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TAX INCENTIVES: PROTECTING THE TAX BASE

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Overview of Presentation

- Introduction to tax incentives
- Benefits and costs of tax incentives
- Political economy of tax incentives
- Design and administrative considerations
- Influence of tax systems in developed countries on the desirability and effectives of tax incentives in developing countries
- How does the BEPS project change the tax environment for tax incentives?

3

Introduction to Tax Incentives

- What are tax incentives?
- What role should government play in encouraging investment?
- What are the benefits and costs of using tax incentives?
- What factors influence decisions where to invest?
- What has changed in desirability of tax incentives?

4

Definition of Tax Incentives

- "Revenue losses attributable to provisions of the Federal tax laws which allow special exclusion, exemption or deduction from gross income or which provide special credit, preferential rates of tax or a deferral of tax liability" (Congressional Budget Act of 1974).

- "an exemption or relief which is not part of the essential structure of the tax in question but has been introduced into the tax code for some extraneous reason…"

Prevalence of Tax Incentives around the World (James 2013)

	Number of Countries Surveyed	Tax holiday/Tax exemption	Reduced Tax rate	Investment allowance/Tax credit	VAT exemption /reduction	R&D Tax Incentive	Super-deductions	SEZ/Free Zones/EPZ/Free port	Discretionary process
East Asia and Pacific	12	92%	92%	75%	75%	83%	8%	83%	25%
Eastern Europe and Central Asia	16	75%	31%	19%	94%	31%	0%	94%	38%
Latin America and the Caribbean	24	75%	29%	46%	58%	13%	4%	75%	29%
Middle-East and North Africa	15	73%	40%	13%	60%	0%	0%	80%	27%
OECD	33	21%	30%	61%	79%	76%	18%	67%	27%
South Asia	7	100%	43%	71%	100%	29%	57%	71%	14%
Sub-Saharan Africa	30	60%	63%	73%	73%	10%	23%	57%	47%

Country	Response	What types of tax incentives does your country use or has used in the past?													
		1.1 a Tax Holidays [Currently Used]	1.1b Tax Holidays [Used in the past]	1.1c Reduced Tax Rates [Currently Used]	1.1d Reduced Tax Rates [Used in the past]	1.1e Investment Allowances [Currently Used]	1.1f Investment Allowances [Used in the past]	1.1g VAT Exemptions/reductions [Currently Used]	1.1h VAT Exemptions/reductions [Used in the past]	1.1i Research and Development Tax Incentives [Currently Used]	1.1j Research and Development Tax Incentives [Used in the past]	1.1k Special Economic Zones [Currently Used]	1.1l Special Economic Zones [Used in the past]	1.1m Payroll Tax Holidays [Currently Used]	1.1n Payroll Tax Holidays [Used in the past]
Brasil	1	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	No	No
Dominican Republic	2	Yes	No	Yes	No	Yes	No	Yes	No	No	No	Yes	No	No	Yes
Ghana	1	Yes	No	Yes	No	No	No	Yes	No	Yes	No	Yes	No	No	No
Guatemala	1	Yes	Yes	No	No	Yes	Yes	Yes	Yes	No	No	Yes	Yes	No	No
Indonesia	1	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No
Lesotho	1	No	Yes	Yes	No	Yes	No	No	No	Yes	No	Yes	No	No	No
Mexico	2	No	No	Yes	Yes	Yes	Yes	No	No	No	No	No	No	Yes	Yes
Peru	1	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
Philipines	1	Yes	No	Yes	No	No	Yes	No	No	Yes	No	Yes	No	No	No
Swaziland	1	No	Yes	Yes	No	Yes	No	Yes	No	No	No	No	No	No	No
Tanzania	1	Yes	Yes	Yes	No	Yes	Yes	Yes	No	Yes	No	Yes	No	No	Yes
Uruguay	1	Yes	No	No	No	Yes	No	Yes	No	Yes	No	Yes	No	No	No
Zambia	1	Yes	Yes	Yes	No	Yes	No	Yes	No	Yes	No	Yes	Yes	No	No

Benefits of Tax Incentives

- If properly designed and implemented, tax incentives can be a useful tool in attracting investments that would not have been made without tax benefits

- By increasing investment by reducing the after-tax cost of investment, countries may realize
  - Increased capital transfers
  - Transfers of know-how and technology
  - Increased employment and improved workforce
  - Assistance in improving conditions in less-developed areas

- Spillover effects
  - Increased economic activity from related suppliers and consumers
  - Increased tax revenue from investor (after tax incentives have expired) or from employees, suppliers and consumers

8

More purported benefits

- Symbolic
  - Signal foreign investors that country is an "investor-friendly" location
- Compensate for inadequate tax systems
  - High rates
  - Inadequate net operating loss and depreciation provisions
- Compensate for other externalities
  - Bad infrastructure
  - Inadequate dispute resolution procedures, etc.

9

Costs of Tax Incentives

- Erosion of tax base
  - Investments that would have taken place even without tax incentives
  - Investors exploiting tax incentives to other activities or other types of income (abuses and leakages)
- Efficiency and welfare costs
  - Shifting of tax burden to immobile tax bases (labor)
  - Distortion of resource allocation
- Complexity
- Undermine tax system—increase tax burden on non-qualifying activities
- Lobbying and unproductive rent seeking activities
- Compliance considerations
- Equity --disadvantage other investors
- Discretionary practices create opportunities for corruption
- Tax degradation (race to the bottom)

10

Estimates of Direct Costs of Tax Incentives

- Tax expenditure budgeting
- Methodology for estimating the costs of a particular tax incentive program
  - Determine the number of taxpayers covered by the program
  - Estimate the revenue, compliance and enforcement costs
    - Information and data requirement
    - “Packages” of behavioral assumptions

11

What Has Changed in Recent Years?

- Although tax incentives may have been ineffective in the past, this may no longer be true
  - Tax incentives may be more generous than in past years
  - Tax incentives may be better targeted and better designed
  - Substantial trade liberalization and greater capital mobility
    - As non-tax barriers decrease, the significance of taxes in investment decisions increase
  - Businesses have changed
    - Changes in organizational structure, production and distribution methods, and types of products being manufactured and sold
  - Growth in common markets, custom unions and free-trade areas

12

Political Economy of Tax Incentives

- Why do countries continue to use tax incentives in light of the mostly negative economic evidence of their effectiveness?
  - “This time is different”
  - Politicians need to do something to improve economic growth—tax incentives are relatively easy to adopt and costs are less transparent
  - Capture theories
    - Outside capture (economic elite seeking to minimize tax liability)
    - Inside capture (government agencies seeking to maximize the level of new investments without major concern for tax revenue)

Political Economy – Unanswered empirical question

- Do countries with “better” institutions have better results on either not adopting tax incentives or designing them in a way that improves effectiveness?
  - Greater transparency (necessary, not sufficient)
  - Better decision-making structure on designing and granting tax incentives
  - Better ability to estimate the costs and benefits of tax incentives
  - Better ability to monitor for abuses of tax incentive regimes

Design Considerations for Tax Incentives

- Eligibility criteria
- Process for qualification
- Scope of benefits
- Reporting and monitoring requirements
- Recapture provisions
- Review and sunset provisions

15

Administrative Considerations

- Which agency makes decisions?
  - Development authority vs. tax authority
- Criteria for qualification
  - Subjective vs. objective tests for qualification
- Monitoring continued compliance (which agency?)
  - Filing requirements
  - Auditing requirements
- Penalty provisions for non-compliance and abuse
- Sunset provisions and recapture of tax benefits

16

Benefits and Cost of Targeting Tax Incentives

- Benefits
  - concentrate resources on most desirable investments (reduce costs)
  - restrict incentives to those investments most likely to be influenced
- Costs
  - administrative burden
  - possibility of corruption
  - poor record of governments in “picking winners”

17

Objectives of Tax Incentives

- Possible objectives:
  - Stimulate domestic investment
  - Stimulate foreign investment
  - New vs. old investors
  - Large investors
  - Reduce unemployment
  - Technology transfer
  - Export promotion
  - Promote specific economic sectors
  - Address regional development needs – locational incentives

18

Different Types of Investors

- In designing tax incentives, important to think about different types of investors and their potential responses
  - Foreign vs. domestic
  - Reasons for investing in your country
  - Size and “mobility" of investment
  - Type of investment (mining, manufacturing, distribution and services)
  - New or incremental investment
  - Investment horizon

Tesla “Gigafactory”– the Process

- Announce plans to build facilities to manufacture “affordable” lithium-ion” batteries at a cost of $5 billion and 6,200 jobs
- Invite economic development officials from 7 states to visit the Tesla factory
- Give states 3 weeks to put together a proposal as to what incentives they would provide (tax breaks, free land, infrastructure improvements, and cash) and to complete responses to questionnaire (90 questions)
- Tesla selected four states as “Gigafactory Location Finalists”

Tesla "Gigafactory" – the Winning Bid

- Nevada offers a total package of $1.4 billion
  - Free land, electricity discounts, and infrastructure improvements ($113 million)
  - Tax incentives
    - Sales tax abatement on equipment and construction material ($725 billion)
    - Property tax abatement ($350 million)
    - Payroll tax abatement ($30 million)
  - Transferable tax credits that Tesla could sell to other companies ($195 million)

21

Largest US State Tax Incentives

1. Washington: Boeing $8.7 billion
2. New York: Alcoa $5.6 billion
3. Washington: Boeing $3.2 billion
4. Oregon: Nike $2 billion
5. New Mexico: Intel $2 billion
6. Louisiana: Cheniere Energy $1.7 billion
7. Pennsylvania: Royal Dutch Shell $1.65 billion
8. Missouri: Cemer Corp. $1.64 billion
9. Mississippi: Nissan $1.25 billion

22

Specific Design Considerations (Tax holidays)

- Determination of start date
- Scope of holiday—from which taxes
- Filing and reporting requirements
- Termination and recapture provisions
- Interaction with depreciation provisions
- Interaction with net operating loss provisions

23

Determination of Start Date

- Alternatives
  - Date application approved
  - Date activity begins
  - Date “open for business” or “begin production”
  - Date operations are profitable (current tax period)
  - Date operations are profitable (cumulative basis)

24

Scope of Holiday

- Eligible taxes
  - Federal income taxes
  - Local or provincial taxes
  - Trade taxes (import duties and export taxes)
  - VAT (exemption or preferential treatment)
  - Employment taxes

25

Filing & Reporting Requirements

- Reporting requirements
  - Specialized tax forms for firms operating under tax holidays
- Type of information required
  - Investment information (to monitor compliance with conditions of holidays)
  - Earning information (to allow estimation of costs of tax holiday provisions)
  - Related party transactions (to assist in identifying certain “abusive” transactions)

26

Interaction with Depreciation Provisions

- Do tax holiday provisions or regulations:
  - Specify depreciation treatment during holiday period
  - Specify method of depreciation or “minimum” amount of depreciation
  - Allow for depreciation of property acquired during holiday period after holiday period is over
  - Provide for recapture of depreciation upon disposition of property

27

Interaction with Net Operating Loss Provisions

- Do tax holiday provision or regulations:
  - Allow taxpayers to carry forward NOLs earner during the holiday period to subsequent periods?
  - Specify how to determine amount of NOLs available for carry forward (how treat profits previously exempted?)

28

Tax Credit Accounts

- Description—grant investors a set amount of tax credits and provide accounting for determining remaining balance in an account (Tanzi & Zee)
- Advantages
  - Compared to tax holidays—easier to target, easier to control and costs are more transparent
  - Requires tax return—allows for better auditing on use of tax credit
- Disadvantages
  - Distort towards short-term investments
  - Same transfer-pricing concerns as tax holidays

29

Transparency

- Legal and regulatory dimension
  - Explicit rationale for granting tax incentives
  - Incentives be part of tax law and not part of informal decrees or executive orders
  - Sunset provisions
- Economic dimension
  - Determine effective tax burden and "relief" provided by tax incentives
  - Tax expenditure analysis—estimate revenue costs
  - Periodic review of effectiveness of tax incentive programs
- Administrative dimension
  - Qualifying criteria that are clear and objective
  - Automatic vs. discretionary entitlement
  - Reporting and filing requirements

30

Top 10 Abuses of Tax Incentive Regimes

1. Existing firms transform to new entities to qualify for incentives.
2. Domestic firms restructure as foreign investors.
3. Transfer pricing schemes with related entities (sales, services, loans, royalties, management contracts).
4. Churning or fictitious investments (lack of recapture rules).
5. Schemes to accelerate income (or defer deductions) at the end of a tax holiday period.
6. Overvaluation of assets for depreciation, tax credit, or other purposes.
7. Employment and training credits -- fictitious employees and phony training programs.
8. Export zones – leakages into domestic economy.
9. Regional investment incentives and Enterprise zones – divert activities to outside the region or zone.
10. Disguise or bury non-qualifying activities into qualifying activities.

31

Summary Principles to Design and Implement Tax Incentives (Bird 2008)

- Keep them simple
- Keep records
- Evaluate the results

32

OECD Draft Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries

1. Make public a statement of all tax incentives for investments and their objectives within the governing framework.
2. Provide tax incentives for investment through tax laws only.
3. Consolidate all tax incentives for investment under the authority of one government body, where possible.
4. Ensure tax incentives for investments are ratified through the lawmaking body or parliament.
5. Administer tax incentives for investment in a transparent manner

33

OECD Draft Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries

6. Calculate the amount of revenue forgone attributable to tax incentives for investment and publicly release a statement of tax expenditures.
7. Carry out periodic review of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives.
8. Highlight the largest beneficiaries of tax incentives for investment by specific provision in a regular statement of tax expenditures, where possible.
9. Collect data systematically to underpin the statement of tax expenditures for investment and to monitor the overall effects and effectiveness of individual tax incentives.
10. Enhanced regional cooperation to avoid harmful tax competition.

34

Tax Incentive Review Project

1. Compile list of existing tax incentives in your country;
2. Review process of designing and granting tax incentives among different government agencies;
3. Review any reporting requirements for taxpayers receiving tax incentives, examine current efforts to monitor compliance, and review penalties for non-compliance;
4. Review past and current efforts to evaluate effectiveness of tax incentives;
5. Develop methodology for evaluating the effectiveness of existing tax incentives; and
6. Develop methodology for evaluating the costs and benefits of new tax incentives.

35

Impact of Other Countries' Tax Regimes on Effectiveness of Tax Incentives

- Globalization and increased mobility of capital and labor, countries no longer able to design tax rules in isolation
  - Need to consider tax regimes of countries of foreign investors (tax sparing arrangements)
  - Need to consider the tax regimes of other countries in the region
    - As potential investors
    - As competitors for foreign investment
    - As potential customers (particularly trade taxes)

36

Revenue Transfer from Developing Countries to Developed Countries

- Simple model: foreign investor invest directly in a developing country either through a branch or through a foreign subsidiary that immediately repatriates any profits
- Tax regime of country of foreign investor
  - Foreign investor is taxed on their world-wide income
  - Foreign investor is allowed a credit for foreign income tax paid
- Foreign investor's aggregate tax liability unchanged
  - Little or no tax in developing country but increased tax in home country
  - Tax incentives merely transfers tax revenues from poor countries to rich countries (UNCTAD 2000)

37

Revenue Transfer Argument Likely Overstated

- Many developed countries tax residents under a "territorial" approach
- Other tax systems provide for no "current taxation" of income from foreign operations until income is repatriated
- Multinational corporations can structure activities to minimize tax liability
  - Use of offshore entities
  - Transfer pricing arrangements

38

Continuum of Types of International Tax Regimes

Full exclusion of active and passive foreign source income

Full exclusion of active income

Taxation of income that is not taxed at a sufficient rate

Territorial tax systems---------------------------World-wide tax systems

Provisions that facilitate base erosions and profit shifting

Deferral of active business income (but not passive income)

Full inclusion (no deferral on aggregate basis)

39

United States Tax Regime

- **General rule**: US taxes US multinationals on world-wide income
- **Exception**: No tax on active income of foreign subsidiaries until repatriated
- **More complex model:**
  - Structure investment in developing countries through other countries (a large percentage of foreign investment in Africa goes through Mauritius, Netherlands Antilles, or Switzerland)
  - Little repatriation of funds from investments in either developed or developing countries (about $2 trillion in un-repatriated profits)
  - Blending of low-tax active income from developing countries with high-tax income from other countries

40

Possible Tax Reform in US May Influence the Economic Benefits of Tax Incentives to Investors

- Several proposals in the US eliminate deferral of active income of foreign subsidiaries and impose a “minimum” tax on foreign source income
- Politically “optimal” tax rate on foreign source income somewhere between zero and the regular corporate rate
- These changes may result in some of the benefits from tax incentives accruing to foreign governments rather than foreign investors

41

Possible Consequences of BEPS Project on Relative Tax Burdens

- Change relative tax burdens in countries for activities that qualify for tax incentives and those that do not.
- Change relative tax burdens in doing business in developed and developing countries
- Provide additional tools to tax authorities in developing countries to better enforce their tax laws
  - “best practices” for limiting base erosion and profit shifting
  - increasing the quality (and hopefully, not just the quantity) of information available to tax authorities

42