Na Li

The Tax Sparing Mechanism and Foreign Direct Investment

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The Tax Sparing Mechanism and Foreign Direct Investment

Why this book?

This book reviews the rationale for the tax sparing mechanism and analyses its effects within a framework of foreign direct investment (FDI) from China into EU Member States. The author argues that the tax sparing mechanism should not be regarded as a foreign-aid tool used by developed countries to help developing countries; it is, rather, a technique that should be used by both residence state and source state to achieve their different objectives in respect of FDI.

Tax sparing is a mechanism usually reflected in tax treaty provisions, whereby one state commits to crediting the taxes spared (i.e. not actually paid) in another. The spared taxes are the common link between the tax sparing mechanism and FDI, so the book focuses on them throughout, examining the following questions: Which state sacrifices its tax revenue to generate the spared taxes? Who benefits from the spared taxes? Why would contracting states agree to include tax sparing in their tax treaties? And how does the tax sparing mechanism preserve the effect of the spared taxes? The answers lead to the author's findings: First, the residence state is not alone in sacrificing tax revenue, as the source state also forgoes tax revenue to generate the spared taxes. Furthermore, the residence state can benefit from the tax sparing mechanism, given that the spared taxes preserved by the mechanism can enhance the competitiveness of its residents in overseas markets and can reduce the distortional effects on its residents' decisions regarding the repatriation of profits. Second, the tax sparing mechanism is a treaty technique, with both positive and negative effects. The necessity of adopting the tax sparing mechanism is rooted in the inadequacy of the residence state's foreign credit method, which nullifies the effectiveness of spared taxes for foreign direct investors. The tax sparing mechanism can resolve this inadequacy by obliging the residence state to credit the spared taxes as if they had been duly paid in the source state. Finally, as a policy suggestion, both residence state and source state should use the tax sparing mechanism in their tax treaties.

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Preface

The doctoral thesis on which this book is based was written during my time as a research associate and PhD candidate at the Institute for Austrian and International Tax Law at WU Vienna, from September 2012 to June 2015.

The thesis topic – the tax sparing mechanism and foreign direct investment – first came to mind in 2008, when I entered an LLM in taxation programme at Boston University. I was puzzled by the fact that China's 20-year tax incentives might not have effectively benefited US investors due to the fact that, in the absence of a tax sparing mechanism between China and the United States, US investors were required by US law to pay all their spared Chinese taxes to the US government. My patriotic devotion to China motivated me to take a deeper look into this puzzle.

My supervisor, Prof. Dr Dr h.c. Michael Lang, gave me the opportunity to study this topic when, in 2012, he admitted me to the Doctoral Program in International Business Taxation (DIBT) at the Institute for Austrian and International Tax Law, where I received high-quality interdisciplinary training. Prof. Lang also supported my participation in numerous international conferences, encouraged me to publish, gave me valuable advice and guided me through the several phases of writing my thesis and growing into my academic life. I owe him a debt of gratitude for all he has done for me.

My thanks also go to Prof. Dr Andreas Wagener and Prof. Dr Luís Eduardo Schoueri, my second and third supervisors, respectively. Their valuable comments and suggestions helped me to make significant improvements in the quality of the thesis.

In addition, I have been helped by many professors and colleagues from both inside and outside of the Institute. Univ.-Prof. Mag. Dr Eva Eberhartinger, Prof. MMag. Dr Josef Schuch, Prof. Dr Claus Staringer and Univ.-Prof. Dr Martin Zagler agreed to sit on the committee for my *defensio* in the very early morning of 9 June 2015, and Prof. Dr Pasquale Pistone brought me to numerous workshops and roundtables, where I received comments from academics from all over the world. My colleagues from the DIBT and from the Institute also helped me a great deal through sharing their collections of scholarly literature and discussing with me many issues surrounding this topic from multiple angles. I am grateful to all of them.

Finally, I would like to thank my family – my parents and my husband – for their support. I dedicate this book to my father, who was unable to finish

high school due to China's Cultural Revolution in the 1960s and 70s, but who always encouraged me never to stop learning and, more importantly, to smile whenever facing any challenge.

Na Li
Vienna, May 2015

Sample Content

Introduction

1.1. Research topic

The research topic of this book is the relationship between the tax sparing mechanism and foreign direct investment (FDI). This research is conducted through an analysis of the effect of the tax sparing mechanism on FDI from China to European Union Member States.

1.2. Research scope

Tax sparing is a mechanism usually reflected in tax treaty provisions whereby one state commits to crediting the taxes spared (i.e. not actually paid) in another. FDI refers to cross-border investment made by an investor from one state to establish interest in an enterprise resident in another state.

Tax sparing and FDI seem to be terms coming from two different fields, but these two terms are in fact bound by an important common link: the spared taxes. When the contracting states provide taxpayers with means of sparing certain taxes through providing tax incentives or as a result of implementing the tax treaty between them, these spared taxes can reduce the global tax burden of foreign direct investors and consequently could be a factor influencing those investors' location decisions. While one function of a tax sparing mechanism is to preserve such spared taxes for the benefit of foreign direct investors, tax sparing mechanisms in this sense might also be able to contribute to influencing foreign direct investors' location decisions.

This book differs from previous studies of tax sparing mechanisms and FDI. Previous studies have mainly been conducted under an investment setting of FDI from developed countries into developing countries, because developing countries were usually capital-importing states allowing taxpayers to spare taxes in order to attract FDI from developed countries[1] (which

1. Defining developed countries and developing countries is a difficult task, because there are no universally agreed criteria for what makes a country developing as opposed to developed and, in addition, the categories change frequently with the continuing development of various countries. In order to clearly address the rationale for the tax sparing

were usually capital-exporting states). This particular investment setting determined that the majority finding in previous studies was that tax sparing is a foreign-aid tool used by developed countries to aid developing countries through committing to crediting the taxes spared in those developing countries.[2]

In contrast, the research in this book is conducted under an investment setting of FDI from China[3] to EU Member States,[4] which represents a new global trend of FDI flows from developing countries to developed countries.[5] Thus, when developed countries are, from a tax treaty perspective, in the position of source state, they also tend to grant taxpayers opportunities for sparing taxes for the purpose of attracting FDI. Therefore, this new investment setting provides us with a different angle that allows us to reconsider whether the tax sparing mechanism is a foreign-aid tool and whether this mechanism may be used to attract FDI from China to EU Member States.

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mechanism in this book, and especially in the context of discussing the primary issue of whether the tax sparing mechanism is still an instrument used by developed countries to aid developing countries (i.e. is a foreign-aid tool), the author has had to take the simplified approach of classifying all OECD member countries and all EU Member States as developed countries, while non-OECD member countries and non-EU Member States are classified by the author as developing countries. The author is aware that there are non-OECD member countries and non-EU Member States that are in fact more industrialized than some OECD member countries and/or EU Member States. The author's classification is intended only for the purpose of writing this book.

2. The studies that found the tax sparing mechanism is a foreign-aid tool include, but are not limited to, Surrey, *The Pakistan Tax Treaty and "Tax Sparing"*, 11 National Tax Journal (pre-1986) 2 (1958); ABI/INFORM Global, p. 156; Crockett, *"Tax Sparing": A Legend Finally Reaches Print*, 11 National Tax Journal (pre-1986) 2 (1958); ABI/INFORM Global, p. 146; Martin, *Treaty Tax-Sparing Credits*, 27 Tax Management International Journal 9 (1998); Laurey, *Re-Examining US Tax Sparing Policy with Development Countries: The Merits of Falling in Line with International Norms*, 20 Virginia Tax Review 467 (2000-2001); Toaze, *Tax Sparing: Good Intentions, Unintended Results*, 49 Canadian Tax Journal/Revue Fiscale Canadienne 4, p. 887 (2001); and Brooks, *Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice?*, 34 Queen's Law Journal 2 (2009).

3. China, in this book, means only the mainland part of the People's Republic of China, which does not include the Hong Kong Special Administrative Region or the Macau Special Administrative Region.

4. The 28 EU Member States are Austria, Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom. *See* the European Union's website: http://europa.eu/about-eu/countries/index_en.htm, last accessed 5 May 2015.

5. UNCTAD, Global Investment Trends Monitor, *The Rise of BRICS FDI and Africa*, Special Edition (25 March 2013), online version available at http://unctad.org/en/PublicationsLibrary/webdiaeia2013d6_en.pdf, last accessed 5 May 2015.

1.3. Aim of the book and research methodologies

This book has a two-fold aim.

From an academic perspective, it intends to identify the rationale of the tax sparing mechanism and its effects on FDI. It will analyse the tax sparing mechanism's evolvement and rationales, the different approaches taken by countries and international organizations, its function of preserving spared taxes and its effects on FDI. These analyses will result in supporting the author's opinion that the tax sparing mechanism should not be regarded as a foreign-aid tool; rather, it is a technique that can be used by both contracting states to achieve their different objectives in respect of FDI.

From a policy perspective, it will serve as a policy suggestion to both EU Member States (as source states) and China (as residence state) with regard to their tax treaty policies, in particular their policies in respect of tax sparing mechanisms. The author suggests that both China and EU Member States should use the tax sparing mechanism to stimulate Chinese FDI into EU Member States.

In order to achieve this two-fold aim, the research methodologies used in this book comprise both legal-research methods and interdisciplinary methods. The legal-research methods include literary analysis of legal norms in EU law, Chinese law and international tax law; a narrative review of the tax sparing mechanism's history; and comparative studies of different tax sparing treaty provisions and different approaches taken by various countries and international organizations. The interdisciplinary methods include review of the relevant economic and accounting literature; analysis of FDI statistics; and calculation of foreign direct investors' global tax costs.

1.4. Structure of the book

This book consists of five chapters.

Chapter 1 introduces the research topic and research scope, the aim of the book, the research methodologies and the structure of the book.

Chapter 2 introduces the basic features of FDI, the tax sparing mechanism, the tax sparing mechanism's interaction with both the residence state's and the source state's tax systems, and taxation's effects on FDI.

Chapter 3 addresses two different rationales for the tax sparing mechanism: (i) the tax sparing mechanism as a foreign-aid tool; and (ii) the tax sparing mechanism as other than a foreign-aid tool. Comparative studies are conducted on various elements of the economic and legal literature, as well as the different approaches taken by selected countries and international organizations. After conducting these analyses, the author expresses her opinion that the tax sparing mechanism is not a foreign-aid tool used by developed countries to help developing countries. The mechanism is, rather, a technique, with both positive effects and negative effects, that can be used by both contracting states.

Chapter 4 reviews the tax sparing mechanism's effects on Chinese FDI into EU Member States. Although statistics show that the tax sparing mechanism has not significantly influenced the distribution of Chinese FDI into EU Member States, the author argues that the mechanism will be a more important factor with Chinese private foreign direct investors increasing their outbound investment in the coming years. Therefore, the author suggests that both China and EU Member States use the tax sparing mechanism in their tax treaties to stimulate Chinese FDI into EU Member States.

Chapter 5 provides a summary of and a conclusion to the research findings produced.

Notes

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