Tax Incentives for Investment (Panel Discussion)

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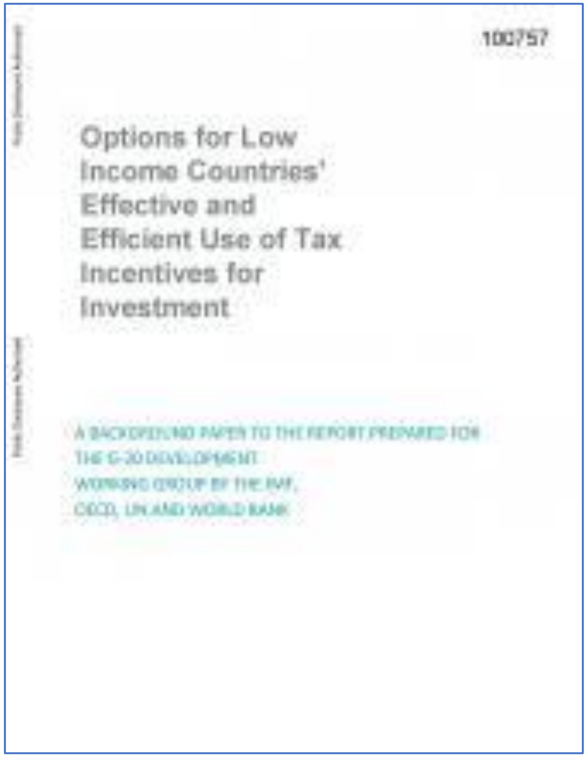
Recap

- Request from G20 Development Working Group for a paper on "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment"
- Tax incentives not part of G20/OECD BEPS
  - But major concern in developing countries
  - 2015 PCT Toolkit (led by IMF)
- Going forward – need to consider impact of proposed global minimum tax on tax incentives

PCT Toolkit - Overview

- Tax incentives
  - Prevalence and trends
  - Effectiveness and Efficiency
    - High fiscal costs; redundancy
- Guidance in the use
  - Design
  - Governance
  - Evaluation
- International coordination
- Making progress
  - Toolkit – background document contains tools for assessment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Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment

A BACKGROUND PAPER TO THE REPORT PREPARED FOR THE G-20 DEVELOPMENT WORKING GROUP BY THE IMF, OECD, UN AND WORLD BANK

Tax incentives were growing in popularity

- Tax incentives

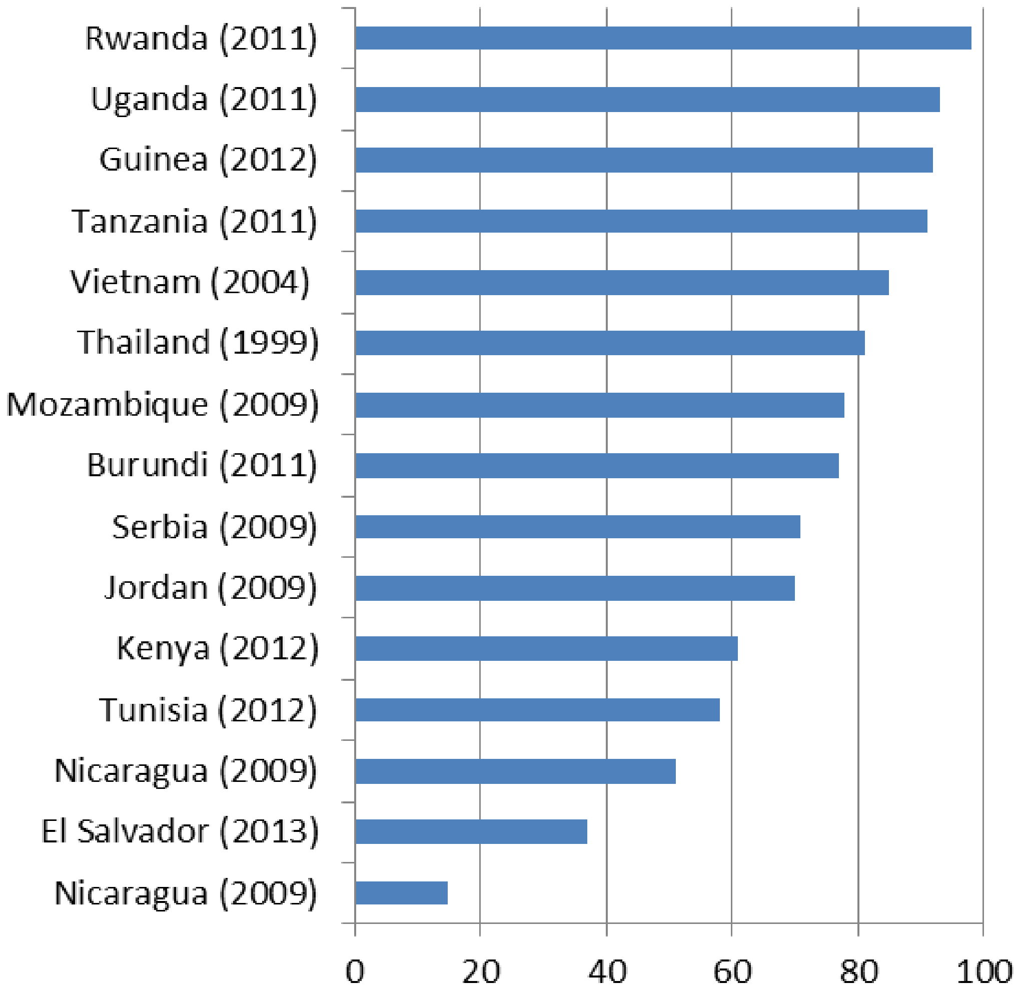
  "… any special tax provision granted to qualified investment projects or firms that provide favorable deviation from the general tax code"

- 1980s
  - Tax holidays in 40 percent of Sub-Saharan Africa
  - < 200 Economic Zones in 46 countries
- Today
  - Tax holidays in > 80 percent of Sub-Saharan Africa
  - > 3500 Economic Zones in 130 countries

High expectations on effectiveness should be tempered

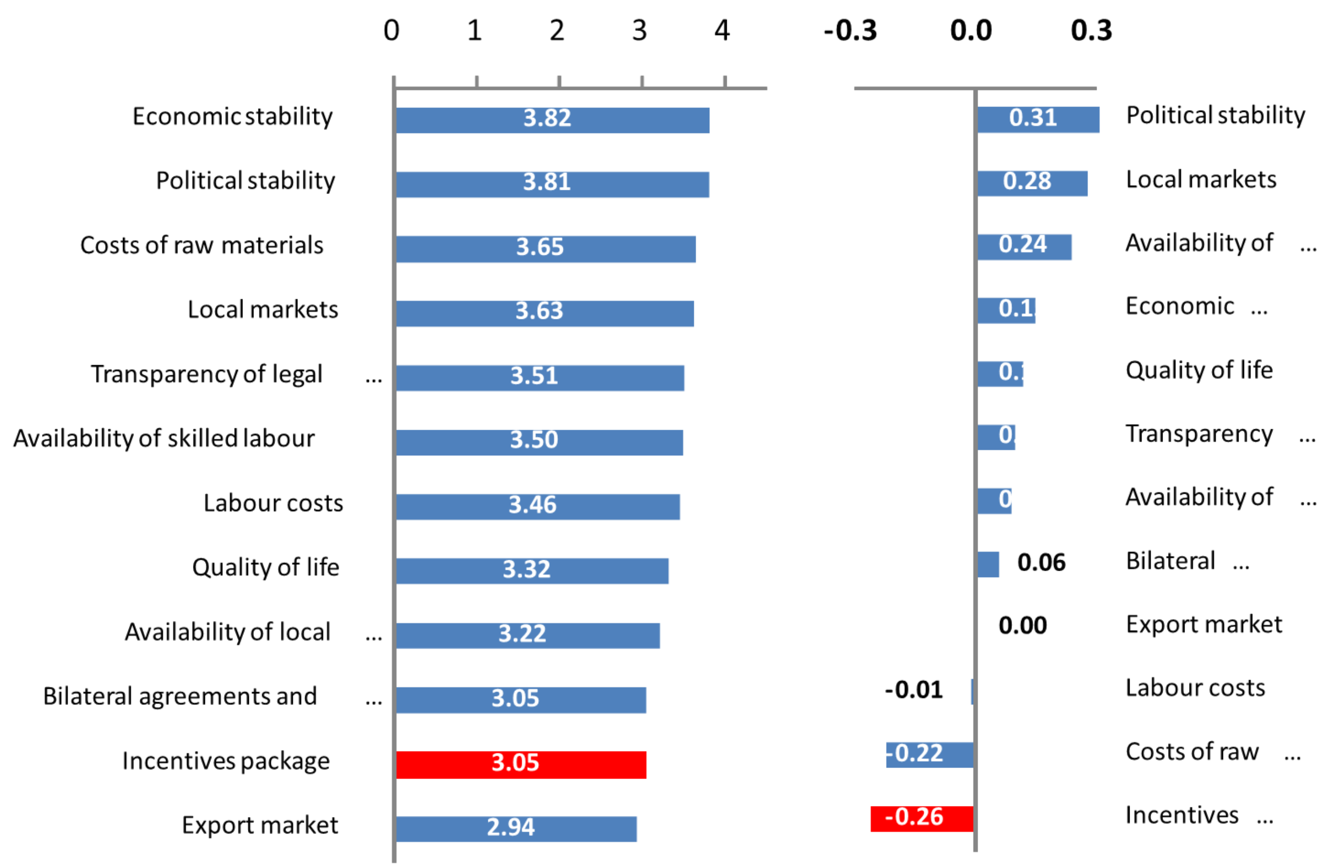
- "Effective use": achieve stated objectives
  - ➢ Usually investment/FDI
- Attracting FDI important for 'development', but incentives
  - ➢ … may not matter much
    - ❖ Investor surveys
    - ❖ Econometrics /anecdotes
  - ➢ … cannot make up for weak conditions

Would have invested even without the incentive



Source: James (2014)

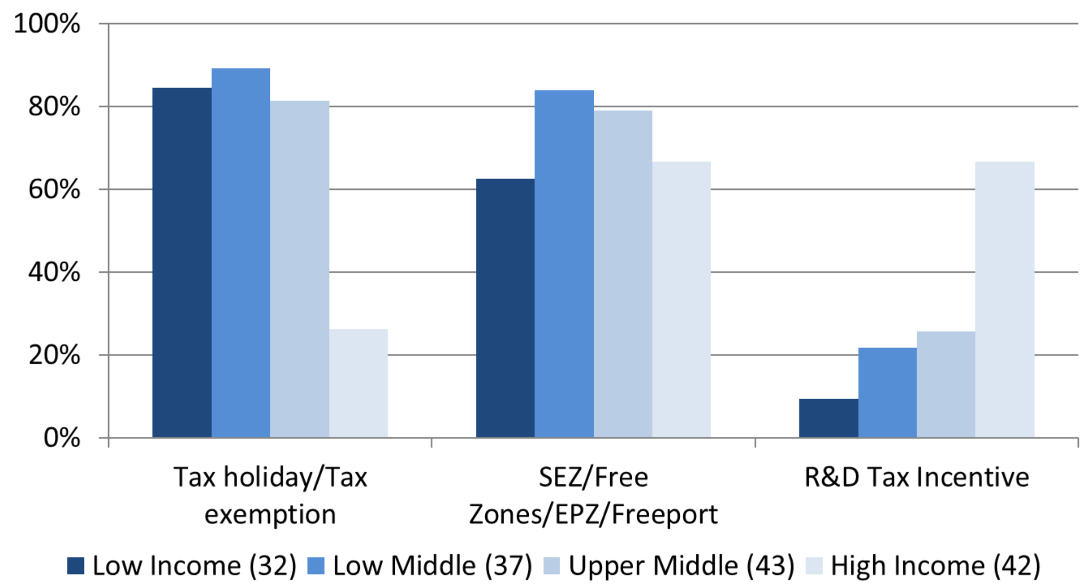
Effects on Investment: Survey evidence



Source: UNIDO (2010)

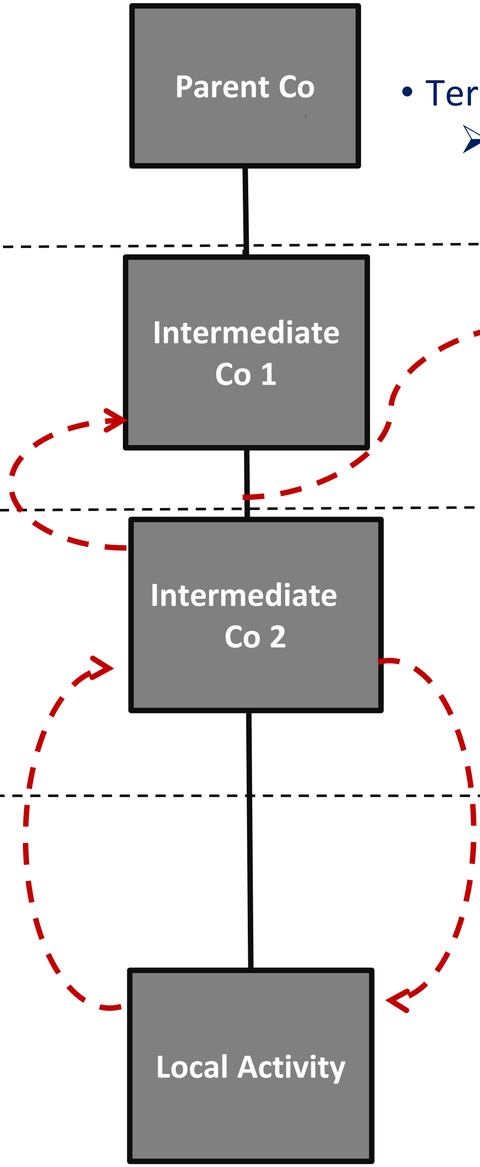
Instrument choice

- Tax incentives that lower the cost of investment are to be preferred over profit-based tax incentives:
  - *Cost-based tax incentives* involve specific allowances linked to investment expenses (e.g., accelerated depreciation schemes, special tax deductions and credits).
  - *Profit-based tax incentives* generally reduce the tax rate applicable to taxable income (e.g., tax holidays, preferential tax rates, income exemptions).



Source: World Bank 2015

Tax incentives/features: Current system



System features/weaknesses

Ultimate Residence Country (High Tax)

- Territorial/participation exemptions
  - Low residence-based taxation or tax deferral (could retain benefit of host country incentive)

Intermediate Country (Low Tax)

- Low tax jurisdictions or territorial/participation exemptions
  - Low tax on dividends and exit gains

Intermediate Country (Low Tax)

- Low tax jurisdictions or preferential regimes
  - High (residual) profits shifted
  - Tax competition

Source/Market Country

- Inefficient and ineffective tax incentives (or low rates)
  - Tax competition (so called “race to bottom”)
  - Tax forgone could be collected in residence country (via CFC rules or on repatriation) – raises issue of tax sparing
- Low routine profits recognized (profit shifting)
- Current system taxes on source/origin basis (ALP - also need PE) not destination basis

Minimum Taxation - Overview

- **Objective:** Ensure MNE's global business income is subject to at least a minimum level of taxation
- **Two approaches:**
  - ***Outbound taxation***: residence country taxes foreign earnings if tax abroad below some minimum level
  - ***Inbound taxation***: source country imposes a minimum tax on resident affiliate's base to combat base eroding payments (e.g. to related parties)
  - Designed to preserve sovereignty on tax rates
- **Attractions:**
  - Reduces profit shifting and mitigates tax competition
  - Backstop to current arrangements/weaknesses; modest need for coordination
  - Developing countries would gain from minimum on inbound; many have already adopted inbound rules to protect tax base
- **Challenges/issues**:
  - Can be blunt and increase distortions; design important
  - At what rate should minimum be set?; at least 15% (per G7 commitment)

Impact of Global Minimum Tax: Pillar 2

Impact

Ultimate Residence Country (High Tax)

Remaining lowly taxed residual profits of Intermediate Co 2 subject to minimum tax for Parent Co (P2)

Parent Co

- Strengthens worldwide taxation (P2); country by country basis

Intermediate Country (Low Tax)

Intermediate Co 1

- Limited impact (P2 preserves IJ holding model)
- Continued need to reinforce source taxation on OITs; 13(4) (PCT toolkit)
- Inversion risk (if becomes non-adopter HQ – avoid P2 on unrelated (and remote related) party profits)

Intermediate Country (Low Tax)

Reallocation of some in scope residual profits to market country (P1)

Intermediate Co 2

- Incentive to raise effective tax rate (to avoid top-up tax elsewhere under P2):
  - Substance-based carve-out preserves some incentives (e.g. over routine profits) (see proposal to eliminate carve-out); cost based incentives preserved (timing)
  - Unwinds benefit over residual profits (e.g. IP regimes)
  - Possible trend toward alternative minimum tax (with same rate and base as P2)

Source/Market Country

Source taxation (UTPR) subordinate to residence country (IIR); however STTR (P2); rule order raises inter-nation equity issues

Portion of residual profit taxed in market jurisdiction (P1)

Local Activity

- Limited impact on tax incentives: over routine profits (P2: substance-based carve-out); cost based incentives (see modifications); for out of scope MNEs (<EUR 750M); design still important (PCT toolkit)
- Disincentive to lower rates below minimum (otherwise top-up tax elsewhere under P2)
- Need to ensure ability to enforce tax rates above minimum (assess impact of priority rules); cf. proposed US SHIELD (+ incentivizes others to adopt)

Pillar 1 (P1): New nexus/profit allocation
Pillar 2 (P2): Global minimum tax

Regional coordination can still help, but is not easy

- Proliferation of tax incentives is a manifestation of international tax competition – global minimum tax helps
- Coordination efforts ongoing in e.g. SADC, EAC, WAEMU, Central America
- But not easy: to be effective, need to…
  - Cover full enough range of instruments
  - Cover wide enough range of countries
  - Have proper supranational enforcement mechanism (e.g. EU State-Aid versus non-binding Code-of-Conduct)
- Cooperation on data/reporting can still be a useful step