial fiscal jurisdiction. This is seemingly contrary to the perception of Barker, cited above, who discards the argument of "inter-nation justice". A question that may be raised is of course why the State of residence should limit the scope of the worldwide income principle. One possible reason is that many developing countries emphasize the territorial principle as primary source of revenue, rather than the worldwide principle.[40] Hence, their tax governance is concentrated to the territory. It could therefore be asserted as equitable to allow developing countries greater discretion in respect to which measures they could effectively deploy within their territory.

The asserted justifications to prevent the nullification of host country tax incentives are diverse. Overall, it appears difficult to discard the moral argument, that the result in the absence of tax sparing is "inappropriate". The justification provided by Vogel could support this view, as it focuses on respecting the fiscal measures of the host State. Moreover, the perceived positive effects of tax sparing, promoting economic development, is of course a relevant aspect of the justification as it is the basic rationale of tax incentives and

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[39] For a brief discussion on whether matching credit should be perceived as a form of exemption, see Viherkenttä (1991) p. 141.
[40] Barker (2008) p. 360.

the purpose of tax sparing. Thus, it appears an appropriate claim that tax sparing is justified in that it allows developing countries to introduce measures aimed at contributing to their economic development.[41]

## 3.7 Investment inducement for economic development

### 3.7.1 General

The purpose of ensuring that tax incentives offered by the host State accrue to the foreign investor, and not the revenue of the State where the investor is resident, is the notion that the tax benefit will attract foreign investment. The justification of attracting foreign investment is the idea that it will contribute to economic development, which is thus the overarching objective. As this constitute both the factual basis and important aspects of the rationale and purpose of tax sparing, it appears appropriate to provide an outline of these concepts.

### 3.7.2 Economic development

The United Nations Conference on Trade and Development (UNCTAD) World Investment Report 2012 establish certain general policy objectives as factors to roughly measure the impact of developing country investment policies.[42] These factors reflect primary aspects of development and are therefore appropriate to clarify the concept of economic development and thus the overarching objective of tax sparing provisions.

The first group of objectives is called "Economic value added" and includes the more apparent and general advantages of foreign investment, such as increased Gross Domestic Product (GDP) and fixed capital formation, i.e. the value added to the economy. Any inbound capital flow will in principle be in accordance with these objectives. The group comprises more specific objectives as well: The investments should contribute to export,

[41] For a summarized overview of different asserted rationales and general arguments opposing and proposing tax sparing, see Knoll (2008) p. 8-12.

[42] UNCTAD (2012) p. 121.

and induce entrepreneurial development and increase the formal economy by using several separate business entities in its value chain. For example, in the case of investment in natural resources, the investment should not only consist of extracting the resources but should also consist of refining them. The last objective under this category is increase of tax revenue. However, this factor is distorted by the premise of tax incentives. Nonetheless, it reflects that tax revenue should only be sacrificed if the advantages of investments that would not be made without the incentive exceed the loss of tax revenue.

The second group of objectives is “Job creation”. Under this category, it is set forth that foreign investments should increase the total number of jobs, increase general household income and improve workforce skills. The third group of objectives is denoted “Sustainable development”. Under this general objective, foreign investment should inter alia improve working conditions, increase availability of basic goods and services, develop environmentally prudent industries, develop available natural resources and entail technology transfer.

Ultimately, the objective of tax sparing is thus to contribute towards the achievement of these general objectives. However, how these objectives are best met by means of foreign investment will of course vary on a State to State basis. Moreover, the development objectives of a specific country are much more specific than those outlined above.[43] Nonetheless, the general objectives provide an apt perception of what the overarching objective of tax sparing is.

### 3.7.3 Tax incentives

In principle, all taxes affect economic activities and distinct types of taxes could therefore be characterized as either incentives or disincentives for specific economic activities.[44] Accordingly, it may be difficult to make a distinction between tax incentives and other tax measures. Somewhat different criteria have been used to determine what should be consi-

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[43] UNCTAD (2000) p. 12-13.

[44] Viherkenttä (1991) p. 17.

dered a tax incentive. One approach is the statutory criterion. Under this approach, a tax incentive is a tax rule subject to special criteria, which is more favorable than the general tax provision that would otherwise apply.[45] This characteristic emphasizes that a distinctive feature of tax incentives, compared to other tax measures, is that they are “selective in their application”.[46] Another approach is the teleological approach, where the decisive criterion is whether the State intends to provide a special tax benefit for the purpose of promoting specific policy goals, such as attracting foreign investment.[47] This approach is important as some tax incentive measures, such as tax holidays, in fact may entail more tax in the long term than general tax rules. This will be addressed under section 6.3.1.1. Moreover, in accordance with this approach, unintended tax benefits are not considered tax incentives for the purpose of this thesis.

Within this definition, a distinction can be made between direct and indirect tax incentives. The first category includes incentives which directly affect the level of income tax, such as tax exemptions and accelerated depreciation. The second category is incentives such as exemptions from import tariffs and value added tax, which affect the profits of the enterprise and thus indirectly the overall level of taxation.[48] The latter will not be the topic of this thesis. Hence, in respect to tax incentives, the thesis will focus on income tax incentives.

Income tax incentives may be implemented in a wide variety of forms. Different general types of tax incentives will be discussed in greater detail under section 6.3.

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[45] Zee and others (2002) p. 1498 and Easson (2004) p. 2-3.

[46] Easson (2004) p. 105.

[47] Vogel (1997) p. 1256 and Viherkenttä (1991) p. 17-18.

[48] Zee and others (2002) p. 1505-1506: The distinction between direct and indirect tax incentives is generally congruent with the distinction between income tax and other taxes.

### 3.7.4 Foreign investment

Many developing countries adopt tax incentive regimes to attract foreign investments. Commonly, such incentives are directed at attracting investment involving substantial business operations. Conversely, such tax incentive regimes generally do not favor short term passive investments in easily tradable assets.[49]

The term "foreign investment" is seemingly very broad and implies a capital flow from a source in one State to a recipient in another State. However, in reports and analysis on cross-border capital flows, the term "foreign investment" has a more specific meaning. It denotes transfer of capital from one State to another, between parties acting in a private capacity, i.e. private cross-border capital flows. This contrasts so-called official capital flows, which are investments and economic aid provided by States and certain organizations, such as the World Bank and the International Monetary Fund.[50]

Developing country tax incentives directed at foreign investors are usually only granted for foreign *direct* investment (FDI),[51] which is another term commonly used in context of both cross-border capital flows and tax incentives as such.[52] A commonly deployed general definition is set forth in the OECD *Benchmark Definition of Foreign Direct Investment* 2008 on page 17:

> "Direct investment is a category of cross-border investment made by a resident in one economy (the *direct investor*) with the objective of establishing a lasting interest in an enterprise (the *direct investment enterprise*) that is resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long-term relationship with the direct investment enterprise to ensure a signif-

[49] Easson (2004) p. 4.

[50] The definitions and distinctions are based on Easson (1999) p. 1-3.

[51] *Tax Law Design and Drafting* (2000) p. 986 and Zee and others (2002) p. 1499.

[52] For example: OECD (1995) p. 29-30.

> icant degree of influence by the direct investor in the management of the direct investment enterprise."[53]

There is a seemingly consensual opinion that FDI has greater potential of contributing to economic development than so-called portfolio investment (PFI). This is reflected in theory,[54] in developing country tax incentive measures and tax sparing provisions. PFI is investment where the motivation is exclusively the return rate of the investment, not being actively involved in carrying out the venture. Hence, it usually involves investment in easily tradable assets such as equity shares, bonds, derivative contracts and other financial instruments.[55] Thus, the latter does not involve any partaking in the business operations as such. The primary reasons why FDI is considered a better contribution to development than PFI is that it generally spans over a longer period of time, has several positive "spill-over" effects, for example technology transfers, and has proven to be less affected by global economic fluctuations. As to the latter, it is illustrative that from 2007 to 2008, when the financial crisis occurred, FDI inflows to developing countries continued its increase from previous years and increased by USD 64,2 billion, whilst PFI decreased by USD 135,4 billion and generated a capital outflow of USD 57,1 billion from existing PFI.[56]

The term FDI reflects that tax incentives and tax sparing aims at attracting investment involving active and substantial business operations. However, the term may be somewhat misleading as it usually implies equity investment in existing companies' resident in the host country or equity investment for the establishment of a new host State company.[57]

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[53] The same general definition is found in The World Bank (2010) p. 312, UNCTAD (2012), reflected on p. 162, and OECD (2001) p. 57.

[54] For example, Viherkenttä (1991) p. 6.

[55] Easson (2004) p. 4.

[56] The World Bank (2010) p. 1.

[57] For example, The World Bank (2012) p. 312 and OECD (2008) p. 17 stipulate requirements on basis of equity shareholding in foreign companies to define FDI.

Although this is the more common mode of entry for foreign investments,[58] it excludes investment through permanent establishment, which may entail equally beneficial substantial business activities.[59] Hence, the terms *active* and *passive* investment appear more appropriate as it includes the latter mode of entry as well.[60] These terms will be used in the following.

The basic assumption throughout this thesis is that tax incentives and tax sparing is aimed at attracting types of investment involving substantial and active business operations. However, it should be noted that not all active investments contribute positively to the development of a specific country.[61] In the following, the term foreign investment will be used to describe active foreign investment. If there is need to make a distinction in respect to passive investment, this will be done explicitly.

### 3.7.5 Impact on foreign investment and development

From the perspective of the investor, numerous factors influence the decision whether to invest in a specific country and the nature of the investment. Based on an OECD study, published in 1995, the decision is predominantly influenced by non-tax factors.[62] However, more recent studies suggest that tax factors are becoming increasingly important as determinant for foreign investment. Seemingly, this is a consequence of increased market globalization, including the increased mobility of productive capital.[63] Nonetheless, tax factors

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[58] OECD, *Tax Sparing: A reconsideration* (1998) p. 23-24.

[59] OECD MTT article 5.

[60] The terms active and passive investment are used by Viherkenttä (1991) p. 6.

[61] UNCTAD (2012) p. 116.

[62] OECD (1995) p. 8: Based on consultations with foreign investors in transition economies, it was found that tax factors where of "relative unimportance" compared to other factors. It should be noted that the study is based on a limited number of European States, that at the current time where considered transition economies. Moreover, the study has become of some age, possibly not capturing the factor of the more recent increase in productive capital mobility.

[63] OECD (2001) p. 56-57 and Bazó (2008) p. 2.

are generally considered to be secondary determinants for foreign investment, meaning that their influence rely on certain more fundamental factors, such as the basic economic and institutional situation of the potential host State.[64] Moreover, in respect to developing countries, market potential, political stability and relevant legal framework ensuring a market economy, are particularly important factors. In addition, investors tend to care more about the attributes of the general tax system, such as the tax base, general tax rates and predictability, rather than tax incentives.[65]

As to the general influence of tax sparing and tax incentives, on foreign investment, there is some empirical data. A study frequently made reference to is Hines Jr. (2000) *Tax Sparing and Direct Investment in Developing Countries.* The study consists of empirical comparison between FDI flows to developing countries, from Japan, that grants tax sparing, and the US, that does not grant tax sparing. The study showed that

> "Japanese firms are significantly more likely than U.S. firms to concentrate their outbound FDI, and its equity component, in countries with whom Japan has tax sparing agreements."[66]

However, although there is evidence that tax sparing and tax incentives induce an increase of foreign investment, there is no empirical evidence whether the increased level of foreign investment induced by tax incentives and tax sparing provides a development benefit for the host country.[67]

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[64] UNCTAD (2000) p. 11.

[65] *Tax Law Design and Drafting* (2000) p. 987-988.

[66] Hines Jr. (2000) p. 64.

[67] Barker (2008) p. 388.

## 3.8 Normative characteristics of abuse of tax sparing provisions

### 3.8.1 General

A critique against tax sparing is that it is prone to abuse.[68] Moreover, a general purpose of tax treaties is to prevent tax avoidance, i.e. abuse of tax treaties.[69] The objective of this section is to establish the basic normative characteristics of abuse of tax sparing provisions.

Measures that may prevent abuse will be continuously addressed when discussing the specific features of tax sparing provisions under part II of the thesis. Moreover, section 11 will generally address anti-abuse measures and their application in the case of tax sparing and anti-abuse measures that are specifically drafted for tax sparing provisions.

### 3.8.2 The general principle

There is no uniform idea of what constitutes abuse of tax sparing provisions, as there is no uniform and precise perception of what constitutes tax treaty abuse in general.[70] Nonetheless, the OECD Commentary set forth a general idea of the concept:

> "A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."[71]

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[68] For example: OECD, *Tax Sparing: A reconsideration* (1998) p. 28, Knoll (2008) p. 11, Brooks (2009) paragraph III, B, iii, and UNCTAD (2000) p. 28-29.

[69] OECD Commentaries C(1)-19 paragraph 7.

[70] Weeghel (1998) p. 96.

[71] OECD Commentaries C(1)-21 paragraph 9.5. For a similar view on the characteristic of tax treaty abuse, see Weeghel (1998) p. 96.

This general principle appears to be an appropriate starting point, as it is set forth as the general principle of tax treaty abuse in the OECD Commentary and moreover resembles the substance over form doctrine, which, subject to jurisdictional variations, is deployed and recognized as a legal concept in most States.[72]

Applying this principle to tax sparing, it implies that an arrangement is abusive if it is entered into with the main purpose of obtaining a credit for notional tax, and the arrangement used to obtain the credit is contrary to the purpose of the tax sparing provision.

### 3.8.3 The object and purpose

Tax sparing provisions function as an investment inducement measure, to promote investment behavior that is considered expedient to promote economic development. Thus, very generally, it appears appropriate to deem an arrangement abusive if it is contrary to the investment behavior that the contracting States have intended to stimulate with the inducement of tax sparing. What this implies more specifically is relative to the specific tax sparing provision and the specific arrangement. This may be illustrated by examples:

As is addressed under section 10.4.2, if tax sparing provisions are only available for a limited time from the occurrence of a certain event, it could be considered an object and purpose that a credit for notional tax is only available once, for the same person, and for that period of time. Thus, after the time period has elapsed, it could be considered abusive to reproduce the relevant event, initiating a new period of tax sparing, with the main purpose to benefit from tax sparing for an additional period.

A different case is where a third State resident establish a conduit company in the State that grants tax sparing with the main purpose of benefiting from the tax sparing provision. In this case, it could be asserted that as the object and purpose of the benefit of a credit for notional tax is to induce an increase of capital flows from one contracting State to the other

[72] Lang (2010) p. 59-61 and Vogel (1997) p. 117.

contracting State, the benefit should only be available to residents of the State that grants tax sparing, conversely not third State residents.[73]

The examples show that the norm of intended investment behavior, i.e. the object and purpose, is relative to the specific arrangement and the attribute of the tax sparing provision that allows for the benefit to be obtained under that arrangement. Hence, due to the variable basis of establishing what is contrary to the object and purpose, it appears appropriate to operate with a more general standard, which is that an arrangement is abusive if it is contrary to the intended investment behavior.

### 3.8.4 Final remarks

This standard of inappropriate investment behavior will be used when addressing abuse issues in specific contexts throughout the thesis. Moreover, in section 11.2.1 it will be shortly addressed whether this standard, i.e. the general principle of tax treaty abuse, is also a general rule inherent in tax treaties that may be used to deny the benefit of a credit for notional tax.

# 4 Tax sparing and its role in double tax treaties

## 4.1 Introduction

If the concept of tax sparing is adopted, it is usually adopted in double tax treaties.[74] Thus, the basic mechanisms of double tax treaties constitute the functional context of tax sparing. The objective of this part is to outline the basic mechanisms of double tax treaties and to explain the role of tax sparing in this context.

[73] Australia and Vietnam 1992 article 23(7)(c) is a specialized anti-abuse provision that explicitly does not grant a credit for notional tax if the benefit is actually obtained by a third State resident.

[74] *Tax Law Design and Drafting* (2000) p. 1013.

## 4.2 Elimination of juridical double taxation

The primary purpose of double tax treaties is to eliminate juridical double taxation. The OECD provides the following definition of juridical double taxation:[75]

> "International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods."

The primary prerequisite for juridical double taxation is the scope of domestic tax jurisdiction, generalized as the *worldwide income principle* and the *territorial principle*. The worldwide income principle implies that income derived by residents of a State is taxable, regardless of where the income is generated, herein income derived in other States. The territorial principle implies that any income generated within the territory of a State is taxable in that State, regardless of taxpayer residency.[76] Overall, States apply these principles individually or concurrently.[77] The more precise extent of the domestic tax jurisdiction is subject to domestic differences.

Subject to the worldwide income principle and the territorial principle, a foreign investment entails a relevant connection to more than one State, thus creating the possibility of juridical double taxation on income derived thereof, as prescribed by the general definition. Based on the worldwide income principle and the territorial principle, juridical double taxation may generally occur in three distinct ways: (i) Both States may consider the same taxpayer to be a tax resident, thus imposing tax on the worldwide income of that taxpayer, i.e. the taxpayer is subject to a full tax liability in two States. (ii) The taxpayer may be subject to a full tax liability in one State and subject to a partial tax liability in the other State, on

[75] OECD Commentaries I-1 paragraph 1.

[76] Vogel (1997) p. 9.

[77] Holmes (2007) p. 19-22: This includes the concepts of residence and source tax jurisdiction and their combined or separate application.

income derived from sources within that State. (iii) The taxpayer may be subject to a partial tax liability in two States if the taxpayer is not a resident of either of the States. This case is perhaps not as typical as the former types of juridical double taxation. Nonetheless, it may occur if the taxpayer has a permanent establishment in one State, which derives income from another State.[78]

The rationale for preventing juridical double taxation is its detriment on cross-border economic activities. However, the detrimental effects don not occur because of juridical double taxation as such, but because of the overall tax burden imposed on items of income attributed to the same taxpayer. Thus, juridical double taxation is only an impediment to economic cross-border activities to the extent overall tax entails that investment costs exceed a certain threshold of profitability.[79] A host country tax incentive will be the functional equivalent to a unilateral domestic measure to alleviate or eliminate juridical double taxation. Hence, because the overall tax burden is usually sufficiently reduced when introducing a tax incentive, the basic premise for preventing juridical double taxation will usually be void.[80] Thus, tax sparing cannot be derived from the traditional objective of double tax treaties.[81] Moreover, from a *jus strictum* perspective, as tax sparing provisions stipulate a fictional tax paid, it *formally* creates juridical double taxation in a case where it does not actually occur, resulting in actual double non-taxation, something which directly negates the objective of tax treaties. However, as addressed previously, tax sparing has a specialized function and justification. Hence, it could be asserted that tax sparing provision provide the tax treaties with an additional function and purpose.

[78] The overview of different types of juridical double taxation is based on the overview provided in the OECD Commentaries C(23)-1 paragraph 3.

[79] Holmes (2007) p. 24.

[80] Holmes (2007) p. 105-106.

[81] Viherkenttä (1991) p. 141.

## 4.3 Taxpayer residency

A fundamental element in double tax treaties, including tax sparing, is the residency of the taxpayer. The OECD MTT article 4 defines the concept "resident of a contracting State". The concept of residency has several key functions in tax treaties; it defines the subjective scope of the treaty in respect to article 1, it resolves juridical double taxation arising from double residency, and it is consistently relevant throughout the rules allocating the taxing rights of the contracting States in the case where tax residency and source tax, i.e. the worldwide income principle and the territorial principle, lead to juridical double taxation.[82] In respect to the different cases of juridical double taxation outlined above, it is an essential observation that the concept of residency converts the issue of juridical double taxation arising from double tax residency to an issue of juridical double taxation arising from taxation of resident income and source income, in the respective contracting States.[83] Thus, a main premise in the OECD MTT is that a contracting State is either the State of source or the State of residency. Moreover, if both States are States of source, tax treaties are generally inapplicable, as the taxpayer is not resident in any of the contracting States.[84]

## 4.4 The basic system of eliminating juridical double taxation

The rules governing taxpayer residency limit the issue of avoiding juridical double taxation to the case where the taxpayer is resident in one contracting State and derives source income from the other contracting State. Thus, elimination of juridical double taxation requires that the taxpayer is relieved from tax liability in the State of residence, in the State of source or partially in both States. In the OECD MTT, the avoidance of double taxation is based on a two-track system. The provisions in chapter III of the OECD MTT, concerning specific items of income, initially determine how double taxation is eliminated. The provisions set forth that the income is either "taxable only" in one State, generally the State of

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[82] OECD Commentaries C(4)-1 paragraph 1.

[83] OECD Commentaries C(23)-1-2 paragraph 4.

[84] OECD MTT article 1.

residence,[85] or that the income “may be taxed” in the State of source. The former method entails that the income is exclusively subject to tax in one of the States, implying that the other State is obligated to exempt the income from tax. This method is equivalent to the exemption method, which is addressed in the following section. The latter phrase does not itself eliminate juridical double taxation; it refers to a separate set of rules, namely the exemption method set forth in article 23A or the credit method set forth in article 23B, which are alternative methods for eliminating juridical double taxation.[86]

Tax sparing has a direct function for items of income that may be taxed in the State of source. Specifically, this usually includes income from immovable property, profits attributed to a permanent establishment situated in the State of source, dividends, interest, capital gains and royalties. For royalties there is a divergence between the OECD MTT and the UN MTT. It is only pursuant to the latter MTT that royalties may be taxed in the State of source. Between industrialized countries and developing countries, it is fairly common practice that royalties may be taxed in the State of source.[87]

### 4.4.1 The exemption method

In general, the exemption method is conceptually the same as deeming income “taxable only” in one State. The difference is that the exemption in this respect implies that full tax relief is provided by the State of residence, rather than the State of source.

Article 23A(1) prescribes that the State of residence shall “exempt (…) income (…) from tax”. The wording clearly indicates that the income is not subject to tax in the State of residence. More precisely, this involves that the income is to be excluded from the tax base of

[85] OECD Commentaries C(23)-3 paragraph 6. The term “generally” is used to emphasize that the MTTs do not only provide the State of residence exclusive taxing rights. The State of source is pursuant to article 19 provided an exclusive right to tax certain types of source income derived from government service.

[86] OECD Commentaries C(23)-3 paragraph 7.

[87] For example: Norway and Brazil 1980 article 12(2) and United Kingdom and Argentina 1996 article 12(2).

the State of residence.[88] Moreover, this implies that the income shall be exempted irrespective whether tax is actually imposed or paid in the State of source.[89] In continuation of excluding positive income from the tax base, most States also exclude negative income, losses, to the same extent.[90] Thus, equivalent losses may not be deducted in taxable income in the State of residence. Overall, it is apt to say that the exemption method involves "non-consideration" of otherwise relevant foreign income and losses.[91]

If the exemption method is applied, the primary premise for tax sparing is void. The tax incentive is not nullified as the otherwise taxable item of income is excluded from the tax base of the State of residence and consequentially not subject to tax. Thus, the tax incentive is preserved, and accordingly, a tax sparing provision is not needed.

#### 4.4.1.1 Subject to tax clauses

Subject to tax clauses represent a deviation from the general exemption method, as they make exemption subject to the condition that the income is actually taxed in the State of source.[92] An example is article 23(1)a of the tax treaty between the UK and Germany of 2010, in which Germany provide exemption on

> "(…) any item of income arising in the United Kingdom and any item of capital situated within the United Kingdom which, according to this Convention, is effectively taxed in the United Kingdom (…)."

Certain tax incentives, such as dividend withholding tax relief, may involve full relief of source tax liability. If income otherwise subject to exemption in the State of residence is

[88] Vogel (1997) p. 1179.

[89] OECD Commentaries C(23)-15 paragraph 34.

[90] An example is § 9-4(2) of the Norwegian Tax Code, which in respect to alienation of capital prescribe that losses are not deductible if the gain, pursuant to a tax treaty, would be exempt from tax in Norway.

[91] Vogel (1997) p. 1180.

[92] Vogel (1997) p. 361 and 1175.

not taxed in the State of source due to such an incentive, the income would not be exempted and thus taxed in the State of residence. The question here is whether it should be considered a form of tax sparing where the subject to tax clause does not apply for income subject to host country tax incentive measures. In general, this would be contrary to the perception that tax sparing involves "(…) allowing a credit for notional tax (…)".[93] Even though this regulatory technique involves special treatment of host country tax incentives, which is a general feature of tax sparing, it nonetheless does so by exempting the income rather than providing a credit. Accordingly, it does not appear more apt to denote this concept as tax sparing than denoting the general exemption method as tax sparing. Subject to normal terminology the general exemption method is clearly not a form of tax sparing. Moreover the exemption approach and the credit approach have different legal features. As will be discussed under section 4.4.2, the credit approach entails that foreign source income is included in the tax base of the State of residence, which requires the computation of creditable notional tax. This also allows the application of different computation models, which have a significant impact on the operation of tax sparing, as will be addressed in section 9. Under the exemption approach, it is not necessary to compute notional tax as the income is excluded from the tax base of the State of residence. Hence, the distinction is not only of a terminological nature, it is also based on principal substantive differences. Therefore, a modification of subject to tax clauses to not apply in the case of host country tax incentives is not considered a form of tax sparing. Rather, it is the ordinary exemption method, only with a targeted objective scope.

### 4.4.2 The credit method

The use of the credit method in tax treaties, and its possible consequences on source State tax incentives, is the origin of the concept of tax sparing provisions in tax treaties.[94] The basic concept of the credit method as a means to eliminate juridical double taxation is per-

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[93] Vogel (1997) p. 1255.

[94] OECD, *Tax Sparing: A reconsideration* (1998) p. 15-16.

haps the most distinct prerequisite for the concept of tax sparing. The reason is concisely articulated by Vogel (1997) on page 1255:

> "Whenever the credit method is applicable to items of income from foreign sources, tax benefits offered by the State of source for reasons of economic or social policies, especially in the form of incentives to encourage economic development, are siphoned off by the State of residence."

The credit method is a principally distinct concept compared to the exemption method. Instead of excluding foreign income from consideration, the credit method includes foreign source income in the tax base of the State of residence.[95] Juridical double taxation is eliminated by the State of residence providing the taxpayer a credit for tax paid in the State of source, which entails that tax otherwise payable in the State of residence is reduced by the foreign tax paid.[96] Also, as the foreign income is included in the tax base, the method allows the income to be considered when applying progressive tax rates. However, this is of little interest as tax sparing generally include corporate income, usually not subject to progressive tax rates.[97]

#### 4.4.2.1 The connection between the credit method and tax sparing

Paragraph 1a of the article prescribes that "tax on income of that resident" is subject to the deduction. The tax is reduced by "tax paid" in the State of source. Thus, if the income is subject to a higher tax rate in the State of residence, relative to the "tax paid" in the State of source, the State of residence impose tax on the intermediate. For example, if State A imposes 10 percent source tax on business income and State B imposes 25 percent residence tax on that income, the deduction in State B will be 10 percent of the taxable income. Because the income is included in the tax base of State B, the remaining 15 percent is effec-

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[95] Zimmer (2009) p. 137.

[96] Arnold (2002) p. 37.

[97] *The Tax System in Industrialized Countries* (1998) p. 15-16.

tively taxed in State B. Thus, the income is taxed overall by 25 percent. In short, if the State of residence applies the credit method and impose a higher tax rate than the State of source, the overall taxation will be equivalent to the higher tax rate imposed by the State of residence. Thus, a tax incentive, which presumably entails a lower tax rate, will be consumed and consequentially nullified by the tax imposed in the State of residence. This is the essential nullification mechanism inherent in the credit method.

The concept of tax sparing counteracts the nullification effect induced by this mechanism by fictionally fulfilling the general condition of "tax paid". Generally, it does so in one or two ways. One method is to stipulate that an item of income, for example interest, always shall be considered as having been "paid" by a fixed percentage, regardless whether it actually has been paid, i.e. matching credit. The other method is to stipulate that a credit shall be granted as if the income was subject to the ordinary level of tax in the host State, regardless that the income is in fact subject to a lower level of tax, or no tax, due to a tax incentive measure, i.e. tax sparing credit.[98] Accordingly, even though no tax was actually paid in the State of source, the taxpayer is granted a deduction on tax payable in the State of residence as if, for example, 25 percent tax was paid.

#### 4.4.2.2 The treatment of notional tax under the credit method

In general, unless the treaty expressly states something else, notional tax is treated the same as tax actually paid. This implies that the general features of the credit method apply equivalently. If the notional tax is computed using the tax sparing credit approach, the concepts of full credit and ordinary credit could have implications on the overall tax payable on worldwide income. In the case of matching credit, the rate is fixed. Hence, the wording and the context of it being a special provision strongly suggests that it is applied regardless that it exceeds the tax rate on the same income in the State of residence.[99] Accordingly, the

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[98] For example: UK and Sudan 1975 article 23(2).

[99] This is comparable to the "extended tax-sparing credit", described by Viherkenttä (1991) p. 156, which involves that the credit for notional tax exceeds the tax that the State of source may impose under the treaty.

question here is how a tax sparing credit interacts with *full credit* and *ordinary credit*, and moreover which of these approaches appear more appropriate in the case of tax sparing.

According to paragraph 1a of article 23B, the State of residence shall allow

> "as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State".

In the case of tax sparing credit, the wording implies that all notional tax in the State of source shall be deducted from tax payable in the State of residence. This is usually referred to as full credit. For example, the taxpayer has total worldwide income of 100, and 50 is derived from each State. The tax rate in the State of residence on worldwide income is 20%, which equals 20 tax payable on 100, i.e. 10 tax payable on 50. The notional tax in the State of source is 30% on the income of 50, which gives a credit of 15. Here, because the notional tax exceeds the tax on worldwide income, the State of residence effectively concede tax on income that was not derived from the State of source. In the example, the credit effectively reduces tax on the unrelated income of 50 by 5. Thus, the overall tax payable on 100 is 15, rather than 20 which would be the case had the tax rate in the State of residence been applied to the overall worldwide income.[100] This consequence goes beyond what the justification of tax sparing requires. Not only is the tax incentive permitted to accrue to the investor, but the investor also obtains the benefit of lower tax on income generated from activities not even undertaken in the State of source, which are clearly not encouraged by the inducement of tax sparing.

To prevent the potential loss of tax revenue derived from unrelated income under the full credit approach,[101] a modification is set forth in the second sentence of article 23B(1), which states that the deduction may not

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[100] For a general overview of the computation under full credit, see Holmes (2007) p. 28-29.

[101] Vogel (1997) p. 1227.

> "(…) exceed that part of the income tax (…) which is attributable, (…), to the income (…) which may be taxed in the other State."

The wording implies that the credit is limited upward to the tax that would be imposed on the foreign source income in the State of residence. This is commonly referred to as ordinary credit. The difference from full credit is only manifest if higher tax is imposed in the State of source, as in the example above. Based on that example, the ordinary credit would entail a credit for notional tax of 10.[102] Accordingly, in the State of residence, the total tax liability, as if tax was paid in the State of source, is 20. Thus, the State of residence does not concede tax on income that is unrelated to the foreign source income. It appears that for this reason, the ordinary credit is the most commonly adopted approach.[103] In context of the credit method, the function of tax sparing is to prevent that the tax concession is consumed by the worldwide taxation of the State of residence so that it accrues to the investor. This is achieved by the ordinary credit.

Both the basic rationale and justification of tax sparing, and the consideration of protecting the tax revenue of the State of residence, implies that an ordinary credit is more appropriate than a full credit.

#### 4.4.2.3 Domestic treatment of credit for notional tax

So far, the basic assumption has been that a credit for notional tax is treated equally as a credit for tax paid. However, on domestic level this is not necessarily the case.

In a statement by the Norwegian Ministry of Finance regarding the relation between article 24(3) of Norway and Brazil 1988 and § 22A-7 of the Norwegian Tax code of 1911, it was

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[102] [(50 ÷ 100) * 20]. For a general overview of the ordinary credit method and the computation under ordinary credit, see Holmes (2007) p. 29-32

[103] Zimmer (2009) p. 138.

stated that excess credits for notional tax could not be used against tax on income from other States than Brazil. The rationale was that the purpose of the tax sparing provision was to contribute to economic development specifically in Brazil, not to reduce tax on income derived from other States. Conversely, the statement clearly says that an excess credit for tax actually paid in Brazil could be used against tax on income from other States.[104] Accordingly, a credit for notional tax was considered to have different features than a credit for tax paid. Presumably, this general approach is in conformity with article 23B of the OECD MTT, as it does not govern the domestic treatment of excess credits.[105]

A different example is found in UK law. In general, pursuant to section 18, subsections 1-3, of Taxation (International and Other Provisions) Act 2010 (TIOPA), a credit is granted for tax paid in the State of source as set forth in a tax treaty. However, pursuant to TIOPA section 20, subsection 3a, a credit for notional tax, as set forth under a tax treaty, is only granted for tax foregone in the State of source if the tax concession is made

> "(…) under the law of that territory with a view to promoting industrial, commercial, scientific, educational or other development (…)"

If a condition with the same substance is not set forth in the tax treaty, the UK is generally prohibited from denying a credit on this basis. However, in treaty abuse cases, it is feasible that it could be used to deny a credit, but only to the extent that a general rule of tax treaty abuse would otherwise be applicable. This is addressed generally in section 11.2. Moreover, in context of abuse, the provision could contribute to reflect the standard of appropriate investment behavior.

Accordingly, in domestic law, a credit for notional tax is not always treated equally as a credit for tax paid. The extent in which this is permissible depends on the treaty.

[104] Utv. 1998 p. 96b.

[105] OECD Commentaries C(23)-27 paragraph 66.

# Part III: The Separate Features of Tax Sparing Provisions

## 5 Introduction

### 5.1 Topic

In part II, the basic concept of tax sparing and its functional position in tax treaties was presented. This section will provide an analysis and systematization of, and comments on, the general features that may be found in tax sparing provisions adopted in double tax treaties. The view is that the different general features collectively constitute the concept of tax sparing. The features selected are those that are perceived to be representative of general and distinct features.

### 5.2 Possible reasons for the broad range of design variations

Ultimately, the design of a tax sparing provision under a specific treaty is determined by numerous considerations that are of both a specific and general nature. As to the specific considerations, these may arise from traits in the domestic tax systems of the State parties or their general policy positions.[106] For example, Australia has time limitations in all its tax treaties that have tax sparing provisions, suggesting a clear policy position on this matter.[107] Another example is the policy position reflected in the tax treaties Brazil is party to, where most tax sparing provisions provide a credit for notional tax pursuant to a fixed rate, i.e. matching credit.[108] Hence, separate tax sparing provisions have a diversity of features.

Another complication is that the design of a tax sparing provision is subject to the consensus of the State parties. In practice, under bilateral treaty negotiations, the State parties may have converse positions and make trade-offs, making the design of the tax sparing provision a result of compromise.

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[106] Viherkenttä (1991) p. 145.

[107] Brooks (2009) paragraph IV F.

[108] *Tax Law Design and Drafting* (2000) p. 1014.

However, these reasons are general and not specific to the drafting of tax sparing provision. Nonetheless, it is feasible that they have a greater influence in this case as, contrary to many other types of provisions, the commentaries to the OECD and UN MTTs do not set forth a model provision, but merely three very basic examples of different forms that tax sparing provisions may take.[109] Moreover, the OECD report of 1998, *Tax Sparing: A re-consideration*, set forth best practices on pages 35-39. However, not that many tax sparing provisions have been adopted in tax treaties concluded after the report was issued. It is therefore difficult to measure the influence of the recommendations.

# 6 Tax incentive measures

## 6.1 Introduction

As the objective of tax sparing is to attract foreign investment by providing tax benefits to foreign investors, the host country tax incentive measure is clearly a crucial aspect of tax sparing. First, this section will discuss the stipulation of conditions in tax sparing provision regarding host country tax incentive measures. Second, it will present and discuss various general types of tax incentive measures that may be implemented by the host State and that may be covered by tax sparing provisions.

In respect to the contracting States under a tax treaty, the focus here is on the developing country and the aspect of tax sparing provisions that directly concern the developing country tax incentive measures.

## 6.2 Conditions regarding the tax incentive measure

### 6.2.1 Introduction and considerations

Many operative tax sparing provisions stipulate special conditions in respect to the host country measure under which the tax incentive is granted. Generally, such conditions are

[109] OECD Commentaries C(23)-31 paragraph 74 and UN Commentaries p. 336 paragraph 74.

designed as a reference to statutory law of the developing country, as a generally phrased condition, or both. Such conditions entail that only tax foregone under qualifying incentives is subject to tax sparing, and moreover effectively limit the discretion of the host State to amend or deploy tax incentives after the tax treaty is binding.

The OECD generally recommends the adoption of conditions regarding the tax incentive measure

> "(…) to ensure that tax sparing is only granted for agreed concessions."[110]

This appears to reflect that the basic rationale is to ensure a certain level of predictability, as to which incentives qualify and the characteristics of those measures, and the amount of credits that have to be granted for tax not actually paid. From a principal point of view, it is also a restriction on the derogation from the consideration of capital export neutrality. Nonetheless, other considerations are also relevant when assessing the appropriateness of conditions regarding the tax incentive measure.

#### 6.2.1.1 The need for dynamic adaptions

The host State may have legitimate reasons to amend its tax incentive measures without the consent of the other State party. Generally,

> "Investment policies should be regularly reviewed for effectiveness and relevance and adapted to changing development dynamics."[111]

Changing conditions, for example newly emerging sectors needing foreign capital and saturated sectors where tax incentives are granted, may induce the need to change tax incentive measures. Moreover, the rationalization of tax incentive measures, i.e. improving their im-

[110] OECD, *Tax Sparing: A reconsideration* (1998) p. 35.

[111] UNCTAD (2012) p. 107.

pact on foreign investment whilst reducing their adverse effects, may require subsequent adjustments. Also, tax incentive measures in developing countries are often adopted on a “trial and error” basis,[112] strongly implying a practical need for subsequent revisions. Generally, for these purposes, alterations on treaty level may entail an overly cumbersome process that may inhibit otherwise appropriate alterations.

#### 6.2.1.2 Prevention of abuse

Conditions as to the tax incentive measure may also contribute to prevent abuse.[113] An example of treaty abuse that may be counteracted by stipulating conditions for the tax incentive regime is routing schemes involving establishment of a conduit company in the host State.[114] By stipulating statutory references to tax incentive measures that require profits to be derived from active business operations in the host State, or by establishing this as a separate condition under the tax sparing provision which will be addressed under section 8, such routing schemes may be prevented.

In the case of matching credit, a credit for notional tax may in principle be obtained without benefiting from host country tax incentives as the credit is fixed and not based on the tax foregone. For example: The State of source A has a tax treaty with State B. Under that treaty, profits attributed to a permanent establishment are exempted in A. In B, the permanent establishment is subject to very low tax, i.e. 5 percent. The profits earned by the company resident in A, from the permanent establishment, are subsequently paid as interest to a company in State C. The withholding tax on interest in State A is 8 percent. Between State A and C there is a tax sparing provision providing a credit at the fixed rate of 20 percent. Overall, in A and B, the taxpayer pays total of 13 percent tax on the gross amount of the interest, thus obtaining a credit for notional tax of 7 percent in State C without benefiting from tax incentives in State A. Such an arrangement may be motivated by the higher level

[112] Bazó (2008) p. 3.

[113] Brooks (2009) paragraph IV D.

[114] OECD, *Tax Sparing: A reconsideration* (1998) p. 29 and p. 71-72 provides an example of routing interest.

of tax between B and C, which is for example 20 percent on interest payments. If conditions are stipulated as to the tax incentive measure, ensuring that the income subject to tax sparing is also subject to qualifying tax incentives, such arrangements are prevented.

#### 6.2.1.3 Overview

An important practical argument is the "oversight" provided by establishing specific conditions.[115] It is the home State tax administration that has to determine the creditable amount. If the computation of the credit for notional tax is based on the difference between tax that would have been payable and tax payable under the tax incentive regime, the home State tax authorities have to make a distinction between what is considered tax incentive measures and what is considered ordinary tax measures. For this operation it is expedient that the tax incentive measures are sufficiently defined. Making this distinction based on broadly phrased criteria could be very difficult in practice as it presupposes thorough knowledge of the host State domestic laws and of host State legislative amendments. Presumably, this is the reason why tax sparing provisions that adopt this computation method often stipulate precise conditions as to the tax incentive measure or set forth other mechanisms that ensure oversight.[116] Conversely, the argument of "oversight" is generally not valid if the credit is subject to a fixed amount, as a fixed credit is generally provided, regardless of the ordinary tax liability and the tax actually paid. Consequently, many provisions that adopt this computation approach do not specify which tax incentive measures it applies for.[117]

### 6.2.2 Statutory reference

In operative tax treaties, many examples are found of tax sparing provisions that limit their application to specific statutory tax incentive measures in the host State. Moreover, this is one of the more widespread design features of tax sparing provisions.[118] The domestic laws of the host State, referred to in the tax sparing provision, effectively provide conditions to

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[115] Brooks (2009) paragraph IV, D.

[116] Vogel (1997) p. 1256-1257.

[117] For example: Norway and Zimbabwe 1989 article 24(2)c and France and Brazil 1971 article XXII(2)d.

[118] Brooks (2009), IV D.

qualify for tax sparing. Hence, the conditions for tax sparing may vary substantially. An example is article XXIV(3)b of the Canada and Kenya treaty of 1983, prescribing that tax sparing is only available if the exemption or reduction of tax in Kenya is provided under

> "(i) paragraph 24 of the Second Schedule to the Income Tax Act, 1973;
> (ii) paragraph 2(b) of the Third Schedule to the Income Tax Act, 1973;"

Under this treaty, the reference is highly specific. The first domestic provision provides beneficial treatment of capital expenditures incurred when constructing buildings, and when acquiring and installing machinery. The second provision applies to foreign companies having a permanent establishment in Kenya and grants the benefit of a general CIT rate reduction, fixed for separate tax periods.[119] Accordingly, tax sparing is only provided for tax foregone by the host State in these specific cases. Thus, other tax incentives, already implemented when the treaty became binding or at a subsequent time, are not subject to tax sparing. Another example of statutory reference is article 24(2)c of the Norway and Indonesia treaty of 1988. Here, tax sparing is available if Indonesian tax is

> "(…) exempted or reduced in accordance with the provisions on special incentive measures under Indonesian Law No. 1 of 1967."

The Indonesian provisions referred to, provide for tax holidays, withholding tax relief and accelerated depreciation.[120] The reference entails that only the incentive measures provided in the referred provisions qualify for tax sparing. However, the Indonesian Government is provided comprehensive discretion as to which taxpayers qualify for the incentives and what type of activities that qualifies for the incentives.[121] A similar example is article

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[119] The general substance is derived from the provisions of the Kenya Income Tax Act of 1973, referred to in the treaty.

[120] Indonesian Law No. 1 of 1967 Concerning Foreign Investment, articles 15 and 16.

[121] Indonesian Law No. 1 of 1967 Concerning Foreign Investment, article 16 in conjunction with article 5.

22(2)e of the Finland and Thailand treaty, where a credit is granted for any tax foregone under the Investment Promotion Act B.E. 2520 (1977) of Thailand. Pursuant to section 16 of the Act, a "Board" makes the discretionary decision whether to grant tax incentives, and if so, which types of tax incentives.[122] As these tax sparing provisions do not impose any restrictions on the exercise of such discretionary powers, key conditions for tax sparing are in practice governed by the authorities of the State of source. Of course, this is presumably part of the agreed concession. Nonetheless, the examples illustrate that the interaction between the statutory reference and the statute does not necessarily imply that measures that qualify under a statutory reference are static.

Generally, statutory references provide the home State predictability in respect to which concessions are subject to tax sparing. However, the degree of predictability is nonetheless determined by domestic law of the host State. The Norway and Indonesia treaty and the Canada and Kenya treaty are illustrative for the significance of this factor and how its variable characteristic may relate very differently to the basic considerations.

### 6.2.3 Generally phrased conditions

Under this approach, conditions are set forth in the tax sparing provision, stipulating general requirements in respect to the tax incentive measure of the host country. An example of this approach is article 22(3) of the Canada and Thailand treaty of 1984. It requires that the tax incentive is

> "(…) granted with a view to promoting industrial, commercial, scientific, educational or other development in Thailand, (…)"

Similar requirements are found in a number of treaties. Under this provision, it is an additional requirement that the incentive is granted under specific domestic legislation in Thailand. When analyzing the significance of such a condition, a distinction should be made

[122] Investment Promotion Act B.E. 2520 (1977) sections 31-34.

between the case where it is the only requirement in respect to the tax incentive measures and the case where the provision also includes a statutory reference.

If a general substantive requirement is stipulated in addition to a statutory reference, the question arise what the separate significance of the substantive requirement is. More precisely, does the separate substantive requirement allow for the State of residence to deny tax sparing if the statutory requirement is fulfilled? The wording, "granted with a view to", which is commonly used, implies that the tax incentive has to be implemented under an assumption set forth by the source State, that the incentive will induce a certain result, in this case promotion of development. Whether it actually does, is not relevant. Thus, the subjective opinion set forth by the source country is effectively decisive. Therefore, assuming that the domestic law has not been subject to amendments after the treaty was binding, the most plausible conclusion seems to be that the State of residence is generally precluded from denying tax sparing on such grounds. However, the opposite conclusion may perhaps be made in exceptional cases. If a taxpayer accrues benefits from the tax incentive measure in a way that is clearly contrary to the objective of the measure, as set forth by the developing country, and the behavior clearly does not contribute to development, it could be argued that the specific benefit in question was not "(…) granted with a view (…)" to contribute to development. Hence, it is plausible that a general requirement stipulated in addition to a statutory requirement could have a separate function to prevent that benefits accrue to taxpayer arrangements that are contrary to the purpose of the domestic tax incentive measure, thus to some extent preventing abusive as generally defined under section 3.8.

If the substantive condition is the only requirement made in respect to the source country tax incentive measure, the limitation is asserted to

> “(…) 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.”[123]

An example of this approach is Canada and Mongolia 2002 article 23(3):

> “(…) under specific provisions of Mongolian legislation and provided that the competent authority of Mongolia has certified that any such exemption from or reduction of Mongolian tax given under these provisions has been granted in order to promote economic development in Mongolia.”

It is not doubtful that this would provide the host country with comprehensive discretion. If the phrasing “granted in order to” or “granted with a view to”, or a similar criterion, is adopted, the opportunity of the home State to refuse tax sparing on basis that the measure is not expedient to fulfill the objective of economic development is in principle limited to the same extent as described above. Accordingly, under this provision, the host State is in practice free to subsequently implement any tax incentive measures. Hence, if the considerations of predictability, administrative burden and prevention of abuse are heavily emphasized, broadly phrased criteria appear insufficient. However, as to the cited provision the potentially adverse effects are presumably limited as the provision is only in effective for the three first years when the treaty is in force. Moreover, the oversight provided for the home State in respect to tax incentive measures is seemingly sufficient as it is a requirement that the tax incentive measure is “certified” by the competent authority. Presumably, information on which tax measures are tax incentives is therefore available.

The consideration that the host State should be provided an effective access to make appropriate amendments to its tax incentive measures is maintained by this approach. However,

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[123] OECD, *Tax Sparing: A reconsideration* (1998) p. 35.

it could also to some extent be ensured by stipulating a simplified amendment process on treaty level, which will be discussed under section 6.2.5.

### 6.2.4 Conditions connected to the duration of the measure

A somewhat peculiar condition regarding the host country tax incentive measure is found in the Norway and Malta treaty of 1975, which is no longer in force.[124] Its article 24(1)(c) set forth as a condition for tax sparing that

> "(…) the Malta tax has been wholly relieved or reduced for a limited period of time (…)"

This implies that tax sparing would not be provided in the case of a permanent tax concession. The Norwegian Ministry of Finance interpreted this provision so that tax sparing would not be granted if a Malta tax concession was not time limited.[125] However, nothing was stated as to the maximum duration of the incentive measure if it were time limited. Pursuant to the wording, there is seemingly no limitation in that respect. In light of the rationale behind stipulating conditions in respect to the tax incentive measure, this approach appears to have significant weaknesses as it does not provide predictability for the State of residence. However, if the States agree that only time limited tax incentive measures are to be covered under the tax sparing provisions, the approach under article XXIV(3)(b) of the Canada and Kenya treaty of 1983 appear more expedient. Here, the time limitation is set in connection to a statutory reference. It states that tax sparing is not granted

> "(…) to the extent that any of the said provisions has the effect of exempting or relieving a source of income for a period in excess of ten years;"

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[124] A new treaty between Norway and Malta entered into force on February 14, 2013. It does not grant tax sparing.

[125] Utv. 2007 p. 1034.

As a fixed time limitation is set, the host State is precluded from effectively circumventing the condition be setting an “illusory” time limitation. This also provides predictability for the home State. Moreover, contrary to the Norway and Malta provision, the host State does not have to domestically impose time limits on its measures as the effect of the measure is time limited in the treaty.

### 6.2.5 Special regulation of subsequent amendments

The effective access of the source State to amend tax incentive measures, after the treaty is binding, is limited if conditions are set with respect to the tax incentive measure. However, the access to amend tax incentive measures is determined by the conditions set and these conditions may differ as to the leeway provided. In the case of general conditions, the host State is provided almost unlimited discretion, whilst in the case of statutory conditions there is practically no room to amend the tax incentive measures. An approach to deal with host State amendments in the latter case is to set forth a simplified amendment process and a right for the host State to unilaterally carry out minor amendments. An example is article 25 (4)ii) of the Spain and India treaty of 1993. In relation to the very specific statutory reference in article 25(4)i), it prescribes that

> “any other provision which may be enacted hereafter granting a deduction in computing 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.”

The approach reflected in this provision is fairly widespread. As a general rule, for host State amendments to be covered by the tax sparing provision, it is required that the “competent authorities (…) agree” that the amendment is sufficiently similar to the previous measure. Thus, as a general rule it does not entail that an amendment is automatically subject to tax sparing, i.e. a unilateral change of the treaty condition. Rather, it provides a simplified process for tax incentive amendments to be subject to tax sparing, compared to the often more elaborate constitutional processes that otherwise have to be followed to amend treaties.

However, if "minor" amendments are made that do not change the "(…) general character (…)" of the original incentive measure, effective amendments may be made unilaterally by the host State. This implies a comparison between the original and the new measure. For example, this would probably include the case of legislative reforms where the original provisions are replaced by new statutes that are substantially the same. Generally, the wording suggests that the incentive measure has to be the same form, provide the same benefit and be available to the same extent, i.e. eligible persons and activities. However, with respect to the benefit and the availability, a distinction could be made between the case where the measure is subsequently expanded and where it is limited. An expansion will generally have burdensome implications on the host State, potentially involving that it has to provide more credit to a broader class of investors. However, as to limiting the original measure, the host State may in any case unilaterally repeal the measure. Moreover, for the home State, there are no apparent disadvantages of the measure being curtailed. On this basis, it could be argued that the host State may go further in limiting the measure than expanding it. Nonetheless, this is contrary to the wording, which does not make this distinction. The objective of tax sparing, which is to induce economic development, does not provide for much guidance, other than perhaps in the case where the remaining measure is obviously insufficient to achieve the objective and constitutes a mere revenue cost. Overall, it appears that the leeway of the host State is the same, regardless whether the amendment involves a limitation or expansion. However, in practice, it is feasible that the home State will accept limitations to a greater extent than expansions.

The approach of specially regulating the access to make subsequent amendments appears to be an appropriate compromise between the interest of the developing country to amend its tax incentive measures and the interest of the State of residence to have predictability and involvement in the amendment process, to foresee potential consequences of the amendments.

## 6.3 General types of tax incentives

### 6.3.1 General

Conditions stipulated in respect to the tax incentive measure of the developing country effectively determine which types of tax incentive measures that are subject to tax sparing.

This section will present general types of tax incentives commonly deployed by developing countries. The tax incentive regimes of developing countries are diverse.[126] Hence, the presented types are generalizations heavily based on legal theory.[127] Moreover, it is not in any way exhaustive. It should also be noted that under tax incentive regimes, many of the types of tax incentives may be deployed concurrently.

It is the host country tax incentive that directly provides the special tax benefit to the taxpayer. Hence, the tax incentive measure is the direct determinant in respect to the effects of the tax sparing provision, herein the influence on economic development and possible abuse issues. In this respect, the host country tax incentive measure constitutes an integral part of the concept of tax sparing.

### 6.3.2 Targeting and eligibility of tax incentives

A practically very important issue is the targeting of tax incentives. The targeting is generally carried out by rules governing the eligibility to tax incentives. Such rules set forth which investments that are considered expedient to promote development and moreover limit the revenue cost of tax incentives by limiting eligibility only to such investments.[128] However, the criteria may be more or less precise, and it is not uncommon for States to

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[126] For a comprehensive overview of tax incentive measures in developing and transition countries, see the survey in UNCTAD (2000) p. 37-176.

[127] Especially: OECD (2001), *Tax Law Design and Drafting* (2000) p. 990-996, Easson (2004) p. 132-150, Viherkenttä (1991) p. 23-27, Zee and others (2002) p. 1503-1505 and UNCTAD (2000) p. 11-22.

[128] Easson (2004) p. 105.

grant tax incentives on a more discretionary basis, as already exemplified under section 6.2.2. Development needs are highly country specific and so are the rules governing eligibility to tax incentives. Hence, this will not be addressed further. It is illustrative that in Lebanon, after the civil war, tax incentives were granted to developers to construct new buildings. The result was an excess of new buildings and that damaged buildings were neglected. Moreover, the increased construction activity resulted in a liquidity deficit.[129]

### 6.3.1 Corporate income tax incentives

The term corporate income tax (CIT) incentives is used to describe tax incentives available to a subsidiary company resident in the host State or to a permanent establishment located in the host State, i.e. a company not resident in the host State. CIT incentives may be deployed in a wide variety of forms. In context of the basic structure of an income tax system, they could apply to gross income, costs and losses, taxable net income and timing. Thus, the possible design and features of CIT incentives are vast. Nonetheless, this section will focus on a selection of what appears to be the more common forms CIT incentives. Moreover, the following overview will concentrate on models and basic concepts.

#### 6.3.1.1 Tax holidays

A tax holiday is considered to be the most commonly adopted tax incentive measure in developing countries.[130]

A tax holiday has the general characteristic that it provides a full exemption from tax[131] for a fixed duration; for example five years.[132] Usually, tax holidays apply to corporate in-

[129] UNCTAD (2000) p. 23.

[130] OECD (2001) p. 25 and Easson (2004) p. 134.

[131] UNCTAD (2000) p. 19.

[132] See Easson (2004) p. 135 for an overview of the duration of tax holidays in different countries. The duration varies from 1 year to 20 years.

come, i.e. it is an alleviation of the separate tax otherwise imposed on the company as such.[133]

As tax holidays are time limited and intend to attract active investments, their eligibility is generally limited to new business operations.[134] Conversely, established business operations usually do not qualify for tax holidays. Accordingly, tax holiday regimes generally make a distinction between existing business operations and new business operations. This could be connected to the incorporation of a company, the commencement of certain activities or the licensing to conduct business under special development programmes. An example of the latter is the Kenyan Export Processing Zones Act of 1990 section 29(2)(c), which states that

> "exemption from the payment of income tax as specified in the Income Tax Act (Cap. 470) for the first ten years from the date of first sale as an export processing zone enterprise, (…)"

Here, the tax holiday becomes available when the company qualifies as an export processing zone enterprise, which is subject to strict criteria requiring it to conduct specific business operations in designated areas.[135] If the distinction is connected to the incorporation of a company, a distortion may occur as to the mode of entry of the investment. If the investment is made by acquiring shares in an existing company in the host State, that company may not qualify for a tax holiday. This could have valid reasons as the acquisition of shares by a foreign investor does not necessarily entail additional capital for the company to utilize in its operations. However, it is quite possible that this may be circumvented, for example by merging the existing company into a newly established company.

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[133] Easson (2004) p. 134-135.

[134] UNCTAD (2000) p. 19 and OECD (2001) p. 25.

[135] Kenyan Export Processing Zones Act of 1990 sections 19-22.

Tax holidays generally commence either at a time linked to the commencement of the new business operations, for example indicated by the "first sale", as in the provision above, or at the time when the company first generate net profits.[136] Both alternatives have latent weaknesses. If the tax holiday commence when the new business operations commence, the tax holiday may be ineffective. This is a practical consequence of the fact that costs are usually much higher and gross profits much lower in the initial phase of newly started business operations. Consequently, there may be no or very modest net profits to be alleviated by the tax holiday. In this respect, under consideration to the effectiveness of the tax holiday, it appears more appropriate to let the tax holiday commence when the business start generating positive net profits. However, this timing criterion may induce financing distortions. To fully utilize the tax holiday a company may want it to commence first when it derives significant net profits, not only net profits as such. The timing could be controlled by debt financing by the parent company, something which usually implies that the subsidiary may set off paid interest in its income, keeping the taxable net profits negative, and conducting a debt for equity swap when it wishes to use the tax holiday. To be overall profitable, this would require fairly low tax on the interest derived by the parent company. Such arrangements typically fall within the scope of thin-capitalization rules, i.e. rules that under certain conditions treat debt financing as if it was equity financing, thus limiting the extent in which interest is set off in positive income, which may "increase" net profits to become taxable.[137] A practical aspect is that such arrangements may nevertheless be feasible as tax administrations in developing countries tend to have difficulties handling internal transactions and the arms-length principle.[138]

As a tax holiday involves full exemption from CIT, costs and losses do not qualify for deductions as there is no taxable income to reduce. Considering that new business ventures may produce little or no profits in its starting phase, it is an important question whether

[136] Easson (2004) p. 137.

[137] Gjems-Onstad (2012) p. 1059-1060.

[138] UN (2012) Chapter 1, p. 21-22.

costs and losses may be carried forward until after the tax holiday. It is a fairly common concept in domestic tax systems that costs and losses are deductible only if they are incurred to obtain taxable income.[139] Hence, it is not uncommon that a tax holiday involves that the company is not granted the opportunity to carry forward costs or losses that incurred during the tax holiday.[140] This is presumably most precarious if the tax holiday starts simultaneously as the business operations commence. In which case, the investor may have earned no or only very modest net profits during the tax holiday but has incurred significant costs and losses. In this case, a tax holiday could be counterproductive in light of its purpose, and in fact increase the overall tax burden in a longer perspective.[141] However, in the majority of States granting tax holidays, losses incurred during the tax holiday may to some extent be carried forward until after the tax holiday.[142] Letting costs and losses incurred during a tax holiday to be carried forward constitutes an additional revenue cost that may be difficult to foresee. Nonetheless, it may in some cases be decisive in respect to the benefit actually provided by a tax holiday, and accordingly the presumed effectiveness of the measure in attracting foreign investment.[143]

In respect to long term investments, the former paragraph suggests that tax holidays raise some efficiency issues. In respect to ventures that generate income in the initial phases, such as construction ventures, tax holidays are presumably more effective. However, it is

[139] *Tax Law Design and Drafting* (2000) p. 606: This concept is applied in the UK and is moreover adopted by developing countries with inspired tax systems, such as Kenya and Zambia. This is also the general rule in Norway, pursuant to § 6-1(1) of the Norwegian Tax Code, which states that costs are deductible only if they are incurred to obtain taxable income.

[140] OECD (2001) p. 25.

[141] Easson (2004) p. 138-139.

[142] Viherkenttä (1991) p. 26-27.

[143] See OECD (1995) p. 159-161 for an illustration of the interaction between a tax holiday and the carry forward of losses.

an assertion that such investments often would be made regardless of the tax holiday. In this case, the tax holiday merely involves a revenue loss.[144]

Another typical weakness of tax holidays is that they may be prone to abuse. Naturally, this will depend on how the measure is implemented and its specific features, such as qualification criteria and the administration of the measure. A typical scheme is to reproduce the situation that qualifies for the tax holiday once the tax holiday is over. This could imply that instead of continuing established business operations, new business operations are commenced, using capital from the prior venture.[145] From the perspective of economic development, it is presumably more appropriate to uphold already established operations. Not only are the general benefits of the investment provided for a longer term, but tax revenue is also generated for the host State when the tax holiday expires. Thus, recommencement of qualifying activities may be contrary to the purpose of the tax holiday whilst creating an unintended revenue loss.

In respect to abuse, a major concern is transfer pricing arrangements, especially in the case where the investor has two enterprises in the host State, only one of which qualifying for the tax holiday.[146] In the case of tax sparing, this could also negatively impact the tax revenue of the home State, as it collects tax from the source income of the non-qualifying enterprise, through dividends or current taxation, depending on the status of the enterprise as a host country company or a permanent establishment.

Although tax holidays have apparent weaknesses, the concept is nonetheless commonly deployed in developing countries, presumably because developing countries tend to have poorly developed tax administrations and that tax holidays are perceived as relatively easy

[144] OECD (2001) p. 26.

[145] Easson (2004) p. 141.

[146] Easson (2004) p. 142.

to administer.[147] The general justification of tax sparing, which is to allow for developing countries to effectively grant tax incentives, should also take into account the administrative capabilities of developing countries. Hence, from a policy perspective it could be difficult to defend the position of excluding tax holidays from tax sparing provisions.

#### 6.3.1.2 Reduction of corporate income tax rates

Unlike tax holidays that involve a full tax exemption, CIT rate reductions uphold some of the tax liability of the taxpayer. In comparison with tax holidays, this may be beneficial to the taxpayer with respect to the treatment of costs and losses in the initial stages of business operations. The targeting of the measure and the CIT rate reduction may vary substantially. To reduce revenue loss, such reductions may be narrowly targeted to income from very specific sources or enterprises fulfilling specific conditions. In addition, the CIT rate reduction may be limited to foreign investors.[148] Moreover, CIT rate reductions may be temporary or indefinite.[149] Because the general implications of a temporary CIT incentive where addressed when discussing tax holidays, CIT rate reductions will be discussed under the assumption that they are initially indefinite.[150]

In respect to new investments, if the CIT rate reduction is indefinite, it generally overcomes the issues arising from lacking profitability in the initial phase of investment. This makes CIT rate reductions generally more attractive to foreign investors than tax holidays and thus more efficient. Moreover, CIT rate reductions tend to discourage certain abusive and distorted behavior, such as establishing new companies to continue benefiting from a tax holiday instead of expanding the existing company, or repatriation of profits when the tax holiday expires.

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[147] OECD (2001) p. 26.

[148] *Tax Law Design and Drafting* (2000) p. 994-995 and OECD (2001) p. 26.

[149] OECD (2001) p. 26.

[150] This is also considered a basic characteristic in *Tax Law Design and Drafting* (2000) p. 994.

An asserted deficiency of CIT rate reductions is that they may include existing enterprises, which entails a revenue cost without stimulating new foreign investment.[151] However, CIT rate reductions may induce additional investment and reinvestment in existing enterprises. If this is the case, the measure may prevent tax induced repatriation and increase inbound active capital flows.

As CIT rate reductions in principle are indefinite, they may imply a substantial revenue cost, depending on the scope of the measure. Moreover, as CIT rate reductions in practice are only initially indefinite, implying that they nonetheless may be terminated, and usually does not involve transition measures upon their termination,[152] there is a lack of predictability that may reduce the effectiveness of CIT rate reductions. Also, tax sparing provisions in tax treaties are often time limited, something that significantly reduces the effect of the otherwise indefinite temporal scope. Such time limitations will be generally addressed in section 10.

Overall, it appears that CIT rate reductions are efficient in that they are generally very favorable to investors. However, the corresponding revenue cost is potentially vast, suggesting that CIT rate reductions should be narrowly targeted.

#### 6.3.1.3 Investment tax credits

Investment tax credits are connected to the acquisition of qualifying assets and generally involves that a percentage of the acquisition expenditure may be credited against taxable net income, i.e. tax otherwise payable.[153] Hence, investment tax credits incentivize by effectively decreasing the cost of acquisitions.

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[151] OECD (2001) p. 26-27 and Easson (2004) p. 141.

[152] Easson (2004) p. 135: This is based on the basic fact that "Tax rules and tax rates do not remain unchanged forever."

[153] UNCTAD (2000) p. 21.

The scope of application may vary. However, if the purpose of the incentive is to increase active investment, it will typically include productive assets, such as machinery and production facilities. Such arrangements may also be time limited.

Contrary to tax holidays and CIT rate reductions, investment tax credits are aimed at new investments, i.e. new acquisitions, regardless whether it is made by a new investor or an investor with already established business operations. [154] Hence, it induces reinvestment of profits earned in the host State and may induce additional capital financing from the home State. Nonetheless, in the initial stages of investment, the effectiveness of investment tax credits is limited as net income may be negative. Thus, a relevant aspect in this respect is whether the credit may be carried forward and used in subsequent tax periods.

#### 6.3.1.4 Investment allowance

Like investment tax credits, investment allowances are also connected to the acquisition of assets. Moreover, in respect to scope of application, the rate of the incentive and the general rationale, these concepts are very similar.[155] Hence, these issues will not be addressed, as it would be a mere repetition. The primary difference between an investment allowance and investment tax credits is their functional context in the domestic tax system. Whilst investment tax credits directly reduce tax payable, an investment allowance is set of against gross income, thereby reducing the amount that is basis for computing tax payable. This has some implications. The benefit of an investment allowance is variable dependent on the tax rate applicable to taxable net corporate income. The benefit will increase proportional to the tax rate. Thus, a higher tax rate will give a greater benefit.[156] This is not the case for investment tax credits as they consist of a fixed amount deducted from tax otherwise payable. Moreover, as the investment allowance is set off against gross income, it is not dependent that there are taxable net profits. However, unless the incentive induces a threshold

[154] Easson (2004) p. 142-143 and OECD (2001) p. 27.

[155] *Tax Law Design and Drafting* (2000) p. 992-993.

[156] OECD (2001) p. 27.

effect, making taxable net income negative and thus not taxable, the value of an investment allowance in the case of negative net profits will depend on the extent in which the domestic tax system allows carry forward of losses from previous tax periods. If the investment allowance merely increases negative income, it will be of no use unless it may be set off in positive income in a subsequent tax period.

An investment allowance may be deployed differently, for example in the form of accelerated depreciation or increased cost deductions, or both. Hence, these concepts are often considered subordinate types of investment allowance.[157]

Accelerated depreciation involves that acquired assets may be written off more rapidly than prescribed by general rules. Normally, this implies that depreciation is inconsistent with the economic life of the asset. Perhaps the most distinct trait of accelerated depreciation is that it does not necessarily involve a reduction of overall tax payable, compared to ordinary depreciation; the same amount is subject to deductions only within fewer tax periods than prescribed by the general rules.[158] Thus, isolated to one tax period, it may provide a greater deduction than ordinary rules, but not overall. However, accelerated depreciation may be combined with generally increased cost deductions. Naturally, the period may vary. In some cases, a full write-off is provided within the same tax period as the acquisition is made. In other incentive regimes, the difference from ordinary depreciation rules may appear more modest. For example, an asset may be depreciated over the same period as prescribed by ordinary rules, but with an increased deduction the first tax period or tax periods. Based on the inherent feature of more rapid depreciation, accelerated depreciation can also take several other forms.[159]

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[157] OECD (2001) p. 27.

[158] Easson (2004) p. 147-148.

[159] Viherkenttä (1991) p. 24-25.

Increased cost deductions allows for the deduction of a greater amount than prescribed by ordinary deduction rules. It is not uncommon that increased deductions are combined with accelerated depreciation. In which case, the deductions will not only be provided within a shorter period of time, but also exceed the amount of deductions otherwise provided by general provisions. Moreover, in this case, it is not uncommon that a deduction for capital acquisitions, normally subject to depreciation, is provided within the same tax period as the asset was acquired. The increased deduction may be a certain additional percentage of the cost otherwise deductible. In some States, the increased deduction may be 100 percent of the acquisition cost, allowing the double amount to be deducted.[160] Increased deductions may also be granted for expenses, such as training of workers and marketing.[161]

### 6.3.2 Tax incentives on outbound transactions

The tax incentives outlined above directly favor profits derived by a company resident in the host State or a permanent establishment situated in the host State, i.e. a foreign company. This section will address tax incentives that are applied to transactions from a host State company or permanent establishment to the investor resident in the other State. Tax concessions on this type of transactions are usually denoted withholding tax relief. Usually, such tax incentives are granted for payment of dividends and certain types of interest and royalties.[162]

Generally, similar questions arise here as for CIT incentives. The specific features of withholding tax relief are subject to jurisdictional differences. This particularly concerns qualification criteria, types of income subject to relief, the duration of the relief measure, the rate deviation compared to ordinary rules, and whether the incentive is provided as part of a special regime including other tax incentives as well. The different incentive measures are discussed under the assumption that they only apply to outbound transactions of an enter-

[160] Easson (2004) p. 148-149.

[161] UNCTAD (2000) p. 22.

[162] Easson (2004) p. 149-150.

prise, a host State company or permanent establishment, conducting active business activities.

#### 6.3.2.1 Relief from withholding tax on dividends

Relief from withholding tax on dividends is a fairly common concept. It involves relief from the tax levied on the entity paying dividends. Withholding tax relief on dividends is often granted in combination with CIT incentives, such as tax holidays.[163] In this case, the relief from withholding tax does not only function as a separate incentive, but it also prevents that withholding tax otherwise imposed partially exhausts the CIT incentive. This occurs as the CIT incentive increase profits and consequently dividend payments subject to withholding tax. However, whether this is deemed inexpedient is a domestic policy issue.

From a policy perspective, relief from withholding tax on dividends poses a dilemma. On one hand, it provides an obvious benefit and thus presumably attracts investment, both separately and in the case that it is combined with CIT incentives. On the other hand, it provides an incentive to repatriate profits rather than to reinvest profits.[164] In respect to economic development, it is clearly counterproductive if withholding tax relief induces repatriation of profits that would be reinvested in the case that withholding tax was imposed.

#### 6.3.2.2 Profit remittances from permanent establishments

From the perspective of private law, profits derived by the permanent establishment are derived by the company as such and not separately by the permanent establishment. Some States, for example Norway,[165] accept this premise in their tax legislation, involving that no tax is imposed on profits remitted from the permanent establishment to the head-office of the company. In this case, there is no tax to concede by the host State.

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[163] Easson (2004) p. 149.

[164] UNCTAD (2000) p. 21.

[165] Gjems-Onstad (2012) p. 1028.

To equate the tax treatment of permanent establishments and subsidiaries, some States impose a so-called branch remittance tax. For permanent establishments, this is the economic equivalent to withholding tax on dividends. Both branch remittance tax and relief from branch remittance tax, presupposes that branch remittances are defined, which in practice is very difficult.[166] Hence, somewhat simplified approaches are often adopted. For example, branch profits may be subject to additional tax on profits that are not reinvested, based on the rationale that profits, in this case, are at the free disposal of the company, similar to as if they where distributed as dividends from a subsidiary to a parent company.[167]

As the tax is directly connected to the profits of the permanent establishment and is levied on a current basis,[168] and not upon distribution, the tax and potential tax concessions are systematically part of the system of taxing business profits derived by the permanent establishment and thus not functionally comparable to withholding tax relief. Hence, the operation of tax incentives in this respect would probably be very similar to the operation of a tax holiday or general CIT rate reduction.

#### 6.3.2.3 Relief from withholding tax on interest and royalties

Relief from withholding tax on royalties and interest could be an appropriate measure to reduce the cost of technology transfers to the host country enterprise and to reduce financing costs of the host country enterprise.[169]

If withholding tax relief is provided for this type of income, it is usually narrowly targeted and subject to strict criteria.[170] For example, relief from withholding tax on royalties may typically be granted on specific technology transfers, and relief from withholding tax on

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[166] *Tax Law Design and Drafting* (2000) p. 774-775.

[167] Easson (1999) p. 52.

[168] *Tax Law Design and Drafting* (2000) p. 1011.

[169] *Tax Law Design and Drafting* (2000) p. 1009-1010.

[170] Easson (2004) p. 149-150.

interest may be granted in the case that a loan is made to recipients with specific characteristics.[171] Presumably, this is to ensure that the withholding tax relief is not provided for passive investment activities.

### 6.4 Concluding remarks

By stipulating statutory references or abstract conditions, tax sparing provisions may include a diverse range of host country tax incentive measures. Although the different forms of incentive measures have general strengths and weaknesses, the appropriateness of the measure largely depends on the specific conditions and needs in the specific developing country. However, observing the measures on a more general level, it could appear unfortunate that tax holidays are frequently deployed, and included in tax sparing provisions, whilst seemingly more effective measures, such as investment tax credits and investment allowances are not as commonly included.[172]

An important observation is the difference between tax incentives that are granted host country companies or permanent establishments and incentives that are granted for outbound transactions to the foreign investor. As the following account on items of income subject to tax sparing will show, this distinction has significant implications on the operation of tax sparing.

## 7 Items of income subject to tax sparing

### 7.1 General

This part is closely connected to the previous part on tax incentive measures, as tax sparing usually is granted for "(…) income derived from tax incentives designed to promote economic development in the host country (…)".[173] Here, the perspective is the common tax base established in tax treaties, and the items of income that may be subject to tax sparing.

[171] Maugüé (1997) p. 165-166.

[172] *Tax Law Design and Drafting* (2000) p. 1014.

[173] OECD, *Tax Sparing: A reconsideration* (1998) p. 32.

A general limitation is that tax sparing cannot be *directly* provided for foreign source income that is exempted by the State of residence. Within this scope, nonetheless, tax sparing provisions may be drafted so they in principle apply to any type of income covered by the tax treaty.

First, this part will shortly present the diversity of tax sparing provisions in respect to which income they cover. The more comprehensive topic of this part will be to analyze tax sparing in relation to the specific items of income stipulated in the common tax base established by tax treaties. This will include business profits, dividends, interest and royalties. The purpose is to clarify when tax sparing is required and, in the case that it is required, to analyze and assess the operation of tax sparing in respect to the specific item of income. This topic will be based on both tax treaties and general concepts of domestic worldwide taxation.

### 7.2 Different approaches under operative tax sparing provision

In operative tax sparing provisions, there is some variation as to which items of income they include. Some provisions are limited to specific types of income, such as for example dividends and interest, and some provisions in principle apply to any item of income. Both variations are common.[174] An example of the latter is article 23(2) of the 1975 UK and Sudan double tax treaty:

> "For the purposes of paragraph (1) of this Article, Sudan tax payable shall be deemed to include any amount which would have been payable as Sudan tax but for an exemption or reduction of tax which is certified by the competent authority for the Sudan as having been given with a view to encouraging industrial, commercial, agricultural, scientific or educational development under:
>
> (i)[reference to Sudan domestic law]"

[174] Viherkenttä (1991) p. 147.

Here, there is seemingly no limitation as to the type of income. However, the incentive legislation referred to may entail that tax sparing in practice is only provided for certain items of income. Assuming that it only provides withholding tax relief on dividends, the tax sparing provision effectively only covers dividends.

An example that the items of income covered are specifically stipulated is article 22(2)d of France and Brazil 1971:

> "as regards income referred to in Articles X, XI and paragraph 2, "c" of Article XII [dividends, interest and royalties], the Brazilian tax shall be considered as being levied at a minimum rate of 20 percent."

This provision positively indicates which items of income are covered, and its application is not conditioned that the tax concession is granted under a specific host country statute. Although this provision appears different from the one previously cited, the substantial difference is dependent on the statute referred to by that provision. Hence, the contents of Sudan domestic law could entail that the provision comprise the same items of income as the Brazil and France provision.

Tax sparing provisions may also adopt a more targeted approach, positively indicating which general items of income are covered and at the same time providing a positive limitation on specific items that would otherwise be covered by the general scope. An example of this is article 24(2)(d) of the Denmark and Thailand treaty of 1998. According to which, a

> "(…) deduction from Danish tax for Thai tax shall be allowed as if no such exemption or reduction had been granted, provided the permanent establishment is engaged in business activities (other than business activities in the financial sector)

> and that no more than 25 per cent of such profits consist of interest and gains from the alienation of shares and bonds or consist of profits derived from third States."

Under this provision, profits from a permanent establishment generally qualify for tax sparing if the profits are subject to a tax concession. However, this does not apply if the profits are derived in a certain way or if the profits are composed in a certain way. Generally, under the provision, typical passive investment profits are excluded from tax sparing. This type of targeting, especially targeting to prevent that the tax sparing provision is applicable to passive income, is common in more recently concluded treaties.[175]

The cited provisions illustrate that there is significant diversity as to which income is subject to tax sparing.

## 7.3 Business profits derived by a company resident in the host State

### 7.3.1 General

The question here is whether home State taxation may compromise CIT incentives granted a subsidiary resident in the host State. The focus is more precisely business profits derived by the subsidiary in its State of residence, i.e. the host State.

In general, neither the territorial principle nor the worldwide income principle dictate that business profits of foreign companies should be subject to tax in a State where it is not resident.[176] Hence, most States do not tax profits of what it considers to be a separate tax entity resident in another State. Thus, host country CIT incentives are generally not directly affected by the worldwide income tax regime of the home State of the investor.

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[175] OECD, *Tax Sparing: A reconsideration* (1998) p. 31. At least treaties concluded recently up to the time when the report was drafted.

[176] Arnold (2002) p. 15 and Holmes (2007) p. 13.

As the income is not subject to tax in the home State, juridical double taxation does not occur. Hence, tax treaties are generally not relevant. However, if the host State imposed tax on such income, the first sentence of the OECD MTT article 7(1), prescribes that "Profits of an enterprise of a Contracting State shall be taxable only in that State (…)". In its context, the wording clearly implies that the host State, where the subsidiary is resident, is granted an exclusive right to tax business profits derived by the host country company. Accordingly, the home State of the investor is obligated to exempt such income from taxation. Thus, home State taxation generally does not directly nullify the effect of CIT incentives granted a company resident in the host State.

#### 7.3.1.1 Current shareholder taxation under CFC-rules

A notable exception from what is stated directly above is CFC-rules, which generally entail that shareholders are taxed currently on their "(…) *pro rata* share (…)" of the undistributed profits of the company.[177] No tax is formally imposed on the company, but from the perspective of the investor the CFC-tax economically creates the same situation as if this was the case. Accordingly, the benefit of CIT incentives is reduced, and nullified if the CFC-tax exceeds the ordinary tax in the host State. As tax is not imposed on the company resident in the host State, the application of such rules is not inhibited by article 7(1) of the OECD MTT.[178]

However, the application of CFC-rules is generally limited to cases where the host country company, i.e. subsidiary, earns passive income. Moreover, their application is often restricted to specified low-tax jurisdictions.[179] Tax incentives granted by developing countries for development purposes tend to be eligible for companies engaging in substantial activities. The same is generally the case for the availability of tax sparing. Hence, it rarely

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[177] Sandler (1998) p. 19.

[178] OECD Commentaries C(1)-32 paragraph 23.

[179] Arnold (2002) p. 94 and Viherkenttä (1991) p. 86-87. As an example, see §§ 10-63 and 10-64(a) of the Norwegian Tax Code.

occurs that CFC-rules affect host country tax incentives or potentially conflict with tax sparing provisions.[180] Accordingly, CFC-rules will not be further addressed.

### 7.3.2 Indirect tax sparing

Even though business profits of a company resident in the host State are exempted from tax in the State of shareholder residence, tax incentives granted a company resident in the host State may be frustrated by home country taxation upon repatriation of profits, i.e. payment of dividends. The exhaustion effect presupposes that the home State imposes tax on received dividends and that tax sparing is not provided for dividends as such or is only provided for a limited percentage of the gross amount of dividends, for example 15 percent of the gross amount, which is very common.[181] The effect occurs as the tax incentive available to the company resident in the host State entails increased profits, which leads to increased dividend payments and consequently more tax payable in the State of shareholder residence. To prevent this effect, some tax sparing provisions provide an additional credit for the portion of the paid dividends constituted by the CIT incentive. The frustration effect and the basic operation of this concept, is reflected in the following example:

[180] OECD, *Tax Sparing: A reconsideration* (1998) p. 38-39.

[181] OECD MTT article 10(2)a.

| | With tax sparing | Without tax sparing | Without tax holiday |
|---|---|---|---|
| **The host State** | | | |
| Company business profits | 100 | 100 | 100 |
| Normal corporate income tax 25% | 25 | 25 | 25 |
| Tax holiday 0% | -25 | -25 | - |
| After tax profits | 100 | 100 | 75 |
| Dividends paid | 100 | 100 | 75 |
| Dividend withholding tax 15% | 15 | 15 | 11,25 |
| After tax dividends | 85 | 85 | 63,75 |
| **The home State** | | | |
| Tax on recieved dividends 25% | 10 | 10 | 7,5 |
| Received dividends | 75 | 75 | 56,75 |
| Indirect credit for notional tax | 25 | 0 | - |
| **Total tax liability** | 0 | 25 | 18,75 |
| **After tax profit** | **100** | **75** | **56,75** |

[182]

Comparing the total tax liability and after tax profits, an important observation is that the investor also accrues a benefit from the tax holiday in the absence of tax sparing. Thus, the concept of indirect tax sparing ensures that the benefit of the tax incentive is not reduced.

#### 7.3.2.1 Credit for tax on underlying profits

Neither the OECD MTT nor the UN MTT provides an indirect credit. However, the concept is not uncommon in operative tax treaties, and it is moreover addressed in the commentaries to the OECD model tax treaty as a concept that States are free to include in their treaties. Generally, the indirect credit, or credit for underlying tax, implies that the credit on dividends is increased by the tax imposed on the host country subsidiary. The general purpose of the concept is the same as participation exemption, namely to prevent recurrent economic taxation.[183] Hardly consistent with this purpose, as there is no recurrent economic taxation in this case, the mechanism may also be used to ensure that host country CIT

[182] The example is based on an example found in OECD (2001) p. 44.

[183] OECD Commentaries C(23)-21-22 paragraphs 50-54.

incentives granted a host country subsidiary are not frustrated upon repatriation. This is generally achieved by stipulating a notional tax on the subsidiary profits.

#### 7.3.2.2 The operation of indirect tax sparing

An illustrative example of indirect tax sparing is article 25, paragraph 1 b in conjunction with paragraph 4, of the UK and Ghana treaty of 1993. The approach deployed here is fairly common if indirect tax sparing is granted. Hence, although the analysis is based on the exemplified provision, it is of general interest. The former paragraph prescribes that

> "in the case of a dividend paid by a company which is a resident of Ghana to a company which is a resident of the United Kingdom and which controls directly or indirectly at least 10 per cent of the voting power in the company paying the dividend, the credit shall take into account (in addition to any Ghana tax for which credit may be allowed under the provisions of sub-paragraph (a) of this paragraph) the Ghana tax payable by the company in respect of the profits out of which such dividend is paid."

This provision sets forth that a credit is provided for CIT paid by the host country company on the portion of the profit that dividends are paid from. For example, if the profit is 100 and the tax is 20, and a dividend of 50 is paid, a credit of 10 is granted. As this provision requires that tax is paid, this provision itself does not prevent the exhaustion of the CIT incentive. Furthermore, paragraph 4 prescribes that

> "For the purpose of paragraph (1) of this article, the term "Ghana tax payable" shall be deemed to include any amount which would have been payable as Ghana 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 Ghana law:"

In conjunction, these provisions provide a credit for tax spared on the portion of the profits that the dividends are paid from. Thus, the investor is granted a credit for tax spared on subsidiary profits.

An important question is which tax incentive measures this approach could potentially include. The latter paragraph provides a statutory reference, which specifically determines which tax incentives measures are taken into account. The feature of statutory reference is commonly found where this approach is adopted. Disregarding the reference, the potential scope of indirect tax sparing is otherwise very broad in respect to which tax incentive measures that it may include. The latter paragraph prescribes that “Ghana tax payable” includes “any amount which would have been payable (…) but for an exemption or reduction of tax.” This implies that any measure that reduces the tax liability, compared to the ordinary tax liability, is included. Thus, not only measures that directly reduce tax payable, such as tax holidays and CIT rate reductions are included, but also measures that reduce taxable income, such as investment allowance. Accordingly, the different types of CIT incentives outlined above would all be included. Paragraph 1 b establishes the outer scope of the indirect tax sparing, as paragraph 4 has an accessory function in respect to that paragraph. It sets forth that an indirect credit is provided for tax on the “profits out of which such dividends is paid.” Assuming that there is no limitation on distribution of dividends in respect to the nature company profits, this seemingly includes any profits that companies in the host State may derive and the tax on such profits. Herein, also profits from typical passive activities are included. However, this could be prevented by a statutory reference to the qualifying tax incentive measures or by limiting tax sparing to certain activities. This is presumably the reason why such additional conditions often are adopted when indirect tax sparing is provided.[184]

How the credit for indirect notional tax is computed will be addressed under the section 9.2.3.

[184] An example of indirect tax sparing with an activity limitation is found in the Australia and Vietnam treaty of 1992, partially cited in section 8.2.

#### 7.3.2.3 The relation to the fixed limitations on source tax on dividends

It could occur that the creditable amount that results from indirect tax sparing exceeds the maximum amount of credit for tax on dividends in general.[185] This raises the question whether the indirect credit is limited to the same extent as the credit for tax on dividends under OECD MTT article 10(2)a, or is provided in addition to the credit for notional tax on dividends. This question arises regardless whether tax sparing is provided for dividends in general.

In the UK and Ghana provision, this is explicitly resolved by paragraph 1 of article 25, explicitly stating that the credit provided by indirect tax sparing is granted in addition to the credit for dividends. However, in many treaties that deploy the indirect tax sparing approach, such as Australia and China 1988 article 23(5)(4)(3), this is not explicitly resolved. On one hand, the credit is provided for tax reflected in the dividend payment, suggesting that the general source tax limitation for dividends applies. Conversely, the purpose of providing a credit for tax on underlying profits is to prevent recurrent economic taxation which, to be carried out in full, requires that the credit for tax on underlying business profits is provided in addition to the credit for withholding tax on dividends. However, in the case of tax incentives, this rationale may be invalid, for example if no corporate tax is imposed and withholding tax relief is provided, i.e. there is no recurrent economic taxation. Nonetheless, it is a consistent tendency in the case of tax sparing that, unless otherwise stated, notional tax paid is treated as tax actually paid, suggesting that indirect tax sparing provides and additional credit. Following this line of thought, the OECD Commentaries clearly presuppose that the credit for tax on underlying profits is provided in addition to the credit for withholding tax on dividends.[186] This is also the general conclusion, unless the contrary is explicitly stated.

[185] OECD MTT article 10(2) a and b.

[186] OECD Commentaries C(23)-22 paragraph 52b.

## 7.4 Dividends

### 7.4.2 General

For host country CIT incentives and withholding tax relief on dividends to accrue to the foreign investor, home State taxation of dividends is of major importance. If the investment is made as an equity investment in a host country company, paid dividends reflect the profits of the investment, herein the increase of profits presumably created by the host country tax incentive measures.

The first issue to be addressed is the necessity of providing tax sparing for dividends. If the tax incentives that manifest as "tax paid", i.e. tax not paid, on dividends are not compromised by home State taxation, there is no need for tax sparing. The second issue to be addressed is how tax sparing provided for dividends operate in its tax treaty context.

### 7.4.3 Taxation in the State of shareholder residence

In general, received dividends are usually subject to tax in the State of shareholder residence. This is a premise to fulfill the functional rationale of tax sparing. If the dividends are not subject to tax, there is no need to stipulate a notional tax on dividends under the tax treaty. Commonly deployed domestic law concepts of taxing received dividends have features that are asserted to reduce the significance of tax sparing. Moreover, in particular, the concept of participation exemption seemingly renders tax sparing redundant. The topic of this section is to generally analyze whether taxation of received dividends in the State of residence may negate the necessity of tax sparing. Due to the frame of the thesis, the concepts are presented on a very general level. Moreover, there are also other concepts and features of domestic law that may influence the need for tax sparing to include dividends.

Assuming that tax sparing is not provided, tax on received dividends in the State of shareholder residence will compromise both host country withholding tax relief and host country CIT incentives.

#### 7.4.3.1 Deferral

In domestic law, dividends are usually subject to tax when they are paid from the subsidiary. The company paying dividends determines if and when dividends are paid. Under a parent and subsidiary constellation, the parent, holding all controlling shares in the subsidiary, may effectively determine if and when dividends are paid, and consequently if and when a potential tax liability incurs. This concept is sometimes referred to as "deferral".[187] The term will also be used here.

Although deferral grants the investor control as to if and when the tax liability incurs, the tax liability nonetheless incur if dividends are paid, and consequently affects host country tax incentives.

In the case of CIT incentives, postponing the incurrence of the tax liability provides some benefits that seemingly reduce the significance of tax sparing. In fact, it is asserted that

> "(…) tax sparing is actually unnecessary, given the deferral permitted on active foreign income earned by a U.S. person through a foreign subsidiary."[188]

However, as tax liability incurs upon repatriation, for this statement to be true, the assumption is that the profits of the subsidiary are not repatriated. It has been argued that deferral to some extent offsets that the benefit from the host country CIT incentive is reduced upon repatriation of profits. The view is that, especially long term deferral, in practice could be compared to an interest free loan from the home State treasury, which may be used to generate profits, including passive profits such as interest.[189] Moreover, other factors, such as exchange rate fluctuations may provide benefits upon repatriation.[190] However, the latter is

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[187] Viherkenttä (1991) p. 73.

[188] *Joint Committee on Taxation* (1995) p. 54.

[189] Viherkenttä (1991) p. 91.

[190] Viherkenttä (1991) p. 94.

a highly circumstantial argument. Deferral nonetheless limits the opportunity of the investor to dispose over the profits, which has significant implications, especially in respect to the liquidity of investor. Therefore, deferral could hardly be said to render tax sparing functionally unnecessary.

That tax sparing allows for the benefit to accrue to the foreign investor in the case of repatriation is often asserted as a reason why tax sparing is generally insufficient to achieve its development objective.[191] Under this position, deferral is considered a more expedient approach as it may function as an incentive not to repatriate profits and consequently to further utilize the capital in the developing country. However, this argument neglects that a prerequisite for some investments is that profits are repatriated after a shorter period of time. If this is the case, tax incentives lose their effect if it is not safeguarded that the incentive accrues to the investor upon repatriation. Presumably, also in the case of this type of investment, the host country accrues the general benefits of active business operations. Moreover, repatriation does not have to involve that all profits are repatriated. Some of the profits could be left in the company for reinvestment.

Although deferral does not make tax sparing redundant, it reduces its significance, especially for long term investments involving reinvestment and development of the host country enterprise.

#### 7.4.3.2 Participation exemption

To avoid recurrent economic taxation of dividends, some States provide participation exemption for dividends paid from a subsidiary to its parent.[192] In general, this entails that the State where the parent is resident does not impose tax on received dividends paid from the

[191] OECD, *Tax Sparing: A reconsideration* (1998) p. 22-23.

[192] For example: The Norwegian Tax Code § 2-38(1) and (2), prescribe as a general rule that limited companies are exempt from tax on dividends paid from other limited companies, including foreign companies. The same applies for alienation of shares.

subsidiary. Accordingly, host country tax incentives, both withholding tax relief and CIT incentives, such as a tax holiday, will not be compromised in the direct relation between the subsidiary and the parent. Thus, a tax sparing provision is not needed, except in the case of a personal shareholder where participation exemption generally does not apply.

A requirement for participation exemption is usually that the investing company has a qualified shareholding in the company that dividends are paid from, for example a 10 percent equity and voting share.[193] In the case of active investment, the holding is generally sufficient.[194] If the conditions for participation exemption are not present, entailing that the host country tax incentives are nullified, the investment is generally of a passive nature and not apt for development purposes. Thus, tax sparing should generally not be granted. Accordingly, in the case that the investor is a company, participation exemption may seemingly fully overlap the need for tax sparing for dividends, which is perhaps the most important area for tax sparing. Moreover, the concept of participation exemption is part of an international trend on the tax treatment of inter-company dividends.[195] This could suggest that it will become increasingly widespread.

#### 7.4.3.3 Concluding observations

It is the general observation that tax sparing for dividends is generally redundant if the State of residence applies the concept of participation exemption. If participation exemption is not provided, the concept of deferral is for some purposes apt to preserve host country tax incentives. However, in this case, tax sparing for dividends has a significant separate function.

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[193] For example: The Norwegian Tax Code § 2-38(2)d.

[194] Harris (2010) p. 285.

[195] Proposition to the Odelsting of the Norwegian Parliament no. 1 (2004-2005) p. 53.

### 7.4.4 Treatment of dividends under tax treaties

On tax treaty level, the operation of a tax sparing provisions that apply to dividends is not entirely straight-forward. Tax treaties have mechanism, such as "tax sharing",[196] which have implications on the effect of tax sparing or that may be modified by tax sparing. Moreover, there is the question of indirect tax sparing, which was addressed under section 7.3.2.

#### 7.4.4.1 Article 10 of the OECD and UN model treaties

Pursuant to articles 10(1) and 10(2) of the OECD MTT, juridical double taxation is avoided by a fixed allocation of the right to tax dividends, different from the system of either a primary or exclusive right to tax. This is the concept sometimes referred to as tax sharing. According to article 10(2), the State where the company paying dividends is resident, i.e. the host State, is granted the primary right to tax dividends. However, this right is subject to significant limitations. Subject to subparagraph a, tax on active investment dividends is limited to 5 percent, conditioned that the recipient of the dividends is the beneficial owner of the subsidiary paying dividends, and owns at least 25 percent of its shares. Under subparagraph b, the right of the host State to tax passive investment dividends is limited upwards to 15 percent. The concept of tax sharing is found in the provisions governing interest and royalties as well. Hence, the implications that it has on tax sparing will be addressed collectively in section 7.6.

#### 7.4.4.2 Tax sparing for dividends

The nullification effect on both relief from dividend withholding tax and CIT incentives is prevented if tax sparing is provided for dividends in general. However, it should be noted that the concept of tax sharing, which will be discussed in greater detail later on, may constitute a limitation to this effect, implying that indirect tax sparing has to be provided in addition to tax sparing on dividends for the overall tax incentive to accrue to the investor.

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[196] Vogel (1997) p. 560, uses the term "tax sharing".

## 7.5 Interest and royalties

### 7.5.1 General

Subject to the worldwide income principle, both interest and royalties are generally subject to tax in the State where the recipient is resident. Although these items of income are principally different, their home State tax treatment, and their tax treaty treatment, is fairly similar. Accordingly, to some extent, it is considered appropriate to address these items of income collectively.

On domestic level, the significant similarity is that, opposed to dividends that may be deferred; both royalties and interest are immediately received by the foreign investor.[197] This implies that the home State tax liability generally occur when the interest or royalties arise. Moreover, neither interest nor royalties are generally subject to special home State exemptions or special regulatory mechanisms, as the case is for dividends.

### 7.5.2 Interest

Pursuant to article 11(1) and (2) of the OECD MTT, the allocation of the right to tax interest is also subject to a tax sharing mechanism if the interest is paid to the beneficial owner. Under subparagraph 2, interest "may be taxed" in the State of source, limited upwards to 10 percent of the gross amount. However, the fixed allocation is subject to variance.[198]

### 7.5.3 Royalties

For royalties there is a divergence between the OECD MTT and the UN MTT. Pursuant to article 12(1) of the OECD MTT, royalties are taxable only in the State where the beneficiary is resident. Article 12(2) of the UN MTT, on the other hand, prescribes that royalty

[197] Viherkenttä (1991) p. 128.

[198] In article 12 of the UN MTT, the fixed allocation is explicitly stated to be subject to bilateral negotiations. This implies an assumption that the fixed allocation should be adjusted subject to individual factors in the bilateral relationship.

payment "may be taxed" in the State of source, limited upwards to a certain percentage of the gross amount.

### 7.5.4 The effect on host country tax incentives

Generally, host State withholding tax relief for interest and royalties will be nullified to the extent the home State is obligated to eliminate juridical double taxation using the credit method.[199] Compared to dividends, which in the case that tax incentives may by nullified is subject to deferral, this effect is seemingly more difficult to subdue as both interest and royalties are immediately subject to tax in the home State.[200]

### 7.5.5 Implications of tax sparing

A credit for notional tax provided for interest and royalties, ensure that the benefit of withholding tax relief on these items of income accrue to the investor. Assuming payment at arms-length, the implications are different from those of providing tax sparing for dividends. Payment of interest and royalties do not reflect distribution of underlying business profits, but one side of a mutual performance, i.e. payment for utilizing capital, licenses and patents. Thus, tax sparing effectively reduces the overall costs of utilizing such assets in the host country enterprise. Accordingly, this does not raise the concern of excessive repatriation of profits. In particular, tax sparing for royalties is appropriate in the case that host country incentives are directed at technology demanding industries. Moreover, it functions as an incentive for technology transfers. Reduction of financing costs by providing tax sparing for interest is generally beneficial to induce expansion of host country enterprises.

#### 7.5.5.1 Abuse issues

For interest it is a special concern that not all of the interest paid necessarily stem from appropriate host country activities. Presumably, this is due to the mobility of funds that interest may be paid from and because notional tax paid is based on the gross amount of interest paid, subject to OECD MTT article 11(2). Hence, many tax sparing provisions do not in-

[199] OECD and UN MTTs articles 11 and 12.

[200] Viherkenttä (1991) p. 128.

clude interest.[201] For example, a loan is granted from the home State to a host State company. The received capital is then used for equity financing of a company in a third State. Between the third State and the host State no tax is imposed on intercompany dividends. The dividends received by the host State are then used to pay interest. This arrangement would provide a benefit, assuming that dividends received in the home State from the third State would be subject to tax in the home State. This would generally be contrary to the purpose of the tax sparing provision because the capital is not utilized for active operations in the host State.

A technique deployed to reduce abuse opportunities is to stipulate narrow and targeted conditions for tax sparing on interest and royalties. An example is article 23(2) of the Canada and Argentina treaty of 1994.[202] It prescribes that

> "(…) 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, (…), or
> (b) industrial royalties referred to in paragraph 3 of article 12.
>
> paid by a company engaged in primarily the same sector which is a resident of Argentina shall be deemed to have been paid at the rate of (…)"

Here it is a condition for tax sparing that the home State company and the host State company are engaged in "primarily" the same business sector. The specific sector is defined by the activities of the company resident in the home State. Moreover, in the provision, an outer limitation is set by stipulating that the home country company has to be engaged in either manufacturing or natural resources. For example, if home country company A is en-

[201] OECD, *Tax Sparing: A reconsideration* (1998) p. 32.

[202] This provision is referred to as an example in OECD, *Tax Sparing: A reconsideration* (1998) on p. 32.

gaged in oil extraction, the host State company has to be engaged in something related or similar, such as providing maintenance on oil extraction machinery. Based on the wording, it would hardly be adequate if the host country company was engaged in an unrelated manufacturing activity, such as shoe production. This limitation would presumably prevent the type of abuse outlined in respect to interest, as foreign capital financing would not be included under the qualifying activity.

For both interest and royalties, there is the general concern of transfer pricing abuse. This is particularly precarious in the case of tax sparing as transfer pricing schemes could be used to inflate the credit for notional tax. For example, royalties could be paid at an above arms-length price to the parent, thus increasing the withholding tax foregone, producing a larger credit for notional tax.

Although tax sparing on interest and royalties may be prone to abuse, it appears that the issue to *some extent* may be limited by careful targeting and narrow criteria.

## 7.6 Tax sharing

### 7.6.1 General

In tax treaties, dividends, interest and royalties are usually subject to the concept of tax sharing, as shortly described when addressing the tax treaty treatment of such income.[203]

An important issue when implementing a tax sparing provision that covers such income is how it functions in respect to the tax sharing rates stipulated under the specific distributive provision of the tax treaty. Provided a strict distinction between allocation of income between the State of residence and the State of source, and credit for tax spared: In the case that the potential credit for notional tax exceeds the tax sharing rate, the State of residence

[203] Articles 10, 11 and 12 of the OECD and UN MTTs.

does not only provide a credit for notional tax, it also concedes part of its tax revenue.[204] Hence, for the State of residence, this issue comprise the principal aspect whether to merely allow the effective operation of a tax concession granted by the State of source, or to extend tax sparing to involve a positive concession from tax on worldwide income. If the credit for notional tax is limited to the tax sharing rate, this rate becomes the determinant for the attractiveness of tax sparing and withholding tax relief as a tax incentive. If the limitation on source tax is relatively low, as under the OECD MTT, the effect of withholding tax relief is presumably limited.

### 7.6.2 Rates between industrialized and developing countries

In general, tax sharing is a compromise based on conflicting considerations. On one hand, the income is generated in the State of source. On the other hand, the operations generating the income is financed by the shareholder, thus by capital from the State where the shareholder is resident and moreover, the host State is granted an exclusive right to tax business profits attributed the subsidiary, generated utilizing foreign capital.[205] Hence, the fixed distribution in the OECD MTT is generally considered an equitable solution. However, in the relation between industrialized countries and developing countries, additional considerations come into play, especially that of economic development. Accordingly, operative tax treaties between industrialized countries and developing countries tend to deviate from the standards set forth in the OECD MTT. The primary deviation is that the tax rate limitation on active investment dividends is increased, typically to 15 percent,[206] providing the developing country a larger portion of tax revenue and consequently greater leeway in respect to providing effective withholding tax relief.

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[204] Viherkenttä (1991) p. 157 and Vogel (1997) p. 1256-1257, describes this as a “partial exemption”.

[205] Zimmer (2009) p. 215-216 and OECD Commentaries C(10)-2 paragraph 9.

[206] UN Commentaries, p. 179 paragraph 10; for example, Norway and Brazil 1980 article 10(2).

### 7.6.3 Tax sparing provisions and fixed tax rate limitations

Under operative tax treaties, different approaches are adopted regarding the relation to fixed tax sharing rates. The approach is reflected by the regulated interaction between the provisions on dividends, interest and royalties and the tax sparing provision.

#### 7.6.3.1 Source rate limitation approach

Under some provisions, no reference is made to the tax sharing rates. An example is article 23(3) of the UK and Uganda treaty of 1992. The provision prescribes that a credit for notional tax is provided for

> "(…) any amount which would have been payable as Ugandan 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 Ugandan law:"

As ordinary Ugandan tax payable is effectively limited by the general tax sharing rates set forth in the treaty, the provision implies that the tax sharing rates set forth in articles 10, 11 and 12 of the treaty, effectively limit the credit for notional tax.[207] Assuming that one of the referred Ugandan provisions provides full withholding tax relief for interest, hypothetically involving a 20 percent concession, the credit for notional tax would, pursuant to article 11(2), be 15 percent of the amount. Consequently, only 75 percent of the tax foregone would accrue to the investor. For this reason, it appears redundant, as under article 23(3)(b) of the New Zealand and India treaty of 1986, to explicitly state that the credit for tax foregone shall not exceed the tax sharing rate. If the State of source has an ordinary level of tax that is lower than the rate permitted in the treaty, the State of residence will impose tax on the intermediary between the notional tax and the tax rate limitation.

A somewhat different approach is set forth in article 22(4) of the Japan and Vietnam treaty of 1995. It prescribes that

[207] This view is also held in OECD *Tax Sparing: A reconsideration* (1998) on p. 32.

> "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."

In respect to dividends, pursuant to the referred article, credit for notional tax is limited to the extent in which direct investment dividends generally may be taxed in Vietnam. For royalties, the maximum credit for notional tax is equal to the rate limitation applied if royalties are paid to the beneficial owner. Contrary to the UK and Uganda provision, the fixed credit for notional tax is provided regardless of the ordinary level of tax in the State of source.

If the credit for notional tax is limited to the tax rate limitations, the general allocation of the right to tax is maintained. Thus, the tax sparing provision does not involve a concession in the form of a deviation from the tax sharing rate in favor of the State of source. In this case, tax sparing is provided to the extent required by the general justification of the concept.

#### 7.6.3.2 Concession approach

Some tax sparing provisions provide credit for notional tax exceeding the tax sharing rate. An example of this approach is article 24(2)c of the Norway and Zimbabwe treaty of 1989.

> "Where, however, a resident of Norway derives royalties or technical fees which, in accordance with the provisions of Articles 12 and 13 may be taxed in Zimbabwe, Norway shall allow as a deduction from tax on the income of that person an amount equal to 15 per cent of the gross amount of such royalties or technical fees."

In the treaty, source tax on both technical fees and royalties is limited to 10 percent of the gross amount. Thus, the credit for notional tax exceeds the tax that the State of source could otherwise impose. Assuming that more than 10 percent tax is imposed on received royalties and technical fees in the State of residence, the State of residence does not only respect the host State tax incentive it also concedes tax on the royalty, in favor of the investor. Moreover, as the rate is fixed, the investor will accrue a credit for 15 percent of the gross amount regardless of the ordinary level of tax in the State of source and the tax actually paid. Accordingly, this approach extends beyond the justification of tax sparing by shifting the tax allocation in favor of the State of source, and could thus be perceived as *positive* foreign aid contribution.

#### 7.6.3.3 Limited credit for notional tax

A tax sparing provision may also stipulate that the maximum credit for notional tax is lower than the tax sharing rate.[208] This may be stipulated as a *lower* or *upper* threshold for the tax foregone to be subject to tax sparing.

The *lower* threshold approach involves that a credit for notional tax is only granted if the withholding tax is lower than a set rate, for example 10 percent, which is lower than the tax sharing rate, e.g. 15 percent. The distinct implication of this approach is that a tax concession does not qualify for tax sparing unless part of the tax concession is nullified by the general foreign tax credit rule of the State of residence.[209] For example: In the case of full withholding tax relief, 5 percent of the concession would be nullified. In light of the general justification of tax sparing, this appears inappropriate as it basically implies that the State of source is forced to transfer part of its tax revenue to the State of residence for its tax incentives to accrue to the foreign investor.

Under the *upper* threshold approach it is not a requirement that the withholding tax is below a certain level. Thus, using the same percentages as above, any concession not involving a lower withholding tax than 5 percent will accrue to the foreign investor. This appears

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[208] Viherkenttä (1991) p. 155-166 and OECD, *Tax Sparing: A reconsideration* (1998) p. 32.

[209] Viherkenttä (1991) p. 155.

more reasonable, as it is not necessary to let part of the concession be nullified for the tax incentive to accrue to the investor.

Both approaches are seemingly rare, presumably because of the relatively low tax sharing rates generally set forth in tax treaties and the consequential lack of incentive efficiency.[210]

## 7.7 Permanent establishment

### 7.7.1 General

In general, the worldwide income principle prescribes that all income attributed to a tax resident is subject to tax in the State of residence, regardless of where the income is generated. Income generated outside the territory of the State where the company is resident is generally attributed to the company in the home State. Hence, the income of permanent establishments is usually subject to tax in the home State currently as it is generated.[211]

As stated above, the general rule in tax treaties is that business profits of a company are taxable only in the State where the company is resident. However, this is subject to an important modification, based on the idea that an enterprise should be subject to tax in the State where it participates in economic life.[212] Pursuant to article 7(1) of the OECD MTT, business profits attributable to a permanent establishment of a foreign company "may be taxed" in the host State. A reasonable assumption is that a branch of a foreign company used to engage in substantial business activities will qualify as a permanent establishment, pursuant to the general definition set forth in article 5(1) of the OECD MTT.[213] Hence, the

[210] Viherkenttä (1991) p. 155.

[211] *Tax Law Design and Drafting* (2000) p. 1010.

[212] OECD commentaries C(7)-4 paragraph 11.

[213] Whether business activities of a foreign company constitute a permanent establishment is a comprehensive issue. Due to the limited relevance of this issue, for the topic of the thesis, it will not be addressed further. However, the assumption laid down appears well founded as the general concept, according to Skaar (2006)

home State is obligated to prevent juridical double taxation and the host State is accordingly granted the primary right to tax. Thus, host country CIT incentives granted the foreign company will be nullified if the home State applies the credit method.

### 7.7.2 Distributive implications of permanent establishment

The existence of a permanent establishment has comprehensive implications on the general allocation of taxing rights set forth in the OECD MTT. As mentioned above, article 7(4) states that if business profits include income that is specifically regulated in other articles of the convention, the latter articles prevail. In principle, this also applies if the income is attributed to a permanent establishment. However, article 10(4) on dividends, article 11(4) on interest, article 12(3) on royalties, and article 21(2) on other income, all refer back to article 7. Under the mentioned articles, the reference entails that article 7 applies for such income if the income is "effectively connected with" the permanent establishment. Thus, such income is allocated as business profits attributable to a permanent establishment, and may therefore be taxed in the State where the permanent establishment is situated. An important implication is that the fixed tax distribution, i.e. the concept of tax sharing, under the mentioned articles is rendered inapplicable, thus significantly broadening the potential tax base of tax sparing and consequently the extent in which tax incentives for foreign companies may be effectively implemented.

### 7.7.3 Tax sparing for income attributed to permanent establishment

It is fairly common that tax sparing provisions cover income attributed to permanent establishment. However, as permanent establishments may engage in a very broad range of activities, in principle any business activity, including passive investment activities such as financing and lending, limitations are often set to ensure that the credit for notional tax only cover activities that are considered expedient with respect to the host country development needs. For example, article 24(2)(d) of the Denmark and Thailand treaty of 1998, cited

p. 127, is a more or less fixed facility in which the business operations of the foreign company are carried out. To carry out substantial business activities, such a facility is for practical reasons generally required.

above, generally includes business profits of a permanent establishment, but specifically excludes permanent establishments engaged "(…) in the financial sector (…)" or if more than 25 percent of the profits consist of "(…)  interest and gains from the alienation of shares and bonds or consist of profits derived from third States.". Limitations of this nature are fairly widespread.[214] In light of the considerations of economic development and prevention of abuse, the limitation appears appropriate. Activity limitations will be generally addressed under section 8. However, there are also examples of the contrary, such as article 20(2) of the Canada and Cameroon treaty of 1982. Under this provision, tax sparing is provided for a "(…) company which is a resident of Canada (…) in respect of profits attributable to a trade or business carried on by it in Cameroon, (...)". Seemingly, this includes any business activity, including passive investment activities.

### 7.7.4 Attribution of income to a permanent establishment

Having established the existence of a permanent establishment, the question arise which income shall be attributed to the permanent establishment and which income shall be attributed to the company in the home State. Subject to article 7(2), the permanent establishment shall be attributed business profits, including dividends, interest, royalties and other income as if it were a "separate and independent enterprise". The permanent establishment shall be treated as a separate entity in respect to other independent parties and the company which it is part of.[215] This is commonly referred to as the separate entity fiction. The application of this criterion pose special difficulties as the permanent establishment is not considered a separate entity in other relations, and especially as it is not subject to separate contractual and corporate positions[216] According to the OECD commentaries, the application of the independent and separate entity fiction shall be done in two steps. The first step con-

[214] OECD, *Tax Sparing: A reconsideration* (1998) p. 31.

[215] OECD commentaries C(7)-6 paragraph 16.

[216] Skaar (2006) p. 197 and Zimmer (2009) p. 194: The permanent establishment is not a separate legal entity in respect to corporate and private law. Thus, in this respect the debtor and creditor positions are held by the company of which the permanent establishment is a part.

sists of attributing rights and obligations, and economic ownership of assets, to the permanent establishment. The attribution of these elements depends primarily on the extent in which they are connected to people functions at the permanent establishment. For example, a contract is attributed to the permanent establishment if it is facilitated and entered into by a person at the permanent establishment and is to be performed using assets at the permanent establishment. The profits generated by the attributed production factors are attributed to the permanent establishment.[217] In practice, separate accounting records will often be made for the permanent establishment. Such records often serve as starting point for the allocation assessment.[218] The second step concerns transactions between the permanent establishment and the company in which it is part. Consistent with the separate entity fiction, such transactions shall be considered as if they where made between separate entities. Accordingly, the transactions shall be priced subject to the arms length principle, set forth in the OECD MTT article 9, and in accordance with the OECD transfer pricing guidelines.[219]

# 8 Activity limitation

## 8.1 General

Generally, tax sparing provisions *explicitly* or *implicitly* establish conditions as to the activities that the income has to be derived from in order to benefit from tax sparing. This section will focus on the explicit conditions set forth in tax sparing provisions. Implicit conditions are conditions that are not expressly stated in the provision as such, but are set forth, for example, under the domestic tax incentive measure or are effective due to the items of income covered by the tax sparing provision. For example, as shortly addressed in section 6.2.1.2, if only certain activities qualify for the tax incentive measure that the tax sparing

[217] OECD commentaries C(7)-8-9 paragraphs 20-22 provide the general outline of how profits shall be attributed to permanent establishments. The commentaries are based on the OECD report *Attribution of Profits to Permanent Establishments.*

[218] Skaar (2006) p. 197-198.

[219] OECD commentaries C(7)-8 paragraph 20.

provision makes reference to, the domestic tax incentive measure effectively stipulate conditions as to which activities are covered by the tax sparing provision. Although such conditions will not be specifically addressed, the general issues addressed here are to some extent relevant for such conditions as well.

An example of explicit conditions set forth in the tax sparing provision is reflected by the latent article 24(4) of the Australia and Argentina treaty of 1999. It sets forth that the income has to be attributed to

> "(…) manufacturing activities or the exploration for or exploitation of natural resources (…)"

Stipulating qualifying activities in the tax sparing provision as such generally has the function of effectively limiting the scope of the host State tax incentive measure. Hence, such conditions are presumably a result of the interest of the home State, as the scope of the tax incentive measure reflects which activities the host State considers should be covered. The OECD report of 1998, *Tax Sparing: A reconsideration* on page 36, recommends the use of such conditions

> "Where particular tax incentive legislation is defined in broad terms or where the incentive legislation might conceivably apply to inappropriate activities, (…)"

More precisely, it is recommended that such conditions should limit tax sparing to active business activities, such as "(…) activities that assist in the development of the host country's capital base, such as public infrastructure, plant, equipment, skills, and knowledge (…)" and positively exclude typical passive investment activities, such as "(…) banking and insurance (…)"[220] Although more generally stated, the recommended activities have

[220] OECD, *Tax Sparing: A reconsideration* (1998) p. 36.

characteristics that are generally suitable to contribute towards the development objectives set forth by UNCTAD,[221] as addressed under section 3.7.2.

Stipulating qualifying activities, as those exemplified by the OECD, presumably also reduces the risk of some types of abuse. In practice, it is more difficult for a taxpayer to derive benefits from a tax sparing provision contrary to its purpose if it requires that the income is derived from specific substantial business activities. If the taxpayer actually engages in the activities set forth, it is generally not contrary to the purpose of the tax sparing provision if the benefit of credit for notional tax accrues to the taxpayer.

## 8.2 Predictability

A point made in respect to tax incentive measures, that is also relevant in this respect, is that the stipulation of qualifying activities should provide adequate predictability for the taxpayer, which suggests that the activities should be denoted precisely. Lacking predictability may reduce the effectiveness of tax sparing provision and the tax incentive in attracting foreign investors.[222] An example where the qualifying activities are denoted fairly precisely is the amendment of 1996 to the Australia and Vietnam treaty of 1992, implemented in article 23(6) of the treaty. It provides a detailed list over roughly seven general activities that qualify. However, the level of detail in the description varies. One example is subparagraph e:

> "heavy industry projects including metallurgy, mechanical engineering production, base chemical production, cement production, electrical and electronic materials manufacturing, fertilizer manufacturing and anti-epidemic medicines for use in animal production or forestry; or"

[221] UNCTAD (2012) p. 121.

[222] OECD, *Tax Sparing: A reconsideration* (1998) p. 27.

Although the general criterion is somewhat unclear, the examples provide sufficient specificity to assess with an adequate level of certainty whether an activity is covered or not. An example of more vague conditions is article 22(2)(d) of the Sweden and Malta treaty of 1995, that prescribes

> "(…) industrial or manufacturing activities or from agriculture, fishing or tourism (including restaurants and hotels) (…)"

Although the wording is broader and presumably comprises more types of activities than the Australia and Vietnam provision, it is vaguer in respect to the borderline cases. Herein, "tourism" is ambiguous, although the context "restaurants and hotels" provide some guidance. Especially the former example, "restaurants", suggests that it is not limited strictly to providing services to tourists, i.e. people travelling for leisure. For example, it is unclear whether an activity such as providing general medical services in a tourist area, but not specifically for tourists, would qualify.

Assuming that predictability is an important factor for the effectiveness of the tax incentive measure and the tax sparing provision, the former provision exemplifies an appropriate level of precision, providing the investor with a sufficient level of certainty. The latter example, however, may induce borderline issues. For borderline activities, the lack of certainty may reduce the effectiveness of the tax incentive and the tax sparing provision.

## 8.3 Determining which income is derived from the qualifying activity

An issue when setting forth conditions for the income generating activity, in the tax sparing provision, is determining which income is derived from qualifying activities and which income is not. A company resident in the host State, or a permanent establishment situated there, may conduct different activities some or all qualifying for host country tax incentives, whilst only some of the benefited activities qualify under the tax sparing provision.

The Sweden and Malta provision may be used to illustrate a practical example. A permanent establishment manufactures a part for a ship, which is also developed and designed by people at the permanent establishment. At a total price, the investor does not only sell the manufactured part, but also the rights to the design which has a significant separate value. In general, the permanent establishment venture in manufacturing and research and development, both separately and combined. The host country provides a tax incentive for the overall activity. Assuming that the profits derived from research and development activities are not considered "manufacturing activities", how are the profits from the rights to the design separated from the profits derived from the manufacturing of the part?

For this type of questions, the wording of the treaties tends to provide limited guidance. For example, article 23(6) of the Australia and Vietnam treaty cited above state that tax sparing shall only be granted

> "to the extent that the exemption or reduction is granted in respect of Vietnamese tax on income from the following activities:"

Similarly, article 22(2)(d) of the Sweden and Malta treaty prescribes that tax sparing is provided

> "(…) to the extent that such exemption or reduction is granted for profits from (…)"

The wording of both provisions, especially the phrase "to the extent", implies that tax sparing is only provided for the portion of the income that is derived from the qualifying activities. Hence, profits of the host State subsidiary or permanent establishment has to be allocated as either qualifying income or non-qualifying income. This is also the case if a profit is derived from one transaction. The wording does not provide guidance as to how this allocation is to be carried out. However, if the issue is generalized, the problem is very similar to that of allocating a profit between the head office of a company and a permanent establishment or between two permanent establishments of the same company. The similarity is that separate activities under an enterprise do not have separate entity features. The separate entity fiction applied to permanent establishments is designed to deal with this general problem and is thus an expedient approach. Following this approach, the general question is which part of the profit would be generated by each of the activities if they were conducted independently.[223]

Based on the general outline in section 7.7.4, on how income is attributed to a permanent establishment, the assessment would consist of first defining which people functions and assets that are connected to the respective activities. In the example above, welders, raw materials and industrial equipment would for example be considered part of the manufacturing activity. The designers of the part would probably be part of both the research and development activity and the manufacturing activity. The efforts necessary to create the general design would be part of the former activity. The efforts necessary for the manufacturing of the specific part and the value of the immaterial rights to the design reflected in the value of the specific part would be part of the latter activity. On this basis the proportion of the overall income generated by the respective activities could be established by a price comparability test.[224]

### 8.3.1 Administrative difficulties and abuse

In practice, it is a highly complex operation to allocate income derived by one enterprise between its different activities in the same State. Moreover, the practical difficulties increase as it is the home State tax administration that has to carry out the assessment.

The investor has a clear interest in placing risks and people functions under the qualifying activity to increase the portion of income allocated to the qualifying activity. This is a classic transfer pricing issue. However, in this case, such arrangements may be especially difficult to uncover as the distinction between the activities of the enterprise may be highly diffuse and interconnected. Moreover, in the comparable case of allocating income to a permanent establishment it is usually helpful that the host State requires the permanent estab-

[223] OECD MTT articles 7(2).

[224] OECD (2010) p. 45.

lishment to keep separate accounting records.[225] It could be the case that such records, either of a host State company or permanent establishment, do not reflect income generated by its separate activities in such a way that the activities may be distinguished. Especially, this could be the case if the activities are highly integrated.

### 8.4 Final remarks

The approach of stipulating qualifying activities ensures targeting in the case where the host country tax incentive measure is considered too broad. For this approach to be expedient, the activities should be clearly defined. The primary issue of this approach is allocating income between qualifying and non-qualifying activities. Seemingly, based on the rationale of this approach, which is to limit the availability of tax incentive benefits, this issue is inherently not avoidable. However, when stipulating qualifying activities it should be a relevant consideration that more or less integrated activities are not distinguished as this will presumably make the income allocation very difficult.

## 9 Computation of the credit

### 9.1 Introduction

Under this section, the general topic is to analyze and comment different approaches to computing the notional tax under the tax treaty. In general, tax sparing provisions adopt one of two approaches to computing the credit, which generally align with the distinction between tax sparing credit and matching credit. The first approach is based on the difference between tax payable under ordinary rules and tax payable under the qualifying tax incentives. The second approach provides a credit based on a fixed rate regardless of the tax actually foregone. Within these main approaches there are several variations. It should also be noted that both primary approaches may be adopted under the same tax sparing provision whereby they are typically applied to different items of income. An example is article 22(2)(d) of the tax treaty between Sweden and Malta of 1995, cited in section 3.5.

[225] Skaar (2006) p. 197-198.

## 9.2 Credit based on host country tax foregone

### 9.2.1 General

The general justification of tax sparing suggests that a credit for notional tax does not have to exceed the tax actually foregone by the State of source. This implies that the notional tax is constituted by the difference between tax payable in the State of source under the ordinary tax regime and tax payable under the relevant tax incentive regime. This approach has been denoted as "The most orthodox form of tax sparing-credit (…)", and it is moreover very common.[226] Nonetheless, it is perhaps the most complex computation method, because it presupposes that the State of residence stipulates tax payable under the ordinary tax rules of the State of source. The drafting of tax sparing provisions that deploy this computation approach is fairly similar. Although there may be some divergence as to the wording, the provisions raise the same basic issues. A representative example of this computation method is article 25(4) of the UK and Ghana treaty of 1993.[227] It prescribes that

> "(…) the term "Ghana tax payable" shall be deemed to include any amount which would have been payable as Ghana 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 Ghana law:"

As reflected in this provision, the computation method prescribes a two-step process. First, it has to be determined what the tax payable would be if the income had been subject to the ordinary tax liability of the State of source. Second, it has to be established what the actual tax payable is, based on the qualifying tax incentives. The credit for tax not actually paid equals the difference between these factors.

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[226] Viherkenttä (1991) p. 148.

[227] Other examples are Canada and Cameroon 1982 article 20(2), Norway and Kenya 1972 article 25(4) and (5), Japan and Vietnam 1995 article 22(3) and Australia and China 1988 article 23(5).

As the provision prescribes "(…) exemption or reduction of tax granted for that year on any part thereof (…)", it could potentially include any tax incentive measures and any types of income set forth in the tax treaty. The wording does not make a distinction between tax incentive measures that directly reduce tax payable, such as tax holidays, and incentives that indirectly reduce tax payable, such as investment allowances. Both measures ultimately provide a reduction of tax payable, implying that both types of measures could be covered.

As mentioned in section 6.2.1.3, when discussing conditions stipulated in respect to the host country tax incentive measure, this computation method presuppose a distinction between ordinary tax measures and tax incentives. Normally, limitations in respect to tax incentive measures are stipulated,[228] as is also the case under the UK and Ghana provision. In which case, only the tax foregone under the tax incentive measures covered by the tax sparing provision is subject to a credit for notional tax.

### 9.2.2 Determining which tax would have been payable

Generally, the objective is to determine source county tax payable in the hypothetical absence of the qualifying tax incentive measures.[229] First it has to be established which method is to be deployed for computing the hypothetical tax payable. Second, it has to be determined which specific factors are to be included in the computation.

#### 9.2.2.1 Hypothetical tax liability in the State of source

Generally, the ordinary tax is constituted by the specific tax that would be paid in the State of source in the absence of the relevant tax concessions, by the specific taxpayer, in the specific tax period. Seemingly, this is the general method of computing the credit based on the tax foregone. For example, it is adopted in the UK and Ghana provision cited above

[228] Vogel (1997) p. 1256-1257.

[229] Vogel (1997) p. 1256 and Viherkenttä (1991) p. 148.

and, for the sake of a different example, article 24(2)(d) of the Denmark and Thailand treaty of 1998, which prescribes that a

> "(…) deduction from Danish tax for Thai tax shall be allowed as if no such exemption or reduction had been granted, (…)"

Although the wording is different from the wording in the UK and Ghana provision, the substance is generally the same in respect to the computation. As it is the hypothetical tax payable under domestic law of the State of source, in the specific case, that has to be computed, it is difficult to generalize how the computation is carried out. This fully relies on the tax system and the applicable provisions of the State of source.

Modifications from this general approach could occur. For example, specific provisions of domestic law could be specifically excluded when computing the ordinary host country tax or it could be stipulated that time limited tax measures are not included when computing the hypothetical tax payable. The latter case will be discussed in the following section.

#### 9.2.2.2 Treatment of ineligible tax incentive measures

It is clear that a credit for notional is not provided for tax incentive measures not covered by the tax sparing provision. A different question relating to ineligible tax incentives is whether they are included when computing the tax that would have been payable, i.e. the ordinary tax. In the affirmative case, such tax incentive measures would effectively reduce the credit for notional tax compared to what the case would be in their absence. Thus, the host State would basically reduce the effect of its qualifying tax concessions. If ineligible tax incentives are not included, the credit for notional tax is based on the "actual" ordinary level of tax and the eligible measures are consequently unaffected.

Generally, tax sparing provisions seemingly do not directly deal with this issue. For instance, article 23(4) of the Australia and Vietnam treaty of 1992, taking into account the amendment of 1996, prescribes that the basis for computing the ordinary tax includes

> "(…), 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 (…)"

As tax incentive measures are clearly of a legal nature and relate to tax, the concessions that do not qualify for tax sparing are included in the computation of the total amount that would have been payable, thus reducing the credit for notional tax.

On the other hand, the UK and Ghana provision cited above computes the notional tax on basis of "any amount which would have been payable as Ghana tax for any year". The phrase "for any year", implies that time limited tax measures are not included. Many tax incentive measures are time limited and will thus not be included. However, generally, other tax incentive measures are not excluded. For example, investment tax credits and investment allowances may be of a permanent character and could thus reduce the credit for notional tax.

To prevent this effect, the developing country could repeal tax incentive measures that do not qualify and thereby increase the credit. However, this may be an inexpedient solution, especially if the developing country has several tax treaties that provide tax sparing and the provisions cover different tax incentive measures or stipulate different general conditions for tax sparing.

The basic objective of tax sparing is to ensure that tax concessions granted by developing countries accrue to the investor and not the revenue of the State of residence. It could be argued that including ineligible tax incentive measures when computing the hypothetical tax is contrary to this objective, as it effectively entails that the investor accrue a reduced benefit because of the ineligible tax concession, consequently benefiting the State of residence.

A major practical issue of excluding ineligible tax incentive measures when computing the ordinary tax is that a distinction has to be made between “tax incentives” and other tax measures. First a criterion has to be established, and then it has to be assessed continuously each tax period whether the applicable domestic tax laws, which constitute the tax liability of the investor, are tax incentives or not.

Whether it is appropriate to draft the provision so that ineligible tax incentive measures are excluded from the computation of ordinary tax very much depends on the specific conditions of the developing country, such as the overall tax incentive regime and which of the incentives are available to the investors. Moreover, it is also relevant whether the investor may waive tax incentive benefits that the home State does not want the tax sparing provision to cover, so that the ineligible incentives do not constitute a part of the ordinary tax liability.

### 9.2.3 Computation of indirect credit for notional tax

Generally, the same rules apply for the computation of indirect credit for tax foregone as where a direct credit for tax foregone is provided. Nonetheless, a special complication arise in the case of indirect tax sparing as the credit includes tax foregone in respect to a company resident in the host State. Article 23, subparagraph 3 in conjunction with subparagraph 4 and 5, of the Australia and China treaty of 1988 is apt to illustrate the issue. Subparagraph 3 set forth that the credit

> “(…) shall include the Chinese tax paid by that first-mentioned company [the company resident in China] in respect of that portion of its profits out of which the dividend is paid.”

In conjunction with subparagraph 5, it has to be determined which tax “(…) would have been payable as Chinese tax on income (…)” in the absence of the tax incentive granted to the Chinese company on the portion of the company profit paid as dividends. The computation is most aptly illustrated by an example. The first assumption is that the Chinese company has a profit of 100 and is fully owned by an Australian company and moreover that a dividend of 50 is paid to the Australian parent. The second assumption is that the Chinese company is benefiting from a tax holiday, involving a full exemption from tax on all corporate profits, which would otherwise be taxed by 20 percent. Here, the portion of the profit paid as dividends is 50 percent of the overall profit. The overall profit would be taxed by 20 percent, involving a tax payable of 20 in the absence of the tax holiday. The tax that would be imposed on the portion of the profit paid as dividends is thus 10. Accordingly, the notional tax of 10 is granted as a credit in Australia.

As discussed under section 7.3.2.3, this credit will be provided in addition to any credit for tax paid or notional tax paid on dividends as such.

### 9.2.4 Subsequent amendment of the ordinary tax level

Provisions that compute the credit based on the ordinary level of tax generally do not impose any limitation on the State of source to subsequently amend its general tax legislation and tax level. Thus, the host State may subsequently increase the overall level of tax and thereby increase the credit for tax foregone. This mechanism raises the concern of "*Potential government abuse of tax sparing*".[230] Apparently, this is not entirely impractical as it has occurred that States have subsequently increased the general tax rates for investors that benefit from tax sparing provisions in order to increase the credit.[231]

As noted when addressing the credit method under section 4.4.2.2, the ordinary credit method, which is the more common approach, generally applies in the case of tax sparing. This constitutes a limitation as to the extent the credit could be increased by increasing the general tax burden. However, if the level of tax in the State of residence initially is significantly higher than in the State of source, this limitation is hardly apt. In the case of full credit, there is no limitation.

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[230] OECD, *Tax Sparing: A reconsideration* (1998) p. 29.

[231] OECD, *Tax Sparing: A reconsideration* (1998) p. 29-30.

Dividends, interest and royalties are usually subject to tax sharing. As concluded under section 7.6.3.1, the tax sharing rates effectively limit the credit for notional tax because the tax payable in the absence of the tax incentive is limited by the tax sharing rates. Thus, in respect to dividends, interest and royalties, the State of source is inhibited from inappropriately increasing the credit by increasing the ordinary level of tax. In any case, if the ordinary level of tax in the State of source was initially lower than the tax sharing rate and subsequently increased to the tax sharing rate, this could hardly be considered inappropriate as the State of source, under the treaty, is in any case allocated to right to impose tax up to the fixed rate.

The issue of so-called government abuse is accordingly limited to the case of indirect tax sparing and business profits attributable to a permanent establishment. An approach to prevent this type of abuse is to stipulate a fixed limitation on the credit for tax foregone,[232] which will be discussed in the following section.

#### 9.2.4.1 Fixed limitation on the credit for tax foregone

An approach inhibiting the State of source from increasing the credit for tax foregone, by increasing the ordinary level of tax, is to stipulate a maximum ordinary tax in the tax sparing provision. An example of this is article 23(4) of the Australia and Vietnam treaty of 1992, with the amendment of 1996:

> “In paragraph 3, the term “Vietnamese tax forgone” means, subject to 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.”

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[232] OECD, *Tax Sparing: A reconsideration* (1998) p. 32.

In the parenthesis it is set forth that, for the purposes of tax sparing, the amount of tax foregone, i.e. the ordinary tax, shall not exceed 20 percent of the income that qualifies for the relevant tax incentives. For example, if the ordinary tax on qualifying income of 100 is in fact 25 percent and the tax incentive consists of full relief from corporate income tax, a credit of 20 is provided instead of a credit of 25, which would be the result had the credit been computed based on the actual tax foregone. If less than 20 percent tax is foregone, the credit is equal to that lesser amount.

Adding this limitation to the tax sparing provision seemingly excludes the possibility of host State abuse by means of increasing the general level of tax. However, in light of the general justification of tax sparing it may induce problematic results, depending on the maximum rate set. For example, as part of general tax reform, there may be valid reasons the increase the level of tax. If the fixed rate is lower than the new rate, the intermediate part of the tax foregone would not accrue to the foreign investor.

### 9.2.5 Administrative issues

An important perspective is that the hypothetical tax payable is determined by the tax authorities of the State of residence. Depending on the incentive measure, this may create significant practical difficulties as it presupposes the application of foreign domestic law.[233] On one hand, it may be relatively unproblematic to determine the tax foregone in the case of a general CIT rate reduction or in the case of withholding tax relief. Here, the computation merely consists of applying the ordinary rates to the corporate income or the outbound payment. On the other hand, computing the credit for notional tax in the case of incentives that reduce the net profit subject to tax, such as accelerated depreciation, is typically much more complex.[234] Apparently, these practical difficulties have induced that tax incentive measures that are particularly difficult to compute are not covered by provisions that dep-

[233] OECD, *Tax Sparing: A reconsideration* (1998) p. 30.

[234] Viherkenttä (1991) p. 154.

loy the approach of computing the notional tax based on the tax foregone.[235] This is obviously unfortunate, as it may compromise the development objective by possibly excluding the most effective tax incentive measures of a developing country. However, it is highly uncertain to what extent this practical issue have such implications.

A practical solution to the problem of the State of residence computing the ordinary tax in the State of source is for the State of source to provide information on the tax foregone, especially the hypothetical tax payable.[236] Article 26(1) of the OECD MTT prescribes that the

> "(…) Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention (…)"

The question is whether this includes the computation of tax payable in the absence of the tax incentive measure. For example, under the UK and Ghana treaty, provided the application of the OECD MTT article 26(1) provision, the question is whether the UK may require that Ghana provide information stating the "(…) amount which would have been payable as Ghana tax for any year (…)". In the affirmative case it would not only involve exchange of mere facts, but also a legal assessment. The wording of article 26(1) is not entirely clear as to the distinction between information and carrying out the provision. The latter of which, consisting of computing the credit, is the responsibility of the State of residence as it is obligated to provide the credit. The OECD Commentary prescribes as an example that a State may request information whether a resident of a contracting State is a "beneficial owner" in respect to article 12.[237] This could involve a legal assessment by the State not obligated to carry out the provision. Hence, the provision is not restricted to mere facts, suggesting that information regarding the host State tax otherwise payable may be re-

[235] *Tax Law Design and Drafting* (2000) p. 1013-1014.

[236] Viherkenttä (1991) p. 154.

[237] OECD Commentaries C(26)-3 paragraph 7b.

quested. This is also supported by the objective of the provision, which is to ensure correct taxation,[238] something that may be very difficult to achieve if the home State tax administration has to apply foreign domestic law, perhaps in a language that is practically unavailable. Hence, the general conclusion is that the State of residence may request a computation of the tax payable in the absence of the qualifying tax incentives. Of course, it is still the State of residence that make both the factual and legal assessment, and that State is thus not in any way bound by the information provided by the State of source.

## 9.3 Fixed notional tax

### 9.3.1 General

Computing the credit for a fixed notional tax is significantly less complicated than computing the credit based on the tax actually foregone as it is not necessary to establish a hypothetical tax payable. Nonetheless, this method is not as prevalent.[239] This approach is usually only deployed for dividends, interest and royalties and generally does not include indirect tax sparing or business profits attributable to permanent establishments.[240] The only example found of the opposite is article 23(4)a of the Italy and Vietnam treaty of 1996, which sets forth a fixed notional tax of 32,5 percent for business profits attributed to permanent establishments.

For dividends, interest and royalties, the credit constitutes a fixed portion of the *gross amount paid*. For example, if the interest paid is 100 and the fixed rate is 15 percent, then the credit in the State of residence is 15. An example of this approach is article 23(c) of the Germany and India treaty of 1995. It sets forth that

[238] Naas (2011) p. 1253.

[239] *Tax Law Design and Drafting* (2000) p. 1014.

[240] Viherkenttä (1991) p. 154.

> "For the purposes of credit referred to in letter (*ii*) of sub-paragraph (*b*), the Indian tax shall be deemed to be 10 per cent of the gross amount of interest, if the Indian tax is reduced to a lower rate or totally waived according to domestic law, irrespective of the amount of tax actually paid."

In this case, the computation of the notional tax is straightforward. If the interest paid is 100 and is subject to no withholding tax, a credit of 10 is provided in Germany. The *in fine* of the provision reflects a general feature of this computation approach, namely that the fixed credit is provided regardless of the tax paid. As mentioned under section 3.5, when discussing the difference between tax sparing credit and matching credit, this approach entails that the computation of the credit is not influence by the ordinary level of tax.

### 9.3.2 Credit at a fixed rate limited by the tax foregone

Although it compromises the principal aspect of the fixed credit providing discretion for the host State, a modification of the fixed notional tax is that a credit for notional tax is provided pursuant to a fixed rate only if the ordinary level of tax in the State of source is higher than, or the same as, the fixed rate. If it is lower than the fixed rate, the credit for notional tax is computed on basis of the lower rate. An example of this approach is article 23(4) of the Netherlands and Bangladesh treaty of 1993:

> "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 articles referred to in the provision set forth a tax sharing rate of 10 percent on both interest and royalties. If the “general tax rate”, in the host State, on these items of income exceeds or is 10 percent, a credit equal 10 percent of the gross amount is granted in the State of residence regardless of tax actually paid. However, if the general tax rate is lower, for example 8 percent, a credit equal to 8 percent is granted even though less or no tax is actually paid.

To the extent that the fixed credit is provided, the provision raises the same issues as fixed notional tax in general. In addition, to determine whether the fixed rate is applicable, and to determine the credit in the case that the fixed rate is inapplicable, it has to be determined what the “general tax rate” on that income is. The same standard, i.e. the same wording, is used in article 25(2)d of the France and India treaty of 1994, which deploys the same computation approach. Although this approach is more consistent with the general justification of tax sparing, which implies that a credit for notional tax does not have to be provided in excess of the tax actually foregone, it reduces the practical benefit of computing the credit pursuant to a fixed rate as it also requires computation of the tax foregone. However, as mentioned in section 9.2.5, this is not very complicated in the case of withholding tax relief.

## 9.4 Observations

The primary observation is that there is significant variance as to how the credit for notional tax is computed. Focusing on the primary computation approaches, the computation based on tax foregone aligns more consistently with the general justification of tax sparing, but could be difficult to administer. As to the computation based on a fixed notional tax, it is seemingly much easier to administer, but inaccurate in respect to tax actually foregone, potentially not enabling the full tax benefit to accrue to the investor or entailing that a credit is granted that exceeds the ordinary level of tax in the State of source. However, as addressed in sections 7.6.3.2 and 7.6.3.3, this could also be intended.

Moreover, it appears that the computation based on a fixed rate is commonly limited to the case where the items of income covered are dividends, interest or royalties. Conversely, it appears that the computation based on tax foregone is deployed if indirect tax sparing is provided or where the provision covers income attributed to a permanent establishment.

Finally, the distinction between the two approaches becomes very fluent where the fixed notional tax is limited by tax foregone and where the tax foregone is limited by a fixed rate.

# 10 Time limitations

## 10.1 Introduction

A fairly common feature of tax sparing provisions is that they are time limited.[241] This mechanism involves that tax sparing is only available for a certain period of time. As for time limitations in general, the basic questions is the commencement and the duration. This section will analyze and comment on different approaches to time limitations and moreover the case of no time limitation. Seemingly, the latter alternative has become increasingly uncommon.[242]

## 10.2 The rationale of time limitations

The rationale of stipulating a temporal scope for tax sparing provisions is connected to tax incentives often being time limited:

> "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 (…)".[243]

The rationale is only valid if the tax incentive measures are directed at new operations. Time limited tax incentive measures, such as tax holidays, generally have this purpose. However, many tax incentive measures, such as relief from withholding tax on interest,

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[241] OECD, *Tax Sparing: A reconsideration* (1998) p. 33.

[242] Brooks (2009) paragraph IV, F.

[243] OECD, *Tax Sparing: A reconsideration* (1998) p. 38.

investment tax credits and investment allowances, are not only provided to attract new operations but also to incentivize expansion of existing operations. Moreover, such incentives are generally considered more effective for development purposes.[244] Hence, the asserted rationale has limited validity in light of the general development objective of tax sparing and tax incentives. Moreover, that time limitations is a best practice recommendation from the OECD is somewhat surprising as one of the asserted faults of tax sparing is that it promotes excessive repatriation of profits and not expansion of existing investments.[245] Presumably, making tax sparing available for a certain period only increases the severity of this "fault".[246] However, the validity of this criticism depends on the duration of tax sparing. Moreover, many provisions provide the possibility of prolongation of the availability of tax sparing. Another factor that is relevant in this respect is the development level and needs of the host country. These factors presumably influence the time needed to achieve the intended development results.

A time limitation effectively limits the risk exposure for adversities that may be induced by tax sparing, such as potential tax treaty abuse[247] and the encouragement of harmful tax competition. Whether this is an expressly stated reason to stipulate time limitations is unclear. As to the former risk factor, this significantly relies on other elements of the tax sparing provision, such as items of income, tax incentive measures and activities covered. Also, some provisions include specific anti-abuse clauses, as will be addressed in section 11.3. The latter issue, however, is primarily induced by the basic mechanism of tax sparing and is therefore difficult to prevent by other means than limiting the availability of tax sparing. However, to the only effect of preventing harmful tax competition, it is most effective not to provide tax sparing at all. Hence, the issue of harmful tax competition appears more re-

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[244] *Tax Law Design and Drafting* (2000) p. 1014.

[245] OECD, *Tax Sparing: A reconsideration* (1998) p. 22-23.

[246] This view is also held by Brooks (2009) paragraph IV, F.

[247] Viherkenttä (1991) p. 153.

levant as an argument in the overarching discussion whether to adopt tax sparing provisions or not, which is not the topic of the thesis.

An important perspective when discussing time limitations is that the state of source may unilaterally render the tax sparing benefit ineffective by repealing its tax incentive measures.[248] The State of residence, on the other hand, does not have this opportunity as it is obligated to provide a credit as set forth in the treaty.

## 10.3 Fixed commencement

### 10.3.1 General

Static time commencement denotes the case where the availability of tax sparing commences at a fixed point in time and endures for a fixed period of time. This is often referred to as a sunset clause.[249] An example is article 25(5), second paragraph, of the Norway and Kenya treaty of 1972, where it is stated that

> "The provisions of this paragraph shall apply for the first ten 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."

Here, the commencement of the tax sparing provisions is connected to the time when the tax treaty is effective. From that time, the tax sparing provision is effective for ten years.

The question could be raised whether it is generally appropriate to connect the commencement of tax sparing to the time when the tax treaty is in force. Depending on other features of the tax sparing provision, it is feasible that this approach could severely distort investor behavior and thus be inexpedient in respect to the general development objective. For ex-

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[248] Brooks (2009) paragraph IV, F.

[249] OECD, *Tax Sparing: A reconsideration* (1998) p. 38.

ample, if the tax sparing provision includes a CIT rate reduction available for investors within the field of industry and manufacturing, investments made at the beginning of the period may be of a significantly different character than investments made towards the end of the period. In the first case, the benefit of tax sparing may be accrued by investment projects that use more time to start generating profits, typically long term projects that require workforce training and substantial initial investments in production factors. If such investments are made towards the end of the tax sparing period, it could be unlikely that tax sparing will provide a benefit, as it is unlikely that profits are earned before tax sparing ceases to be available. The type of investment that may typically benefit towards the end of the tax sparing period is shorter term investments that generate quick profits, for example construction projects. Hence, it could be the case that by stipulating a fixed duration, the inducement of tax sparing changes from beginning to end. Thus, it could be the case that for certain types of investments, the tax sparing provision is effective for a significantly shorter period than it could appear.

In light of what was just addressed, another weakness of this approach may be derived from the fact that tax incentives are usually secondary determinants for investment. When the tax sparing provision commences to have effect at a seemingly arbitrary point in time, it appears somewhat coincidental whether the commencement coincides with the occurrence of the primary factors relevant to the investment decision. For example, the tax sparing provision may cover production of aluminum and commence at a time when prices for raw materials and energy are high.

### 10.3.2 Duration

As to the duration, there is some variance, although ten years appears to be a frequently adopted duration. Examples of shorter and longer durations are also found, for example the Canada and Mongolia treaty of 2002 where the last sentence of article 23(3) sets forth a duration of three years. As illustrated by the foregoing example, the duration is an important factor for the effect of the tax sparing provision. The appropriate duration is subject to conditions that are specific in the bilateral relation, such as the development needs of the developing country and the nature of the potential investment contribution from the industrialized country. Overall, the fixed duration should be based on the purpose of the provision.[250] Thus, account should be taken to the changing effect of the tax sparing provision.

### 10.3.3 The possibility of prolongation

Provisions that stipulate a fixed commencement and duration often provide for the possibility of prolongation. An example is the Norway and Kenya provision cited above, where it is stated that the competent authorities may determine to extend the fixed period. This provision merely prescribes a simplified process to agree on prolongation of tax sparing. Prolongation is subject to mutual agreement. Hence, the actual availability of prolongation depends on the specific bilateral relation.

## 10.4 Conditional commencement

### 10.4.1 General

The characteristic feature of conditioned commencement is that tax sparing becomes available and the time limitation commences upon the occurrence of a stipulated event, such as when the investor first benefit from a tax concession covered by the tax sparing provision. From that time, the availability of tax sparing endures for a fixed period. An example is article 22(3), second paragraph, of the Canada and Thailand treaty of 1984. It states that

> "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."

Here, the time limitation commences in the tax period when source income benefiting from a tax incentive is generated. This implies that the time limitation of the tax sparing provision first commence when the enterprise generate profits. Thus, in this case, the circums-

[250] OECD, *Tax Sparing: A reconsideration* (1998) p. 38.

tances under the fixed commencement approach that may induce inefficiency and distortions are not present. Thus, in this respect conditional commencement appears more expedient. Tax sparing is available to investors to the same extent regardless of when the investment is made. For this reason, the duration should also be set under different considerations. For example, account does not have to be taken to the changing effect of the tax sparing provision. However, general issues, such as the inducement of excessive repatriation, are not avoided.

### 10.4.2 Schemes to extend the duration of tax sparing

A concern associated with the conditioned commencement approach is the risk of abuse. Especially, it could induce that upon the end of the tax sparing period for one tax entity, the activities are shifted to another tax entity consequently commencing a new tax sparing period.

To prevent such schemes it is suggested that the time limitation should not only apply to an investor benefiting from tax sparing but also to associated enterprises.[251] The potential of this approach could be reflected in the standard of associated enterprises in OECD MTT article 9(1) a and b. Applying this standard, enterprises connected to the enterprise initially benefiting from tax sparing would be precluded from benefiting from tax sparing. The relevant connection could consist of two enterprises being controlled by a third enterprise or one of the two enterprises controlling the other. Whether there is a sufficient connection is determined on basis of domestic law.[252]

A problem with this approach is that there may be legitimate reasons for an associated enterprise to invest and start business operations at a subsequent time, in which case tax sparing should also be provided for this enterprise. For example, in the case that a host State subsidiary produces and exports clothing, the home State investor may find it appropriate

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[251] OECD, *Tax Sparing: A reconsideration* (1998) p. 38.

[252] Vogel (1997) p. 525.

to establish a second subsidiary to sell the clothing in the domestic market. The reason for this corporate structure could be that the undertaking involves economic risks that it would not be expedient to expose the first subsidiary to. Inhibiting these types of arrangements could also contrary to the general purpose of development as establishing corporate chains are considered to be beneficial.[253]

### 10.5 Absence of time limitations

If no time limitation is set, the tax sparing provision is effective as long as the treaty is in force. An example of this is the Norway and Côte d'Ivoire treaty of 1978. The obvious benefit of this approach is that it creates little inducement to excessively repatriate profits.

However, a problem with this approach is that the developing country may excel to a level of development that no longer justifies the granting of tax sparing. In which case, for the home State, tax sparing is merely an unnecessary deviation from the consideration of capital export neutrality.

### 10.6 Termination on notice

As an alternative to the presented approaches, it has been suggested that tax sparing provisions could be drafted with an indefinite duration and a termination on notice clause that may be invoked by the State of residence after a certain period of time.[254] The only example found of this approach is paragraph 3 of the first protocol to the New Zealand and Malaysia treaty of 1976, which sets forth that article 20(3), i.e. the tax sparing provision, may be terminated on the following conditions:

> "On or before 30 June in any calendar year after the year 1977 the Government of New Zealand may give to the Government of Malaysia written notice to the effect that the provisions of paragraph (3) of Article 20 shall cease to have force or effect

[253] UNCTAD (2012) p. 121.

[254] Brooks (2009) paragraph IV, F.

> and, in that event, the provisions of those paragraphs shall cease to have any force or effect in New Zealand in respect of income derived during any income year beginning on or after 1 April in the calendar year immediately following that in which the notice is given."

The benefit of this approach is that it is much easier to assess in current time or retrospectively when the intended development objective has been reached and consequently when the provision should be terminated, rather than basing the duration on a prospect of the future. However, it is feasible that from the perspective of potential investors, this could be perceived as lacking predictability, especially for long term investment projects. To subdue this problem, it could be stipulated that the tax sparing provision is terminated a certain number of years after notice is given.[255] In respect to this consideration, the notice period under the cited provision could appear to be somewhat short.

# 11 Anti-abuse measures

## 11.1 Introduction

The basic normative characteristics of abuse of tax sparing provisions were addressed under section 3.8. Moreover, specific abuse issues and the possible prevention of such abuse, has been addressed in context of the various preceding subtopics. This section will focus more generally on the prevention of abuse of tax sparing provisions. As to anti-abuse measures, general anti-abuse measures will only be shortly addressed. Rather, the primary focus will be on anti-abuse measures that are specially designed to deal with abuse of tax sparing provisions.

[255] Brooks (2009) paragraph IV, F.

## 11.2 General anti-abuse measures

### 11.2.1 General anti-abuse rule in tax treaties

A debated topic is whether a general anti-abuse rule, based on the general perception of tax treaty abuse,[256] applies in tax treaties, without being explicitly set forth in the treaty. In the case of tax sparing, the substance of such a rule is that credit for notional tax is denied where an arrangement is entered into with the main purpose of obtaining the credit for notional tax and the arrangement is contrary to the intended investment behavior set forth by the contracting States. This is the same as the normative characteristic of tax sparing abuse set forth in section 3.8, which is based on the same general perception of tax treaty abuse. Seemingly, the more prevalent opinion is that treaty benefits may be denied in such cases. However, there is some disagreement as to the legal basis for this position. One view is that this result may only be reached by mode of interpretation of the specific treaty provisions.[257] Another view is that there is a more general basis, based on the object and purpose of tax treaties and the requirement of good faith,[258] or that it is a "general principle(…) of law recognized by civilized nations",[259] because of the international prevalence of the substance over form doctrine in domestic law.[260]

In its very general substance, this general approach to tax treaty abuse may be used in the case of abuse of tax sparing provisions. However, the legal basis may influence the threshold of abuse and the precise stipulation of the rule on a case to case basis, making the precise substance of such a rule uncertain.

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[256] OECD Commentaries C(1)-21 paragraph 9.5 and Weeghel (1998) p. 96.

[257] Lang (2010) p. 63 and Skaar (2006) p. 897.

[258] OECD Commentaries C(1)-20-21 paragraph 9.3.

[259] Article 38(1)c of the Statute of the International Court of Justice.

[260] Vogel (1997) p. 125.

### 11.2.2 Domestic anti-avoidance rules

It is generally uncertain whether domestic anti-avoidance rules, based on the substance over form doctrine, may be used to deny treaty benefits.[261] As this is a general and very comprehensive issue, it will not be addressed. However, it is clear that domestic anti-avoidance rules may be applied in general, or specifically in the case of tax sparing abuse, if this is specifically set forth in the treaty. In the case that a treaty has a tax sparing provision, one of the options generally recommended is to stipulate in the treaty that domestic anti-avoidance rules are applicable to deny a credit for notional tax.[262]

## 11.3 Specialized anti-abuse measures

### 11.3.1 General

Although it does not appear to be very widespread, some tax sparing provisions have integrated and specialized anti-abuse provisions. Moreover, the adoption of such measures on tax treaty level is recommended as a best practice.[263] In any case, although general anti-abuse and anti-avoidance rules which will be addressed under section 11.3 could be applicable in cases of abuse of tax sparing provisions, separate and specialized anti-abuse provisions could be appropriate to target specific abuse schemes.[264]

### 11.3.2 Specialized anti abuse rule

A specialized anti-abuse rule is exhibited in article 23(7)(c) of the Australia and Vietnam treaty of 1992:

> "(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 avoid Aus-

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[261] For various opinions, see for example Vogel (1997) p. 120-122, Lang (2010) p. 59-60, Skaar (2006) p. 891-895 and OECD Commentaries C(1)-32 paragraph 22.1.

[262] OECD, *Tax Sparing: A reconsideration* (1998) p. 37.

[263] OECD, *Tax Sparing: A reconsideration* (1998) p. 37.

[264] OECD Commentaries C(1)-21 paragraph 9.6.

> tralian 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."

According to article 23(7), this provision only applies in respect to article 23(4), which is the general tax sparing provision. This provision exhibits two distinct concepts. One is similar to the general principle of tax treaty abuse, and the second resembles the so-called *look-through* approach, as it denies treaty benefits where it would accrue to a third State resident.[265]

#### 11.3.2.1 The general anti-abuse reservation

The general rule resembles the general principle of tax treaty abuse set forth in section 3.8, in that it requires that the scheme is entered into to "(…) avoid Australian tax through the exploitation of the Australian foreign tax credit provisions (…)". Tax is avoided by being granted a credit for notional tax. Thus, the question is what constitutes "exploitation". In its context, the wording implies that a benefit is derived by using the provision contrary to its purpose. Hence, it reflects the general characteristic of tax sparing abuse set forth in section 3.8.3, that it is an arrangement contrary to the intended investment behavior reflected in the tax sparing provision. The advantage of this approach is that it has a very broad scope. However, it relies on the main purpose test, formulated as "(…) in order to avoid (…)", which could render it ineffective if the policy objective is to inhibit that a credit for notional tax is derived from a specific arrangement as such.

#### 11.3.2.2 The look through approach

The latter alternative set forth in the provision denies a credit for notional tax if the benefit is obtained by a third State resident. This effectively prevents that the benefit of tax sparing may be obtained by a third State resident by establishing a conduit company in the State of

[265] OECD Commentaries C(1)-23 paragraph 13.

residence.[266] The condition, "(…) confer a benefit (…)", is somewhat vague. Seemingly it would be sufficient if any benefit, e.g. any additional amount, derived from the credit for notional tax is obtained by a third State resident. This could appear overly strict, for example in the case that tax sparing allows for the investor to make a somewhat larger equity investment in a third State company. This is presumably the reason why look through provisions generally stipulate as an additional condition that the third State resident have qualified control of the company deriving the benefit.[267]

The general anti-abuse reservation has a very broad scope and could potentially overlap the look through approach. However, under the look through approach, the main purpose test is not relevant. Accordingly, it is very effective to deny treaty benefits in the specific case that the benefit would accrue to a third State resident. Seemingly, this is the separate significance of adopting this approach in addition to the general anti-abuse rule.

### 11.3.3 Discretionary denial of credit for notional tax

A very comprehensive approach to preventing tax sparing abuse is reflected in the identical anti-abuse provisions adopted in article 1 of the 1994 protocol to the tax treaty between New Zealand and Malaysia of 1976 and article 21(5) of the New Zealand and Singapore treaty of 2009. The latter of which is cited here. The provision set forth that a resident of New Zealand shall not be granted a credit for notional tax if

> "(…) 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 prearrangements have been entered into by any person for the purpose of taking advantage of paragraph 3 for the benefit of that person or any other person:

[266] For an example of such a scheme, see OECD, *Tax Sparing: A reconsideration* (1998) p. 72-73.

[267] OECD Commentaries C(1)-23 paragraph 13.

(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 for the New Zealand resident concerned."

#### 11.3.3.1 Restriction on the exercise of discretion

Subject to the first sentence of subparagraph 5, the general condition to deny a credit for notional tax is that it would be "inappropriate". However, what is inappropriate is what the State of residence "considers" to be inappropriate, which implies that the opinion of the State of residence is decisive. As the substance of the general criteria is inherently vague and moreover is defined by what the State of residence "considers", it seemingly does not have a separate significance as a condition to deny a credit for notional tax. Thus, it could appear that the decision is subject to the free discretion of the State of residence.

The alternatives listed in a-d are to be taken "regard to" when assessing whether something is inappropriate. This implies that the mentioned circumstances are to be taken into consideration. However, in context of the State of residence ultimately considering whether something is inappropriate, the list cannot be deemed exhaustive, implying that a credit for notional tax may also be denied on other grounds.

The general requirement derived from article 31(1) of the Vienna Convention that the treaty is to be interpreted so that it is rendered "effective and useful"[268] may be a limitation to

[268] Cassese (2005) p. 179.

what the state of residence may consider inappropriate. For example, the State of residence is probably not permitted to deny a credit for notional tax if the investment behavior is consistent with the intended investment behavior, as reflected by the tax sparing provision, on grounds that are completely unrelated to the circumstances that are to be taken regard to, such as the administrative burden of processing the credit claim.

#### 11.3.3.2 The scope of application

In respect to potential abuse schemes, the comprehensive discretion of the State of residence entails that there is seemingly no limitation as to which abusive schemes are covered as long as they may be prevented by denying the credit for notional tax.

#### 11.3.3.3 Procedural rule

Presumably to counterbalance the comprehensive discretion of the State of residence, a procedural rule is stipulated that a credit for notional tax may only be denied after "(…) consultation with the competent authority (…)" of the State of source. This appears appropriate as it could prevent that the State of source continue to grant tax incentive in a case where tax sparing is not granted, implying that the incentive would accrue to the revenue of the State of residence rather than the investor. Moreover, it is very feasible that a scheme considered abusive in respect to the tax sparing provision is also considered abusive in respect to the tax incentive measure. Therefore, in this respect, the consultation may also contribute to uncover abusive schemes in the State of source.

## 11.4 Concluding remarks

The application of general anti-abuse rules is in general, and thus also in the case of tax sparing abuse, uncertain. Hence, it appears appropriate, to ensure a general safeguard against abuse of tax sparing provisions, that a measure is implemented so that it may be applied effectively. In respect to which type of measure is more appropriate, it is difficult to draw a general conclusion. Whether domestic anti-avoidance rules are sufficient will generally depend on what the specific substance of the rules is. In respect to specialized anti-abuse measures on treaty level, it is presumably easier to have an industrialized country agree on tax sparing if credit for notional tax may be denied on a discretional basis. However, this entails significant predictability issues from the perspective of the investor, potentially compromising the efficiency of tax sparing. Conclusively, it could appear that the specialized anti-abuse rule is the more appropriate approach. It is based on the general perception of tax treaty abuse and the look through approach, which in substance are effective to prevent abusive schemes, but also provide an apt level of predictability.

# 12 Final remarks

The objective of this thesis was to provide a comprehensive analysis of the concept of tax sparing by analyzing tax sparing on a more general level and analyzing and commenting various features that are embodied in the general concept. With this objective as a starting point, it is difficult to draw a general conclusion. The analysis and comments have been undertaken continuously in the separate sections of the two main parts. To summarize all the findings here would be a mere repetition of what is already said.

The primary observation is that although the concept of tax sparing has the invariable core feature of providing a credit for tax not actually paid, it is highly diverse with respect to its other features. As has been shown in the preceding analysis, the variable features, such as items of income covered, computation methods and references to domestic law, have a major impact on the operation of tax sparing. Also considering that many of the features may be combined, the potential diversity of tax sparing provisions becomes increasingly vast. For these reasons, it appears that the nuances are highly significant in order to establish a proper perception of what tax sparing is as a legal concept. Hopefully, this thesis could serve as a contribution in this respect.

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