# Regulatory framework for tax incentives in developing countries

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GLOBTAXGOV
A NEW MODEL OF GLOBAL GOVERNANCE IN INTERNATIONAL TAX LAW MAKING

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# A New Model of Global Governance in International Tax Law Making

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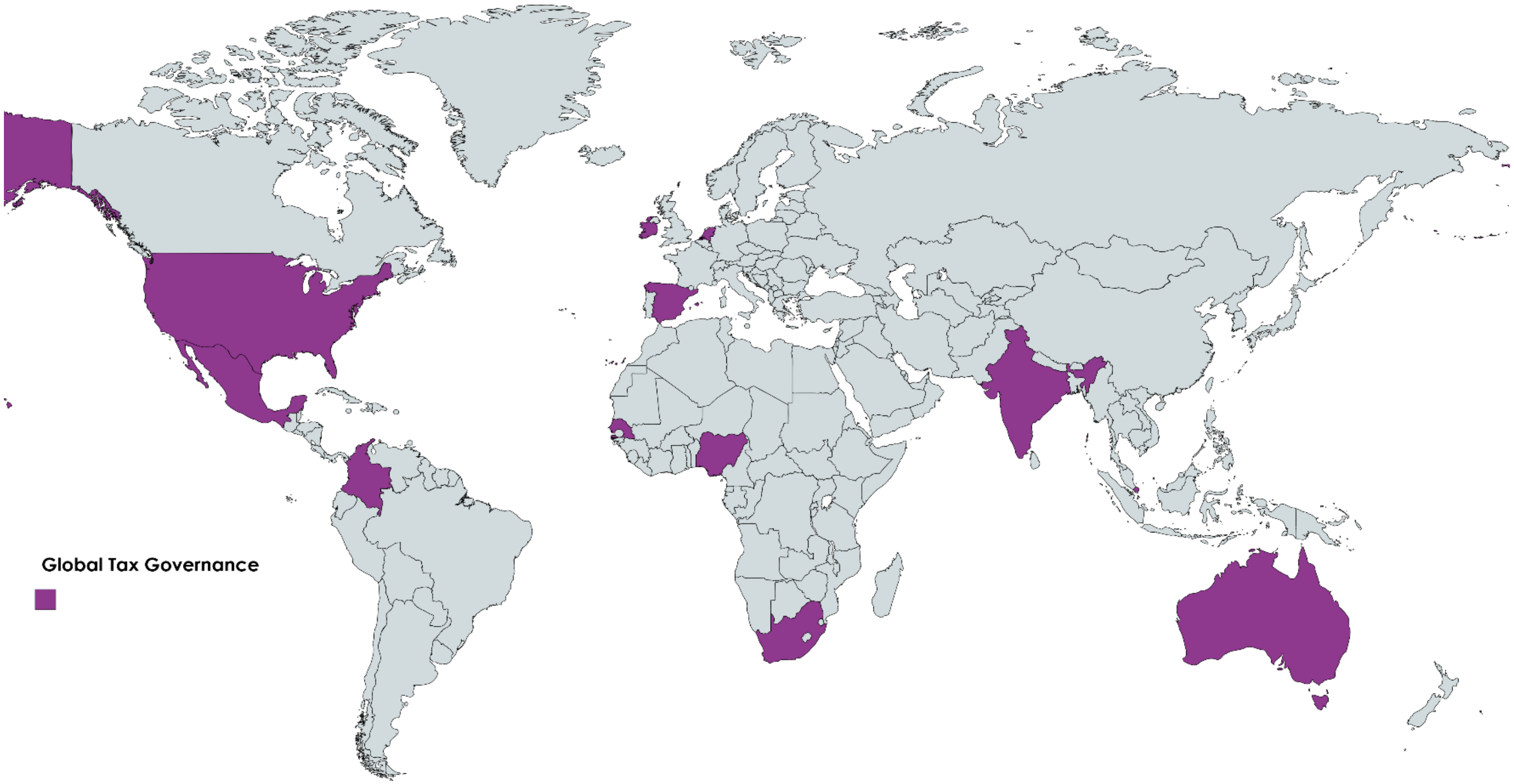
# Global Tax Governance: GLOBTAXGOV



# Topics

**Tax incentives**

**Tax Incentives and BEPS**

**Tax Incentives and SDGs**

# 1. Tax Incentives

- Tax incentives in developing countries aim to attract foreign direct investment to increase economic growth by creating more jobs, transfer of technology and improvement of economic conditions in a specific sector/region.
- Examples
  - free trade zones, reduction of corporate income tax rates, carry back/forward of losses, accelerated depreciation, investment tax credits, favourable tax treatment for expenditures on research and development.
  - the scope of application can be geographical (based on location) or specific for a sector/industry (e.g. hotel industry, agribusiness, research and development, etc).

Literature:

- 2013 Y. Brauner. The Future of Tax Incentives for Developing Countries' in Yariv Brauner & Miranda Stewart (eds), Tax Law and Development, 25 (Cheltenham: Edward Elgar Publishing, 2013)
- 2015: IMF, OECD, WB and the UN, Options For Low Income Countries' Effective And Efficient Use Of Tax Incentives For Investment.
- 2018: UN and CIAT. Report design and assessment of tax incentives in developing countries

# 2. BEPS Action 5 and EU Code of Conduct

- No specific reference was made to the word incentives in the content of BEPS Action 5.
- However, countries are also being reviewed in their tax incentives mainly in the requirement of substantial activity factors to no or only nominal tax jurisdictions.
- This has allowed the OECD and the OECD Forum on Harmful Tax Practices to review tax incentives (including free trade zones, reduction of corporate income tax rates). EU List of Non-cooperative Jurisdictions

1998 Report Harmful Tax Competition – 2018 BEPS IF Progress Report

- Questions
  - ❑ What type of incentives after BEPS?
  - ❑ Same approach OECD BEPS and EU Code of Conduct Group?
  - ❑ How attracting investment by means of tax incentives can contribute to SDGs?

# 3.1. What type of incentives after BEPS?

**<u>2015 Toolkit on Tax Incentives for Low-Income Countries</u>**

"Tax incentives generally rank low in investment climate surveys in low-income countries, and there are many examples in which they are reported to be redundant—that is, investment would have been undertaken even without them. And their fiscal cost can be high, reducing opportunities for much-needed public spending on infrastructure, public services or social support, or requiring higher taxes on other activities".

**Recommendations:**

**National level**: Improve the design of tax incentives (for example by placing greater emphasis on cost-based incentives rather than profit-based ones; and by targeting tax incentives better),strengthen their governance (for instance through more transparency, better tax laws and a stronger role of the Minister of Finance) and by undertaking more systematic evaluations.

**International level**: countries may gain by coordinating their tax incentive policies regionally, so as to mitigate the negative spill overs from tax competition

# 3.1. What type of incentives after BEPS?

**2018: UN-CIAT Design and Assessment of Tax Incentives in Developing Countries**

- Tax incentives cannot compensate for the deficiencies in the design of the tax system or inadequate physical, financial, legal or institutional infrastructure. Better to bring the corporate tax rate regime closer to international practice and to correct the deficiencies rather than provide investors with additional tax benefits.
- Easier to provide tax incentives than to correct deficiencies in the legal system or to improve the infrastructure of one country.
- Cost/benefit analysis:
  - Costs: revenue costs, resource allocation costs, enforcement and compliance costs, and the costs associate with corruption and lack of transparency
  - Benefit: to attract investment, to correct market inefficiencies or general positive externalities.
- Checklist for drafting tax incentives legislation. List of things to be considered to maximise clarity and administration. Consistency of legal drafting with the policy underlying the tax incentive.

| KEY FACTORS OECD –BEPS Action 5 | APPLICABILITY TO TAX INCENTIVES |
|---|---|
| • No or low effective tax rates on income from geographically mobile financial and other service activities.<br>• The regime is ring-fenced from the domestic economy.<br>• The regime lacks transparency<br>• No effective EOI with respect to the regime.<br>• The regime fails to require substantial activities (**included 2018 Report as key factor**) | • Yes. Low or reduced tax rate. Comparison with rates within the country.<br>• Yes, if tax incentive only for certain areas or certain type of investors.<br>• Yes, if tax incentive is discretionary, or no clear evaluation on why the tax incentive is granted, or not information publicly available on the incentives.<br>• To some extent, if information referring to the tax incentives needs to be exchanged amount countries.<br>• The reason to invest in the country is not only the tax incentive and the lack of substantial activities (e.g. mailbox companies) |
| **OTHER FACTORS** | |
| • An artificial definition of the tax base.<br>• Failure to adhere to international transfer pricing principles.<br>• Foreign source income exempt from residence country taxation.<br>• Negotiable tax rate or tax base.<br>• Existence of secrecy provisions.<br>**Removed in the 2018 Report**<br>• *Access to a wide network of tax treaties.*<br>• *The regime is promoted as a tax minimisation vehicle.* | ▪ To some extent linked to transparency above (e.g. in case of discretionary tax incentives, or the existence of secrecy provisions).<br>▪ No clear how the tax incentive can be evaluated regarding an artificial definition of the tax base, or transfer pricing.<br>▪<br>▪ Exemption of foreign source income from residence country taxation can be also regarded as incentive, but its consequences will need to be further evaluated. |

| EU Criteria | OECD Factor | Applicable to tax incentives |
|---|---|---|
| advantages are accorded only to non-residents or in respect of transactions carried out with non-residents | Key factor | Yes |
| advantages are ring-fenced from the domestic market, so they do not affect the national tax base | Key factor. | Yes |
| advantages are granted even without any real economic activity and substantial economic presence within the third country offering such tax advantages | Key factor. Main reference to substantial activities. | Yes |
| the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD | Other (non-key) factor and more specifically referring to international transfer principles without referring to the OECD rules. | Not clear the link between OECD principles, profit allocation and tax incentives, unless that the tax incentives provides for a more specific/favourable profit allocation method (e.g. sixth method in Latin American countries) |
| the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way. | Key factor | Yes, especially if there are discretionary tax incentives granted by the government or law maker. |

# 3.3 Investment and SDGs

Suggested analysis:

- Benefit: Effectiveness of tax incentives in achieving their aims (social and economic growth)
- Cost: Efficiency in terms of revenue loss, fair taxation, and equal opportunities for all citizens

To differentiate between tax incentives:

- For companies (foreign, local)
- For individuals (gender/ education/ religion/ family status)

To link the tax incentives not only to foreign direct investment but also to enhance economic and social development at country level. Examples from investment law: performance requirements (jobs/ transfer of technology)

# 3.4 New Framework for Tax Incentives in light of SDGs

Different from the  by the toolkit on Tax Incentives that provides a more economic analysis of effectiveness (size of the net investment effect, net impact of higher investment on jobs and wages and productivity spillovers (IMF, OECD, UN & et al. 2015:32) and efficiency (net public revenue losses, administrative and compliance costs, scarcity of public funds and distorted resource allocation). The elements of this proposed framework take into account some of the elements of the UN-CIAT cost/benefit analysis mainly revenue costs, and lack of transparency costs (UN-CIAT 2018:15).

# 3.4 New Framework for Tax Incentives in light of SDGs

This framework should be designed by each country and if possible, taking into account the practice of other countries in the region so that countries can also exchange best practices. The following criteria can be used:

- **each tax incentive should be reviewed in a systematic way**. This evaluation should take place before and after the incentive is granted and at least every 2 years so that the incentive is evaluated on a regular basis instead of granting the incentive for 10, 20 or 30 years without any systematic evaluation. This evaluation should focus on whether the tax incentive has achieved the specific goals in terms of effectiveness and efficiency;
- the incentive should have a **clear target and eligibility criteria for granting the incentive**, this target should be measurable to achieve the social and economic development of the region/sector/country;
- there should be **no room for administrative discretion** on the grating of the incentive;
- the incentive should be **transparent (public available** in the website of the tax administration or administrative agency);
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# 3.4 New Framework for Tax Incentives in light of SDGs

- for **each incentive there should a fiscal budget and perhaps also a ceiling in the budget so that once reached the ceiling of revenue loss, the tax incentive will be terminated**. The amount of allocated budget used can be made available on a year basis to investors so that they are not surprised when the ceiling has been reached; and

- To achieve greater accountability and transparency of tax incentives, it is important that the general tax expenditure of the country is periodically analysed and tax budgets are implemented (UN-CIAT 2018:19) .This analysis requires **monitoring and systematic evaluation, and efforts should be made by international organizations to train staff and use data analytics to carry out this analysis in developing countries**.

# 3.4 New Framework for Tax Incentives in light of SDGs

Institutional conditions

- Developing countries should appoint **one person, typically the Ministry of Finance to administer and monitor the tax incentives**. This is often not the case and administration is divided among multiple agencies dealing with that particular industry or region (Mosquera Valderrama & Balhárova 2020, forthcoming);
- **introduction of tax incentives** in the Income Tax Law and/or Investment Law, but **without using several laws or decrees** where tax incentives can be found. The Income Tax Law and/or Investment Law should be publicly available with a specific reference in English (to the incentive, the tax benefit and the criteria used to systematically evaluate the tax incentive);
- The **stability contracts should be re-evaluated** and in any case all contracts should be published in the Government' website, with specific information on the type of contract, the tax benefit agreed under the contract, dispute resolution mechanisms and also the responsible person to grant that agreement; and

# 3.4 New Framework for Tax Incentives in light of SDGs

- The use of **one stop shop agencies** should be encouraged, since investors may find useful to access the information, but also dealing with all permits/licenses, and further questions regarding their investment. This agency should have a code of conduct to guide their activities within the agency, and in addition a list of sanctions (administrative fine or imprisonment) should be introduced. In case that there is any corruption or bribery, the sanction for the respective agency official should be made publicly available.

# Literature


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