Foreign Direct Investment Issues and Corporate Taxation

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The Economic Case for NOT Taxing Foreign Capital

Assume:

- 10% required rate of return.
- No tax.
- Capital moves freely between countries.
- Country A puts tax of 50% on all income derived by non-residents.
- Result – much less investment.

Who are the Winners and Losers?

- Foreign investors in Country A no worse off. Now make 20% pre-tax, 10% post-tax return in Country A. 10% pre- and post-tax elsewhere.
- Workers in Country A are the losers. Less investment resulting in lower wages and/or higher unemployment.
- Capital holders in Country A are the winners. Now get 20% pre-and post-tax return.

Arguments Subject to Important Caveats

- No tax elsewhere in the world – no offset for domestic tax such as foreign tax credits.
- Capital moves freely between countries.
- Economic rents do not exist.

Economic Rents

- Above assumed no economic rents.
- What are economic rents? A rate of return above the required rate of return. In the example a rate of return above 10%.
- Types of economic rents: firm specific and location specific.
- Location specific economic rents the important ones.

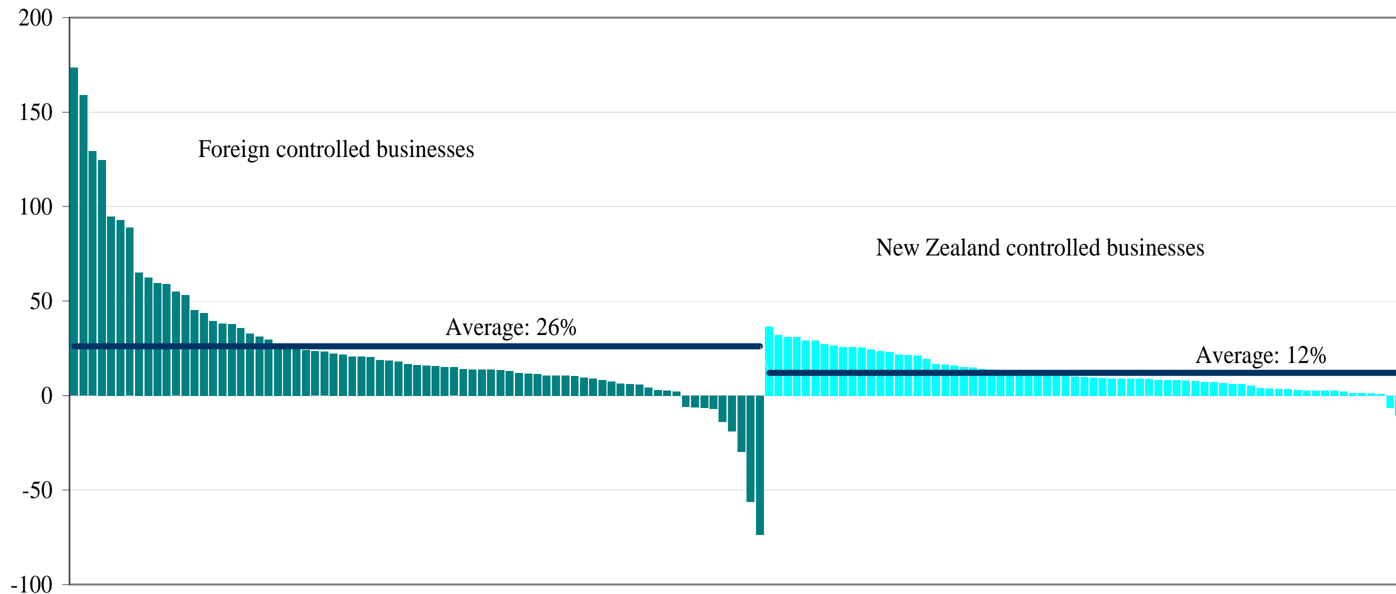
Location Specific Economic Rents

- Rents associated with locating in a specific country.
- Important if a firm must locate in the economy to sell goods or services to that market.
- Can tax these rents and not affect investment.

Do Location Specific Economic Rents Exist?

- Not just high returns – may be capitalised into asset prices.
- Likely to vary from country to country.
- Minerals but also brand names.

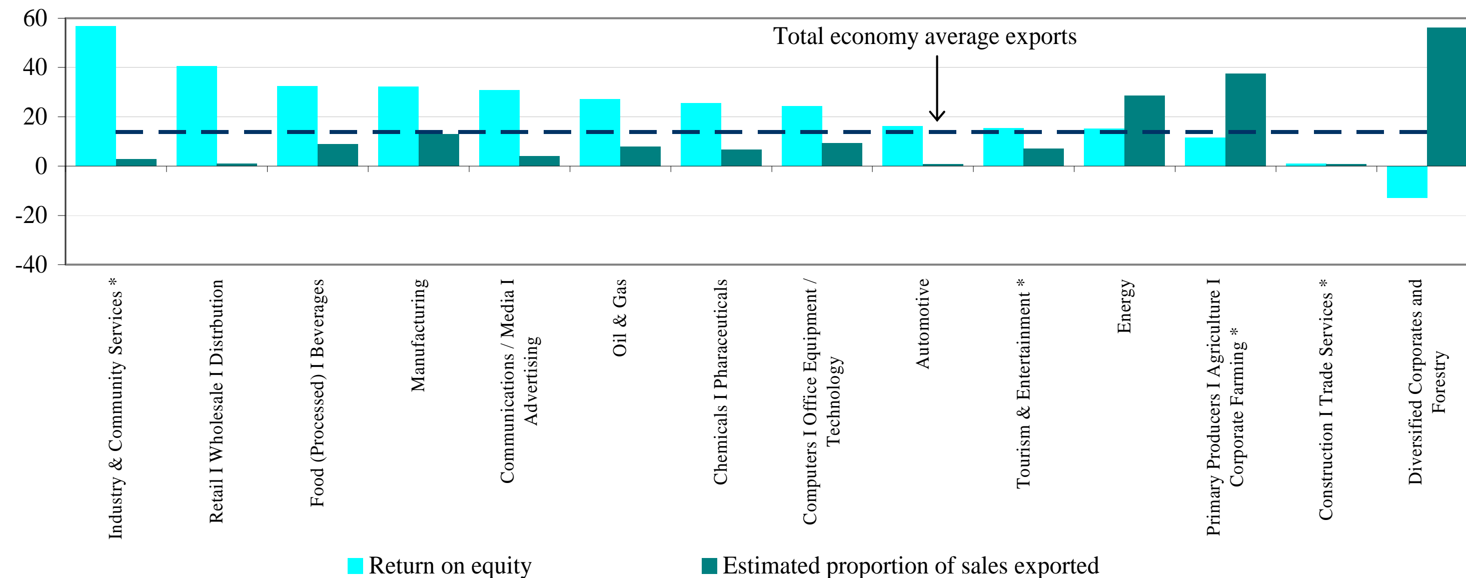
New Zealand After-tax Returns on Equity



The top 200 businesses are identified as follows. Each year the NZ Management magazine writes to 1000 of New Zealand's top businesses to collect annual reports, which are reviewed in a process overseen by Deloitte.
Return on total equity is calculated by profit after-tax divided by average total equity over the past two years.

Source: NZ Management and Inland Revenue

Foreign-controlled Businesses Operating in New Zealand



Businesses with at least five years of data are included.
The proportion of sales exported is measured by the average zero GST rated sales to total sales for 2007 to 2009.
* The industry average is reported due to data confidentiality. It is measured by exports as a proportion of gross output using 2005/06 input-output data from http://www.motu.org.nz/files/datasets/IO2005-06.xls.

Source: NZ Management, Inland Revenue and Motu Economic and Public Policy Research

Relevance

- Company tax rate – lowering this loses tax on location specific economic rents.
- Articles 5 and 7 – PEs.
- Article 6 – Immovable property.
- Article 9 – Associated persons and transfer pricing. Who gets allocated income under the arm's length principle?
- Article 10 – Dividends.

Relevance *(continued)*

- Article 11 – Interest. Generally will not include economic rents.
- Article 12 – Royalties. Stripping out economic rents.