Ever since tax sparing clauses started appearing in tax treaties in the 1950s, there has been disagreement on their merit and impact. While those in favour generally refer to the necessity to preserve the effect of tax incentives offered by developing countries to attract foreign direct investment (hereinafter ‘FDI’), opponents argue that tax sparing clauses are vulnerable to abuse and ineffective in attracting FDI, that they discriminate among investors abroad, and that they encourage source countries to enact harmful tax incentives.

In 1998, the OECD published a report on tax sparing clauses, in which a number of concerns related to their use were identified, most notably their vulnerability to abuse, doubts as to their effectiveness in promoting development and the risk that they encourage the implementation of regimes that have the effect of eroding other countries’ tax bases. The OECD Commentary was subsequently amended to reflect those concerns, and it has been suggested that the OECD’s reconsideration has led a number of countries to change their treaty policy in relation to tax sparing. However, the OECD’s position has been the subject of criticism, and several non-OECD countries have expressed the intention to continue including tax sparing clauses in their tax treaties. It therefore seems that the debate is far from over.

This book by Na Li, which is the publication of a PhD thesis submitted at the Vienna University of Economics and Business, offers an original contribution to that debate by considering whether tax sparing clauses can only be regarded as foreign aid instruments and by examining the relevant issues from the specific perspective of Chinese FDI in EU Member States. The book thus departs from the traditional view that tax sparing clauses constitute a benefit granted by a developed country to a developing country and instead argues that the tax sparing mechanism can promote investment between developed countries and from developing countries to developed countries.

After an introductory first chapter, chapter two first defines FDI and briefly addresses its relevance for purposes of the analysis. This chapter gives a brief historical overview of the tax sparing mechanism and then describes the basic features of the two main forms of that mechanism, i.e. contingent relief schemes and matching credit schemes. In that context, attention is also paid to the question whether matching credit schemes can really be regarded as tax sparing mechanisms (considering that their effect is not dependent on tax incentives in the source state), with the author ultimately concluding that both contingent relief schemes and matching credit schemes should be considered as tax sparing mechanisms. Both types are therefore discussed throughout the book.

The second chapter also considers the effect of taxation on FDI. The first question in that regard is whether tax incentives influence the location and investment decisions of potential investors. Empirical studies in this area have shown conflicting results, and the author points out that those varying results can partly be explained by two reasons: the costs and benefits related to tax incentives are difficult to measure and the effectiveness of tax incentives depends on the tax system of the investor’s home state. The author ultimately concludes that tax incentives can influence the location of FDI, but that their design and implementation greatly determines their effectiveness. The second, and related, question is whether tax sparing mechanisms affect FDI. The empirical studies in
this area, although limited in number, are less equivocal in their results and seem to suggest a positive effect. The author therefore suggests a critical assessment of the OECD’s 1998 report and argues that the debate on the theoretical justification of the tax sparing mechanism and its proper use should be reopened.

The author takes a position in that debate in chapter three. Before doing so, however, she sets out two opposing views on the rationale for the tax sparing mechanism: on the one hand the view that it is a foreign-aid tool, and on the other hand the view that it is not. The first of these views (of which the book considers the United Kingdom and the United States to be the main proponents) considers that a tax sparing clause is a commitment by a developed country to ensure that its tax treatment of residents investing abroad will not nullify the effect of tax incentives offered by developing countries to attract FDI. By agreeing to such a clause in its tax treaty with a developing country, the developed country seeks to ensure that the taxes saved in the source country (i.e. the developing country) accrue to the investor rather than to the revenue of the residence country (i.e. the developed country). The developed country thus agrees to forego potential tax revenue in order that the efforts of the developing country to attract FDI would not be undone.

The opposing view is that tax sparing is not a foreign-aid tool, but an act of recognition of the source state’s sovereignty in tax matters, as well as a mechanism to remedy the distortions caused by the foreign tax credit method in the residence state. The author identifies two distortions, the first of which is that investors from a credit country that has not agreed to a tax sparing clause are normally subject to a higher overall tax burden as regards their investment in the source country than other foreign investors in that country who are resident in an exemption country or in a credit country that applies a tax sparing mechanism. The second distortion is that investors may be reluctant to repatriate profits back to their residence state due to the effects of the foreign tax credit method in that state.

The book discusses the position of four countries – Japan, Singapore, Brazil and China – as illustrations of this view. The case of China exemplifies the change in attitude towards tax sparing that may occur as a country’s position in the world economy evolves: in the 1980s, when China introduced a number of tax incentives to attract foreign investors, it would generally insist on including a (unilateral) tax sparing clause in its tax treaties with developed countries, but in more recent years Chinese outbound FDI has significantly increased, which has led the country to generally refrain from including tax sparing clauses in its treaties concluded since 2008.

After considering the position of the UN (which has shown a more positive attitude towards tax sparing clauses than the OECD), the author sets out her own opinion, which is that the tax sparing mechanism is not a foreign aid tool used by developed countries to help developing countries, but a mechanism that can be used by both developed and developing countries to preserve the effectiveness of tax incentives and to remedy the distortions caused by the foreign tax credit system. As regards the possibility that tax sparing clauses may be used in abusive arrangements, the author argues that the abuse in such arrangements concerns the underlying tax incentives rather than the tax sparing clauses as such and that domestic and tax treaty anti-abuse rules can be used to challenge them.

Chapter four examines the effect of the tax sparing mechanism on Chinese FDI in the European Union. The focus of the analysis is on the five EU Member States – Bulgaria, Cyprus, Italy, Portugal and Slovakia – with which China has a tax treaty in force containing a reciprocal tax sparing clause. The author concludes that the tax sparing mechanism did not significantly influence Chinese FDI in the countries in question. Nevertheless, she argues that, from a theoretical perspective, the tax sparing mechanism should have an impact of Chinese FDI in EU Member States and therefore recommends to include tax sparing clauses in tax treaties between China and EU Member States. Given the continuing increase of Chinese FDI in the EU, the tax sparing mechanism is necessary, in the author’s opinion, to address the above-mentioned distortions that may affect Chinese investors. The author therefore recommends China to resume using tax sparing clauses in order to address the distortions caused by China’s foreign tax credit system (albeit as an interim measure, pending a more fundamental reform of that system), and suggests that EU Member States should include a uniform (reciprocal) tax sparing clause in their treaties with China.

The final section in this chapter discusses whether the tax sparing mechanism can give rise to an infringement of EU state aid rules. The author ultimately concludes that the selectivity criterion is not met, as a result of which it cannot be said that an EU Member State that grants the benefit of the tax sparing mechanism in its capacity as a residence state contravenes the state aid rules (although of

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8 See also Schmuller, supra n. 6, at 51–52.
9 The book does not address the extent to which its conclusions also apply to residence countries that apply an exemption method with a subject-to-tax requirement.
10 A potential explanation identified by the author is that Chinese FDI in EU Member States has, for the time being, mostly been carried out by Chinese state-owned enterprises, which are less likely to be influenced by tax considerations. However, as Chinese FDI by non-state-owned enterprises will likely increase in the future, the author considers that tax considerations (and, consequently, tax sparing clauses) could become more relevant to FDI location decisions.
course the tax incentives that it grants in its capacity as source state may constitute incompatible state aid).

The strength of the book lies in its attempt to cast a new light on the tax sparing mechanism, i.e. to shift the debate away from a focus on foreign aid and towards a more comprehensive view in which that mechanism can be mutually beneficial for both treaty partners, irrespective of their development level. The arguments in favour of that view are well presented, thought-provoking and original. The author not only develops arguments based on legal reasoning, but also draws inspiration from empirical data, case studies and game theory. Moreover, the technical issues related to the application of tax sparing clauses are illustrated by calculation examples, and significant attention is paid to policy recommendations based on the research results. The book’s specific focus on the relationship between China and EU Member States makes those policy recommendations all the more relevant.

Perhaps as a result of that specific focus, however, a number of topics could have been addressed in more detail. For instance, the interaction between tax sparing clauses and Controlled Foreign Corporation (CFC) rules is discussed briefly in the book but further analysis would have been interesting, particularly given the argument that tax sparing clauses may address investors’ reluctance to repatriate profits back to their source state. Similarly, it would have been enlightening to obtain a more in-depth understanding of the author’s position on underlying issues of a more fundamental nature, e.g. the potential criticism on the use of tax incentives to attract FDI (not only the persisting doubts as to their effectiveness, but also the various costs involved that may outweigh their benefits) or the assumption of positive externalities from FDI.

Those are minor points, however. Given the specific research objectives that have guided the study, the decision to focus on other elements is understandable, and it does not in any way detract from the value of the work. The case for a more nuanced understanding of the tax sparing mechanism is convincingly made and the book therefore represents a valuable and timely contribution to the academic literature on the subject. The debate over whether the tax sparing mechanism is a necessary instrument to aid the economic development of low-income countries and safeguard their tax sovereignty, ‘a fundamentally unsound and dangerous approach to the problems of international taxation’ or a tool the usefulness of which transcends the relationship between developed and developing countries will not be settled any time soon, but its importance will likely increase as a resurgence of interest in tax sparing clauses has been predicted following new studies on the effectiveness of tax incentives.\footnote{Surrey, supra n. 2, at 167.} \footnote{Brooks, supra n. 5, at 531.}

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\footnote{Surrey, supra n. 2, at 167.}
\footnote{Brooks, supra n. 5, at 531.}