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Fiscal Affairs Department

50 YEARS 1964-2014 FISCAL AFFAIRS DEPARTMENT

Lessons of Regional Harmonization of Tax System

&

Tax Incentives and WTO rules

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Tokyo, Japan
April 24, 2014

Views are authors' alone, and should not be attributed to the IMF, its Executive Boards, or its management

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Context

- ASEAN will form a common market– the ASEAN Economic Community (AEC) in 2016
- SAARC aims to make customs zero in 2016 (South Asian Free Trade Area (SAFTA))and aims at a single market in 2020 (?)
- Tax harmonization/coordination is key to enhance the functions and operation of a single market.
- Then, what should/could be done in tax areas ?
- Experiences in other regional economic community could provide lessons.
- WTO rules could affect export-linked tax incentives
- WTO rules could set a base for regional harmonization of tax incentives

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Outline

- Economic Integration Process
- Why tax harmonization / coordination is necessary for Regional Integration?
- Overview of efforts to harmonize/coordinate tax system in other regional economic communities
  - EU
  - WAEMU
  - SADC
- Lessons
- Should Intra-region capital flows be tax free?
- WTO Rules That Affect Tax Incentives
- Tax Incentives Contingent on Exports in Asian Countries
- WTO Rules-compliant Tax Incentives ?

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Economic Integration Process

1) Preferential trade area
2) Free trade area
3) Custom Union
4) Common market
5) Economic and monetary union
6) Complete economic integration

(Balassa)

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Why Tax Harmonization / Coordination is Necessary for Regional Integration?

- To avoid tax distortions to the location of economic activity within the single market.
- To ensure that the single market operates as smoothly.

  Tax harmonization/coordination are centered on removing obstacles to the smooth functioning of the single market: free movement of goods, services and capital.
- To stabilize revenue

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Overview of efforts to harmonize tax system in other regional economic communities

- **EU**
  - No need for an across the board harmonization of tax systems, and Member States are free to choose the tax system. (the subsidiarity principle of the EC Treaty
  - But, Member States are refrained from introducing any new harmful tax measures and required to amend the existing harmful tax measures (Code of Conduct– soft law)
  - Prohibition of State Aid could have stronger impacts on tax incentives.
  - VAT
    - Maximum rate: 25%; Minimum standard rate: 15%;
    - Member States may apply one or two reduced rates of not less than 5%
  - Excises
    - Alcohol beverages: minimum rate e.g. Beer =€0.0935 per liter;
    - Cigarettes: minimum rate= 57 % of a retail price + new proposal

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- **EU (cont.)**
  - Paying agents (e.g. banks) need to either report interest income received by a resident in other EU Member States or levy withholding tax on the interest income (Saving Directive) => Automatic exchange of information
  - Dividends paid by a subsidiary company (sub) to its parent company (parent) are exempted from withholding tax if the parent hold at least 10% of the shares in the sub; the Member State of the parent had either: exempt profits distributed by the sub from any taxation or impute the tax already paid in the Member State of the sub against its own tax. (Parent-Subsidiary Directive)
  - Common Corporate Consolidated Tax Base (CCCTB)
    -ECOFIN's report to European Council (2013)
  - European Court of Justice—Powerful guardian of EC Treaty

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- **WAEMU** (West African Economic and Monetary Union)

[Benin, Bukina Faso, Cote d'Ivoire, Mali, Niger, Niger, Senegal, Togo, and Guinea-Bissau]

- Macro-fiscal condition: primary balance should not exceed zero; debt-to-GDP ratio should not exceed 70 percent; tax revenue-to-GDP should be at least 17 percent
- Single currency (CFAF)(before formation of WAEMU)
- Custom Union (2000)
- VAT
  - Single positive VAT rate between 15 and 20 percent
  - Registration threshold
  - Common rules for tax base
- Excises
  - Minimum and maximum tax rate by type of goods

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- **WAEMU** (cont.)
- CIT
  - Single rate between 25 to 30 percent
  - Standard CIT base
- Portfolio income
  - Withholding tax on dividends: 10 to 15 percent; interest: 0 to 6 percent: capital gains: 0 to 7 percent
- Multilateral tax treaty
  - Ceiling rate on interest and royalties: 15 percent; dividends: 10 percent
- No directives/regulation on tax incentives provided by non-tax laws
- Commission nor member states have never brought a case of non compliance with tax directives to the regional Court of Justice

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- SADC (Southern African Development Community)

[Angola, Botswana, the Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, United Republic of Tanzania, Zambia and Zimbabwe]

- SADC Tax Database (http://www.sadc.int/information-services/tax-database)
- Guidelines on tax incentives
  - "State Parties shall…endeavour to avoid (a) harmful tax competition …"(Protocol Annex 3, Article 4)
- Double Taxation Agreement
  - Model DTA for SADC
  - "State Parties shall …establish amongst themselves a comprehensive network of DTA" (Article 5)
- Indirect taxes
  - "Each State party shall, in an effort to minimise..smuggling… harmonise the application of excise rates.." (Article 6(5))
  - "State parties shall …harmonize..VAT regimes…"(Article 6(10))
- Dispute settlement mechanism

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Lessons

- Without strong political commitment, it is difficult to achieve effective harmonization / coordination.
- Priority should be given to excises and CIT and tax incentives.
- Soft law approaches such as Code of Conduct are pragmatic, but rely on goodwill and peer pressure, and are thus inherently difficult to enforce.
- Information sharing is a pre requisite for any harmonization / coordination efforts.
- Institutional arrangements and surveillance mechanism is key to achieve and maintain tax harmonization / coordination
- Tax harmonization / coordination should cover de facto tax laws

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Should Intra-region capital flows be tax free?

- A DTA network, intra-region DTA or bilateral DTAs need to cover all community members. It is desirable that bilateral DTAs among member states be identical.
- If an intra-region or bilateral DTAs exempt source country taxation on investment income, it would facilitate further integration.
- However, without the "harmonization" of CIT structure, in particular, tax incentives, it would induce further concentration of FDI to a business friendly member state or provide an opportunity for tax avoidance.
- Proliferation of "sandwich" schemes in EU could indicate a risk of exempting source country taxation on dividends.

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WTO Rules That Affect Tax Incentives

- Agreement on Subsidies and Countervailing Measures (ASCM)

Article 3: …. the following subsidies, within the meaning of Article 1 ((ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)), shall be prohibited:

(a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;

=> **Tax incentives contingent on exports could be regarded as “export subsidies”**

➢Tax incentives contingent on use of domestic products

- National Treatment Principle in GATT Article 3

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Tax Incentives Contingent on Exports in Asian Countries

Examples

1. A company engaged in manufacturing is eligible for allowance for increased exports that is tax exemption of 10%/15% of the value of increased exports.
2. A company that exports more than 70 percent of its production is eligible fro CIT holidays.
3. A company located in a designated economic zone, which aims to promote exports but has no minimum export requirements , is eligible for CIT holidays.
4. A company located in an export processing zone is eligible for exemption of import duties and VAT for its import.

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WTO Rules-compliant Tax Incentives ?

- WTO does not make a decision unless a member bring a case to the Panel.
- A “gray” export-contingent tax incentives brings in juridical uncertainty that may deter investment.
  - ➢ Need to minimize risks for export enterprises to have tax incentives cancelled unexpectedly
- UN’s Least Developed Countries and ASCM Annex VII(b) countries are exempt from prohibition of export subsidies.
- Complying with WTO rules could set a base for regional harmonization of tax incentives.

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Fiscal Affairs Department

SOME CURRENT ISSUES IN CORPORATE TAXATION

50 YEARS 1964-2014 FISCAL AFFAIRS DEPARTMENT

Michael Keen

International Monetary Fund

Tokyo, April 24, 2014

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Overview

- Trends—in rates and revenues
- Selected current issues
  - Interest deductions
  - Tax competition
  - Alternatives to the current international architecture?

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TRENDS—IN RATES AND REVENUES

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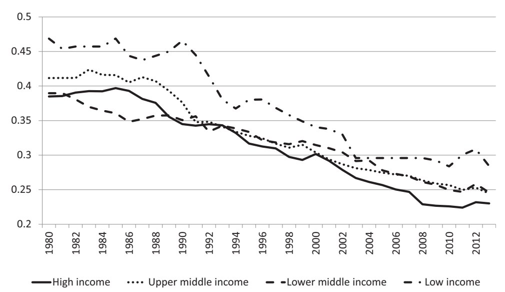
Statutory rates, by income group…



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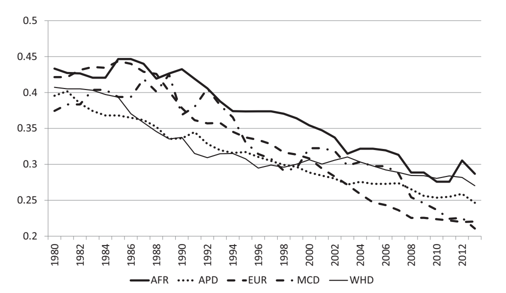
….and by region



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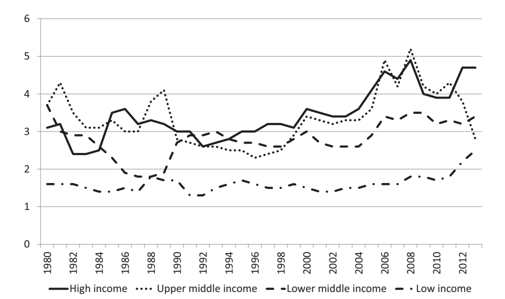
Revenues/GDP, by income group…



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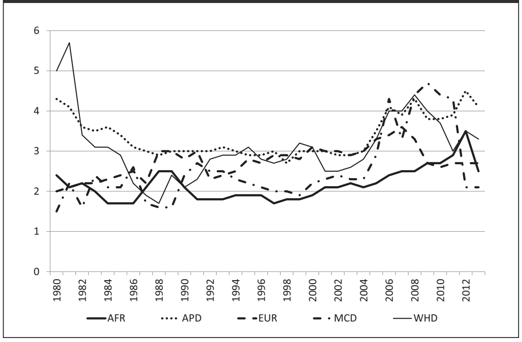
…and by region



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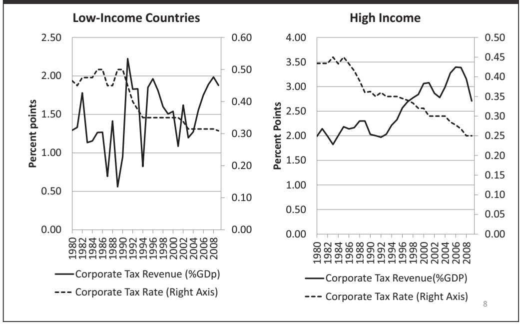
Striking pictures



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How have revenues held up?

- Base broadening?
  - Not the full story
- Importance of financial sector profits
  - At least until crisis
- Increased share of profits in GDP
- Stronger tax incentives to incorporate?
- Laffer effects?
  - Return to later…

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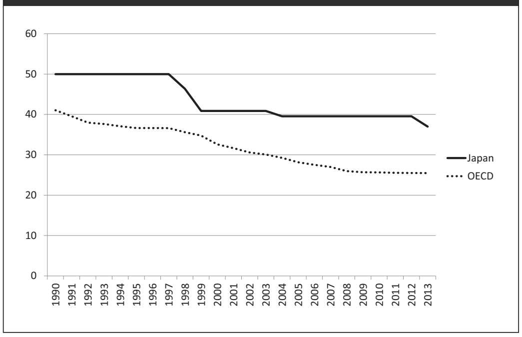
For Japan: The rate….



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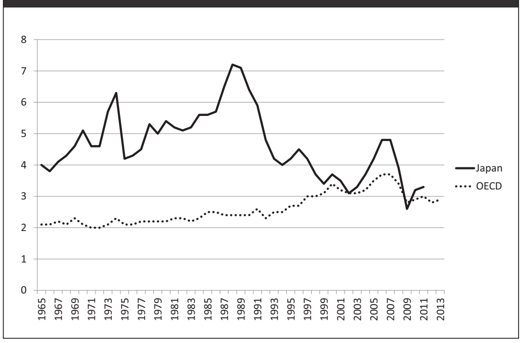
…and revenues



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Laffer effects?

- Always tempting—and some have put in low 30s
- But empirical evidence on revenue maximizing CIT rates contentious
  - Kawano and Slemrod (2012)
  - Likely to depend e.g. on others' tax rates
  - And e.g. to be higher in larger countries
- For a large country like Japan, response of others' a real consideration

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It isn't just the headline rate that matters

- Profit shifting incentives depend on statutory rate
  - relative to others, and on international tax rules
- But also need to consider:

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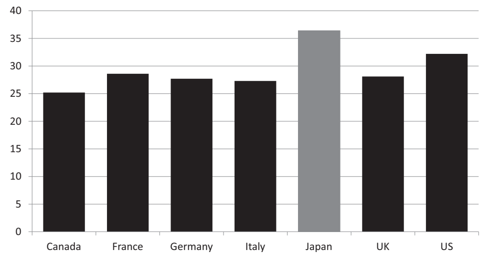
Discrete location choices depend on *average effective tax rate* (AETR)

–on an intra-marginal project



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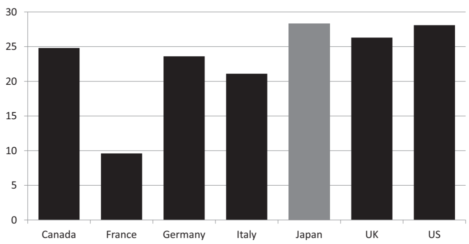
- Investment given location depends on *marginal effective tax rate* (METR)
  - Excess of pre-tax over required post-tax return



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Growth effects of the CIT?

- CIT commonly at bottom of 'hierarchies' of growth friendliness
  - Though less clear in lower income countries
- But effect must depend on form of coproate tax
  - A rent tax has METR =0 and so should not discourage investment

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SELECTED CURRENT ISSUES

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Treatment of interest

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Two distinct issues

- Interest deduction as a profit shifting device
- Tax preference for debt over equity finance: ‘Debt bias’

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Interest and profit shifting

- A straightforward device: Shift (apparent) risk by lending from low tax jurisdiction to high
  – As many times as possible (‘double dips’)
- Increased attention in last few years
  – Addressing this is BEPS Action Item 4
- Why allow any deduction for related party loans?
- More limited responses:

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Possible/actual responses differ widely

- Nature of limit
  – ‘Thin cap’
  – ‘Earnings stripping
  – Use only ALP
- Carry forward?
- Related party only?
  – If so, cannot address debt bias

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Dealing with debt bias

- Unless offset at personal level, deduction of costs of debt but not equity finance creates bais towards debt finance
  – Likely to be high when statutory CIT rate high
- Empirical evidence confirms such an effect
  – De Mooij (2011)

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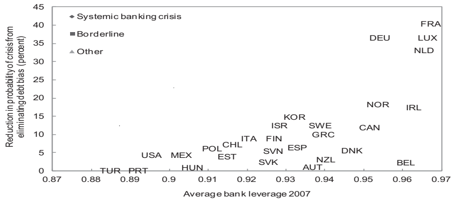
Does this matter?

Effect just as strong for banks—so, with tax linked to leverage and leverage to probability of crisis:

Figure 3.1. Debt Bias and Probability of Crisis



Sources: IMF staff calculations using results in de Mooij and others (2013) and identification of systemic banking crises of Laeven and Valencia (2010).

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Two approaches to eliminating debt bias....

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Allowance for Corporate Equity (ACE)

- Retain interest deduction, but also allow deduction for a notional return on equity
  - Variant: Allowance for Corporate Capital (ACC) would give notional deduction for debt at same rate
- This is a tax on rents:
  - Neutral between debt and equity
  - METR is zero
  - And rate of depreciation becomes irrelevant
- In practice: Italy, Brazil, Belgium, Croatia….

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But some issues….

- What notional rate?
- ACE is base-narrowing
  - Effect can be limited by giving allowance only for equity created after introduction
- May nonetheless need higher statutory rate to preserve revenue at unchanged base
  - Which would amplify risks of profit shifting
- Though lower METR should be good for growth

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Comprehensive Business Income Tax (CBIT)

- Eliminate CIT interest deduction
- (Very) base broadening
  - Mechanically, allows large reduction in statutory rate
  - But potentially large increase in M/AETRs..
  - ..and pressure to cut personal taxes on interest?
- No fully-fleshed proposals
  - Treasury Blueprints 1977

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Tax competition

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…is happening

- Strong evidence of strategic tax interactions
  - Not just common ‘fads’
- And tend to be both (a) in direction of ‘race to the bottom’ and (b) large
  - Devereux, Redoana and Lockwood (2008)

…though the race is taking some time

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The basic challenge…

Loosely, risk is greatest where only ‘source’ taxes are payable and ‘source’ is manipulable

How can this be addressed?

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…and solutions in present framework?

- Full residence taxation without deferral
  – But inversion?
- Failing that, make shifting harder and use CFC rules
  – But leaves scope for competition on 'active' income?

Look later at ideas for changing the framework

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Some politics

- While there is a collective loss, some countries can be winners
  – ..and collective loss cannot be inferred from observed extent of aggregate revenue loss
- Unlike e.g. trade context, small countries can be influential
- Larger now more willing to exercise power?

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'Harmful' tax competition? Two questions

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When is tax competition not harmful?

- 'Tame the beast' argument
  – now less heard
- To extent tax competition takes form of providing most mobile activities with lower METR, enhances efficiency?
  – But not an argument for low EATR

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Are preferential regimes harmful?

Suppose a country has CIT of 20% and an IP box

If the IP box were not possible, might cut CIT to 18%—would that be a good thing?

Better to compete aggressively over most mobile things or less aggressively over everything?

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Regional coordination

- Presumably easier than global
  – Though still hard! And one reason may be:
- By coordinating among themselves, participates risk becoming more vulnerable to competition from rest of the world
- Biggest winners are those who remain outside

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Different international architectures?

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Formula apportionment

(e.g. CCCTB)

- Base is consolidated profit of the group, which is allocated across jurisdictions by some apportionment factors
  - A form of which is used in Japan
- Eliminates need to value intra-group transactions

But…

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…all the action is in the weights

- Which factors to use?
- Competition to attract factors—maybe more intense than that to attract capital under ALP
- ALP challenges remain if operates only up to some ‘water’s edge’

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Formulary profit split

(Avi-Yonah et al)

- Use third party prices where available..
  - E.g. fixed mark up on such purchases

  …and apportion ‘residual profit’ that remains (by sales?)

Little studied, but, e.g.,

- Can have positive liability when group makes loss
- But may lead to less intense tax competition

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Destination-based corporate tax

(Auerbach, Devereux and Simpson)

E.g. a cash flow tax but (a) exclude receipts from exports and (b) no deduction for imports

- Effectively a VAT plus wage subsidy
  - and hence has attractive neutrality properties: e.g. transfer prices irrelevant
- But then why not a VAT plus lower labor tax?

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THE END!

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Rest: IMF