

Lessons of Regional Harmonization of Tax System

&

Tax Incentives and WTO rules



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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

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 ?

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)

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

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

■ 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 holds 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

■ **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

■ **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

■ 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

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

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.

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

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 for 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.

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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