Tax, Law and Development

Edited by

Yariv Brauner
Miranda Stewart

Miranda Stewart dedicates this book to her brother, Thomas Alexander Stewart, who always strived for creative solutions.

Yariv Brauner dedicates this book to his parents, Judith and Isaac Brauner, who always seek fairness.

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Edited by

Yariv Brauner

University of Florida, Levin College of Law, USA

Miranda Stewart

University of Melbourne Law School, Australia

Edward Elgar

Cheltenham, UK • Northampton, MA, USA

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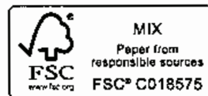
Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2012946671

This book is available electronically in the ElgarOnline.com Law Subject Collection, E-ISBN 978 0 85793 002 6



ISBN 978 0 85793 001 9

Typeset by Columns Design XML Ltd, Reading
Printed and bound by MPG Books Group, UK

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Contributors

Yariv Brauner, Professor of Law, University of Florida, Levin College of Law

Allison Christians, H. Heward Stikeman Chair in Tax Law, McGill University Faculty of Law

Tsilly Dagan, Professor of Law, Bar Ilan University School of Law

Ana Paula Dourado, Professor of Tax Law, Faculty of Law, University of Lisbon

Tracy Gutuza, Senior Lecturer, University of Cape Town

Anthony C. Infanti, Professor of Law and Associate Dean for Academic Affairs, University of Pittsburgh, School of Law

Charlene D. Luke, Associate Professor of Law, University of Florida, Levin College of Law

Lisa Philipps, Professor, Osgoode Hall Law School and Associate Vice-President Research, York University

Pasquale Pistone, Ad Personam Jean-Monnet Chair in European Tax Law and Policy, Vienna University of Economics and Business, and Associate Professor, University of Salerno

Luís Eduardo Schoueri, Professor of Tax Law, University of São Paulo

Miranda Stewart, Professor of Law, University of Melbourne Law School

Wei Cui, Professor of Law, China University of Political Science and Law

Foreword

Stephen E. Shay*

The chapters in this volume examine a series of topics relating to the intersection of tax, law and development. The topics examine, among other matters, the relation of tax incentives in developing countries to tax competition, international tax relations, regional integration and traditional tax policy paradigms; tax expenditure reporting and fiscal federalism in emerging economy contexts; a broader and people-focused conception of tax equity; the expanding institutional role of NGOs in tax policy discussions; and how expanding international tax cooperation can benefit developing countries. The issues considered expand the limited scope of legal academy discussions of tax, law and development[1] and challenge us to adopt a more inclusive approach to thinking about how tax systems can be made more effective to improve the lives of global citizens who live in developing countries.[2]

The timeliness of this work is evidenced by the increasing recognition of 'revenue mobilization' as an important factor in sustainable development. At the turn of this century, the nations of the world adopted Millennium Development Goals (MDGs), including trying to eradicate

* Professor of Practice, Harvard Law School

[1] Prior contributions are cited in the chapters in this volume.

[2] The 2012 World Bank update on poverty in the developing world reports that in 2008 1.29 billion people lived on less than US$1.25 a day and 2.47 billion people lived on less than US$2.00 a day (in 2005 prices). World Bank Development Research Group Briefing Note, 'An update to the World Bank's estimates of consumption poverty in the developing world', at http://siteresources.worldbank.org/INTPOVCALNET/Resources/Global_Poverty_Update_2012_02-29-12.pdf (last accessed 9 July 2012). Anthony Infanti's Chapter 9 reminds us that per capita income is not the only measure of human wellbeing, and points us to other measures that achieve a more people-centered policy focus. Anthony Infanti, *Internation Equity and Human Development*, at p 209 in this volume.

poverty and achieve sustainable and inclusive growth and development.[3] In 2002 representatives from 109 countries assembled under UN auspices in Monterrey, Mexico, to address the challenges of financing achievement of the MDGs adopted just two years before. Acknowledging that there would be a dramatic shortfall in resources required to achieve MDGs, the resulting Monterrey Consensus set out a multi-part plan to address the resource needs, including mobilizing domestic financial resources for development.[4]

Not incidentally, in the face of post-9/11 market declines, Monterrey had the effect of placing a greater burden of meeting MDGs on developing countries. In general terms, it was anticipated that developing countries would have to increase their revenue performance (measured by tax–GDP ratio) by as much as 4 percent of GDP to be able to achieve MDGs.[5] More recently, the United Nations has set an objective that countries mobilize 20 percent of their GDP in tax revenues in order to achieve the MDGs.[6]

The 2008 global financial crisis and associated recession significantly reduced donor country resources for development aid. In its 2010 Seoul, South Korea meeting, the G-20 leaders added a revenue mobilization work stream to the agenda of the G-20 Development Working Group and tasked the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), the United Nations and the World Bank with collaborating on a project plan that would identify actions supporting more effective tax systems in developing countries.

The resulting joint report included recommendations on: key capacity constraints faced by developing countries in their tax systems; helping tax multinational enterprises (MNEs) through effective transfer pricing rules; establishing measures to track progress in tax administrations'

[3] Millennium Declaration, General Assembly Resolution 55/2 (18 September 2000). The Monterrey Consensus formulation in 2002 states: 'Our goal is to eradicate poverty, achieve sustained economic growth and promote sustainable development as we advance to a fully inclusive and equitable global economic system.' United Nations, *Report of the International Conference on Financing for Development*, A/CONF.198/11, para.1.

[4] *Ibid.* paras 4, 15.

[5] United Nations, *Investing in Development* (New York: United Nations, 2005) 245. The IMF has pared back expectations to a more realistic objective of increasing revenue mobilization by a range of 2 to 4 percent of GDP. IMF Fiscal Affairs Dept, *Revenue Mobilization in Developing Countries* (8 March 2011).

[6] United Nations, *What Will It Take to Achieve the Millennium Development Goals? An International Assessment* (UNDP, June 2010) 26.

capacity improvements; and developing a knowledge management platform to support tax capacity of developing countries.[7] The topics and recommendations in the joint report to the G-20 Development Working Group did not address the impact of developed country tax policies on developing countries' revenue mobilization, such as fostering internation tax competition, continuing residence country revenue bias in international tax treaties and tolerating tax avoidance by MNEs.[8] The developed economies have remained steadfast in supporting national tax sovereignty and maintaining residence country treaty benefits for foreign direct investment (FDI).

The contribution of tax competition between developed countries to developed countries' fiscal shortfalls through erosion of business income taxes has not been fully acknowledged.[9] The pattern in recent years has been for developed countries to support their local champion MNEs by matching other countries' tax incentive mechanisms and shifting the cost to domestic taxpayers. Prime examples are the recent actions of the United Kingdom and Japan to finance lower corporate tax rates in material part with increases in consumption taxes.

Internation corporate tax competition reduces fiscal flexibility to an even greater extent in developing than in developed countries as the corporate tax remains an important component of developing country tax

[7] *Supporting the Development of More Effective Tax Systems: A Report by the IMF, OECD, UN and World Bank to the G-20 Development Working Group* (2011), available at www.imf.org/external/np/g20/pdf/110311.pdf (last accessed 9 July 2012).

[8] One sentence in the Report hinted tantalizingly at the issues that plague developed and developing countries alike: 'Perhaps most fundamentally, one theme is that pressures on revenue from trade liberalisation, regional integration and tax competition mean that, *absent greater international policy coordination*, the search for additional revenue will likely focus on relatively immobile bases – most obviously labour, consumption, and real estate' (emphasis in original). *Supporting the Development of More Effective Tax Systems: A Report by the IMF, OECD, UN and World Bank to the G-20 Development Working Group*, *supra* note 7, at 18.

[9] The US Treasury, however, has reported evidence of substantial income shifting to lower tax countries, including evidence from company tax data of operating margin increases correlated inversely with effective tax rates. Testimony of Stephen E. Shay, Deputy Assistant Secretary International Tax Affairs, US Department of Treasury, House Ways and Means Committee, Hearing on Transfer Pricing Issues (22 July 2010), http://democrats.waysandmeans.house.gov/media/pdf/111/2010Jul22_Shay_Testimony.pdf (last accessed 9 July 2012).

revenue. In this volume, Yariv Brauner addresses the pressure on developing countries to provide tax incentives to attract FDI, questioning the benefit of tax incentives for development and growth. He tellingly identifies the linkage of incentives to tax competition.[10] Lisa Phillips examines the use of tax expenditure analysis by India to examine the efficiency of incentives.[11] The chapters in this volume do not prescribe one answer for developing countries, but encourage examination of individual context and circumstances. Developed economies do not provide an unblemished model and their prescriptions require scrutiny.

Notwithstanding the new emphasis on revenue mobilization, there has been little change in the longstanding approach of bilateral income tax treaties, including the United Nations model convention, to require sacrifice of source country taxation in favor of the residence country. There is an important need for rethinking as to whether these treaties make sense for lower- and lower-middle income developing countries.[12] Evidence on whether bilateral tax treaties increase FDI in developing countries is mixed, but an important question for future research is whether treaties in their current form justify the revenue loss.[13] The argument that a double tax treaty provides an important signal to investors that the rule of law and tax system stability will be observed may be addressed by alternative measures that do not sacrifice tax revenue to the same extent. It might be possible, for example, to fashion

[10] See Yariv Brauner, Chapter 2.

[11] See Lisa Philipps, Chapter 8.

[12] The World Bank divides countries into low income, US$995 or less; lower middle income, US$996–3,945; upper middle income, US$3,946–12,195; and high income, $12,196 or more (using 2009 gross national income (GNI) per capita). See *Supporting the Development of More Effective Tax Systems: A Report by the IMF, OECD, UN and World Bank to the G-20 Development Working Group* (2011) 52, available at www.imf.org/external/np/g20/pdf/110311.pdf (last accessed 9 July 2012).

[13] See literature summary in Fabian Barthel, Matthias Busse and Eric Neumayer, 'The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence from Large Dyadic Panel Data' (2010) 28 *Contemporary Economic Policy* 366. From a revenue perspective, it does not make sense for a capital importing developing country to enter into a treaty with a low-tax country that is a mere conduit for investment by a treaty shopping intermediary. As a more subtle example, Tracey Gutuza's Chapter 4 on the South African adoption of a headquarters regime, which is principally a vehicle for treaty shopping using the South African treaty network, poses similar issues. It is questionable whether a headquarters company described in the chapter should be allowed treaty benefits by South Africa's treaty partners.

treaties limited to arm's length transfer pricing, mutual agreement and information exchange provisions.

Developed countries also have turned a blind eye to the publicly reported activities of their own MNEs that use tax havens and low tax treaty countries to strip income from the home country and other taxing countries and thereby earn 'homeless income' (or 'stateless income').[14] The difficulties developed countries have protecting their tax bases are multiplied for developing countries with limited tax administration resources. Revenue mobilization should include work on anti-abuse approaches that can be implemented by developing countries as well as ideas for coordinating tax policies among developed and developing countries to combat homeless income. Transfer pricing is an important cross-border tax issue, but a corporate income tax system should be structured to limit its reliance on transfer pricing to protect its revenue base. The current approaches to transfer pricing are not sufficiently robust to protect a revenue base against the incentives of material rate differentials.

An effective tax system is critical for development. The developed countries, and increasingly the emerging economies as well, are conflicted in assisting developing countries because addressing many of the issues in developing countries' revenue mobilization will result in taxation of local champion MNEs or state-owned enterprises. Not surprisingly, in light of its membership, the G-20 does not probe the linkage between developed countries' tax policies allowing tax competition and their impact on developing countries' ability to mobilize revenue.

There is an important need for independent academic scholarship like that in this volume that takes into account the differing perspectives of developing countries and does not look for 'one size fits all' theories or prescriptions. As Richard Bird has observed:

> What this complex and changing world needs is not some non-existent 'universal fix' but rather a sort of fiscal medicine kit containing a variety of remedies and treatments that may help us cope with the wide variety of fiscal problems and needs that arise at different times and often in different ways in different developing countries.[15]

[14] See, e.g., Bret Wells and Cym Lowell, 'Tax Base Erosion and Homeless Income: Collection at Source is the Lynchpin' (forthcoming in *Tax Law Review*); Edward D. Kleinbard, 'Stateless Income' (2011) 11 *Fla. Law Rev.* 699.

[15] Richard M. Bird, *Taxation and Development: What Have We Learned from Fifty Years of Research?*, International Center for Public Policy Working Paper 12-02 (January 2012), available at http://ideas.repec.org/p/ays/ispwps/paper1202.html (last accessed 16 July 2012).

The diverse group of legal scholars from six continents who have contributed to this volume critically address issues from perspectives not restricted to traditional tax policy conceptions and paradigms. As a result, this volume is rich with insights on new and old issues at the intersection of tax, law and development.

Acknowledgements

We acknowledge the support and financial contribution of the Law School, University of Melbourne, and the Graduate Tax Program at the Levin College of Law, University of Florida. We thank the Faculty of Law at the University of Lisbon, and particularly Prof. Ana Paula Dourado for hosting the Lisbon Workshop in 2011 and Alan Sturmer and the staff at Edward Elgar for their assistance and support. Finally, we thank the late Paul McDaniel for his enthusiasm for this project from the beginning. This has been a project that we have wanted to achieve for some time and Paul's support and active mentorship of each of the editors enabled this to happen. We would like to thank Ruth Ron for her original design featured on the cover. Finally, we would like to thank research assistant Livia Gonzaga for her contribution and preparation of the bibliography.

Abbreviations

BRICS	Brazil, Russia, India, China and South Africa
CBCR	country-by-country reporting
CFC	controlled foreign company
DTA	Double Taxation Agreement
ECJ	European Court of Justice
EITI	Extractive Industries Transparency Initiative
FDI	foreign direct investment
FRBM	Fiscal Responsibility and Budget Management Act (India)
FTA	Free Trade Agreement
GDP	gross domestic product
GII	Gender Inequality Index
HDI	Human Development Index
IBP	International Budget Project
LATC	Law on the Administration of Tax Collection (China)
LOB	limitation on benefits
MCRS	management contract responsibility system
MDG	Millennium Development Goal
MNE	multinational enterprise
NEPAD	New Partnership for Africa's Development
NGO	non-governmental organization

5. Tax sparing: a reconsideration of the reconsideration

Luís Eduardo Schoueri

I. INTRODUCTION

Tax sparing has traditionally been included in the debate concerning tax and development. Such a traditional approach derives from ideas based on the existence of an 'international tax law of development' providing for the rules for the 'proper solidarity between developed and less developed states'.[1]

In such context, it is not surprising that when, on 23 October 1997, the OECD Council approved a report issued by the Committee on Fiscal Affairs on 'Tax Sparing: A Reconsideration'[2] ('OECD Report'), the aim was to reflect member countries' more reluctant position vis-à-vis the adoption of tax sparing.

The purpose of this chapter is to examine the main issues presented in the OECD Report, in order to investigate whether the arguments presented therein can be deemed to be strong enough to convince countries to reject negotiating tax treaties with tax sparing clauses.

After having defined 'tax sparing' and 'matching credit' (in section II), this chapter reviews the main arguments presented in the OECD Report and offers some reasons to show their lack of consistency (section III). Finally, the idea itself that tax sparing and matching credit are mechanisms appropriate only to tax treaties between developed and developing countries will be challenged, since the author argues that there are good reasons for applying these mechanisms in all tax treaties, under the assumption that each contracting state should respect the other contracting state's sovereign decision as to how to exercise their tax policy

[1] See Manuel Pires, *Da dupla tributação jurídica internacional sobre o rendimento* (Lisbon: Centro de Estudos Fiscais, 1984) 517–18.

[2] OECD, *Tax Sparing. A Reconsideration* (Paris: OECD, 1998).

(section IV). This chapter concludes that the OECD tax sparing (re)consideration has taken a paternalistic approach (assuming that tax sparing is only a subsidy from developed countries to developing countries), which leads to a misleading focus by the OECD on whether this mechanism is effective to assist developing countries. Rather, the author argues that tax sparing should be seen as an element of treaty negotiation that aims to respect each contracting state's tax policies and it is on this basis that its adoption should be encouraged.

II. TAX SPARING AND MATCHING CREDIT

The debate between the two basic international tax principles of territoriality and worldwide taxation is a never-ending debate. In tax matters, territoriality may be understood, in general terms, as the principle whereby a state is only allowed to tax facts that have a nexus with its territory, i.e., income arising from sources located within its territory ('pure territoriality'). To the contrary, by adopting the worldwide taxation principle, a state may tax the income derived from both internal and foreign sources. There are certainly several arguments on both sides.[3] Some authors suggest that there is a general consensus for the latter, at least in respect of passive income, in a so-called 'international tax regime'.[4] However, the mere fact that no country is prepared to exempt non-residents from source taxation shows that a complete consensus, and a definitive and uniform solution for double taxation, is not to be found in the near future. Unilateral and bilateral measures to avoid this phenomenon will continue to be the focus of international tax lawyers.

In respect of a territorial approach, although several countries are prepared to exempt some foreign business income (for example, adoption of a participation exemption seems to be a trend in developed countries, at least in Europe), this does not mean that territoriality has been recognized. On the contrary: even European countries will generally adopt a worldwide taxation system and provide unilateral exemptions for only some items of income. Several countries, including the United States, take the approach of taxing their residents on a worldwide basis

[3] See Klaus Vogel, 'World-wide vs. Source Taxation of Income: A Review and Reevaluation of Arguments' in *Influence of Tax Differentials on International Competitiveness* (Amsterdam: Kluwer, 1989) 117–66.

[4] See Reuven S. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge: Cambridge University Press, 2007).

and avoid double taxation by means of the foreign tax credit system, whereby taxation in the source country will be offset against taxes due to the resident country.

The main argument for worldwide taxation with a foreign tax credit system is capital export neutrality: tax systems should be neutral, i.e., economic efficiency would be achieved if taxpayers would decide where to invest globally, independent of tax concerns; moreover, the ability-to-pay principle would require residents and non-residents to have the same taxation. However, this argument is not definitive, since the competing principles of capital import neutrality and the (objective) ability-to-pay principle[5] also play a role in supporting the approach of taxation at source. As one may know, the concept of capital import neutrality is based in the source principle, i.e., local investors should have the same treatment that foreign investors are entitled to, and the latter should be equally taxed, no matter where they are resident.[6] This can only be achieved if the state of residence limits its taxation to the income derived from sources in its territory and if the source state grants equal treatment to all investors.

Moreover, the mere fact that countries limit foreign tax credit, e.g., to the amount of tax due in the country of residence, shows that taxpayers investing abroad will always be subject to the highest taxation, i.e., where the residence country's rate is higher, then the taxpayer is subject to paying the difference to his/her residence country; if the source country's rate is higher, than he/she will not be reimbursed for the over-taxation.

When countries enter into tax treaties, on the other hand, they may be prepared to agree on the exemption method,[7] whereby foreign source income is not taxed in the residence country. On the other hand, they will insist on the credit method, similar to their own domestic provisions.

The exemption method applied by the residence state leaves to the source state the decision whether or not to tax. In contrast, the credit method neutralizes any such decision of the source state (at least, where the residence state's tax rate is higher). Upon application of the credit

[5] See Klaus Vogel, 'Tributação da renda mundial' in *Cadernos de Direito Tributário e Finanças Públicas* (São Paulo: Revista dos Tribunais, 1994) vol. 7, 133–43.

[6] The ideas regarding 'capital export neutrality' and 'capital import neutrality' were first developed by Richard Musgrave. See Richard Musgrave, 'Criteria for Foreign Tax Credit' in *Taxation and Operations Abroad* (Tax Institute Symposium, 1960) 84.

[7] The United States rejects the exemption method based on the savings clause which they expect to include in all their treaties.

method, the residence state will tax its residents on the worldwide basis, but will grant a (limited) credit equivalent to the amount paid to the source state. This means that the residence state's tax has a residual effect, the extent of which depends on the source state's taxation. The more the latter taxes at source, the less will be the (residual) tax due to the residence state. Such a method implies a conflict of interest, since the residence state's taxation will increase if the source state reduces its own right to tax. On the other hand, the source state will be encouraged to tax non-residents at the highest level possible, since any decrease in its rate will not benefit the taxpayer, but will rather increase the residence state's (residual) taxation.

It is in this context that we come to the idea of tax sparing. This mechanism intends to ensure that the residence state's taxation will not increase even if a unilateral decision is made by the source state not to tax (or not to tax fully) non-residents, so that this benefit granted by the source state (reduced taxation) will directly benefit taxpayers and not the residence state.

Tax sparing can aim at assuring that treaty benefits will be maintained, or it may be intended to maintain unilateral tax exemptions. Although both phenomena are quite similar, it is common in literature[8] to refer to the first case as 'matching credit', reserving the expression 'tax sparing' to a more restricted case. Since this chapter examines both cases, mechanisms referring to unilateral measures will hereinafter be referred to as 'tax sparing *sensu stricto*'.

Matching credit is a mechanism whereby, if the source state determines not to tax non-residents at more than some level fixed upon between the two contracting states, the residence state agrees to grant a foreign tax credit which will correspond to a fixed amount, usually higher than the maximum taxation in the source state. In other words, the credit granted by the residence state does not depend upon the amount paid to the source state. On the contrary, although the source state is constrained by the treaty to tax up to a certain limit, the residence state's credit is determined by the same treaty on an independent (usually higher) level.

Several Brazilian treaties have included matching credit provisions, especially those signed in the 1970s; examples may be found in the

[8] See Klaus Vogel, in Klaus Vogel and Moris Lehner, *Doppelbesteuerungsabkommen der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen* (5th edn, München: Verlag C. H. Beck, 2008) Art. 23 Rz. 194–5.

treaties concluded with Austria, Denmark, France, Italy, Luxembourg and Sweden, all of them signed in the 1970s and still in force.

Brazil only commenced to enter upon negotiation of tax treaties in the 1960s. The reigning tax ideology at that time in Brazil (and in Latin America more generally) was that the source state should have the exclusive right to tax income derived from its economy. This can be seen from the fact that the Brazilian regular tax rate on non-residents was 25 percent of the gross amount remitted abroad (in some cases, remittances would be subject to additional taxation). From this point of view, double taxation would derive from some kind of intrusion of the residence state in the source state's resources. It was considered that the source state should not agree to reduce its taxation, since this could imply a recognition of the residence state's right to tax the same income.

In 1964, there was a change in the Brazilian international tax policy, which was not due to a different tax ideology, but rather to the economic policy of the military regime which entered into power. The new policy was that the development of the Brazilian economy would depend upon attracting foreign investment, and that international taxation could be used as a tool for such purpose. From this time onwards, Brazil would be prepared to reconsider its 25 percent taxation at source, in treaty negotiations, provided that any reduction would accrue to the benefit of the foreign investors and not the foreign country's fisc. So, Brazilian negotiators would not agree to reduce Brazilian taxation, if the only effect of such a reduction would be to increase the residence state's (marginal) taxation. Brazil would not be prepared to reduce its taxation from 25 percent to, say, 15 percent, if there would be no benefit to the taxpayer. If one keeps in mind that Brazil understood that it had the exclusive (or at least primary) right to tax income from its sources, there would be no reason to reduce its tax (and thus reduce the credit that the residence state should grant).

The matching credit mechanism was therefore designed to ensure that although the source state would limit its right to tax, the residence state would continue granting credits as if there were no such limitation. Generally speaking, in specific treaty provisions, Brazil would reduce its taxation at source to (e.g.) 15 percent, but the residence state would grant a credit of (e.g.) 25 percent. This would generate an immediate benefit for taxpayers derived from the treaty, since they would earn at least 10 percent free of taxation. The benefit could be even greater, since the source state could (unilaterally) decide not to tax at the full 15 percent rate: in any case, the residence state would grant a credit as if the source state had imposed a 25 percent tax.

This mechanism could be analysed as a benefit granted by the residence state to the source state (investment aid to developing economies). However, it is interesting to see that, from the source state's perspective, there is no such favor perceived. Accordingly, in the example above, Brazil would claim that before the tax treaty entered into force, Brazil would tax non-residents on a 25 percent level, and the residence state would only tax such income if its internal rate would be higher; in other words, the residence state's possibility to tax would have begun at the 25 percent rate. A matching credit mechanism, therefore, would not change the residence state's position. It would continue to tax the same amount (i.e., the amount above 25 percent). Brazil could argue, therefore, that the matching credit mechanism is neutral for residence states, and that it should not be considered a benefit granted to the source state. If one keeps in mind that the reigning ideology was that the source state would be the one entitled to tax, then such argument should be taken into account.

Tax sparing *sensu stricto*, on the other hand, aims at unilateral measures taken by the source state. While matching credit considers the case when the source state's ability to tax is limited by the treaty, i.e., when both countries agreed upon a limitation of taxation in the source state, tax sparing *sensu stricto* has a different approach: in principle, the source state would tax up to a determined level and by treaty (or unilaterally) the residence state would grant a foreign tax credit for said taxation. However, where the source state decides not to tax its non-resident up to the limit which was granted to it by the treaty, the residence state must respect such decision and grant a credit equivalent to the maximum amount the source state could have taxed.

As one can see, the matching credit mechanism derives directly from a decision of the contracting states upon signing a treaty: both states agree that the source state should limit its tax to a certain amount, but they also agree that the residence state's credit will (usually) be higher than said limit. In other words, taxpayers are granted a benefit which is independent from countries' later decisions. The matching credit is therefore independent from unilateral measures. Tax sparing *sensu stricto*, on the other hand, only benefits taxpayers if the source state unilaterally decides to reduce its taxes (reduction independent from any treaty provision), i.e., if the source state decides to grant a benefit to non-residents, which implies a taxation below the level allowed by the treaty.

One can also refer to matching credit in cases where there is no difference between the maximum taxation at source and the credit granted by the residence state, provided such credit is fixed by the treaty independent from any investigation about which was the real taxation at

source. In other words, the matching credit mechanism contemplates a fixed credit by the residence state, which will always be granted upon remittances from the source state. So, the matching credit method is also pragmatic, since the contracting states (or taxpayers affected) do not need to provide any evidence concerning the level of taxation at source, which is irrelevant for purposes of determining the credit to be granted by the residence state.

III. OECD REPORT: REASONS FOR RECONSIDERATION

The OECD Report starts by addressing the changes in the global economic framework. As stated by the Report, the traditional assumption that all OECD members are major exporters of capital while the non-members are major importers of capital can now be questioned. Further, the globalization and liberalization of financial markets have 'blurred a number of traditional distinctions which underlie existing international tax arrangements'.[9]

Taking into account the differences between the current global context and the one of four decades before, when the first tax sparing provisions were negotiated (and especially the alleged considerable improvement in the economy of developing countries in this time), the OECD Report states that 'the new global environment has encouraged, and in some cases even compelled, countries to re-examine established tax structures and the policies upon which taxation arrangements are based'.[10] The Report then suggests that these new structures and policies would comprise tax sparing arrangements. To this effect, the OECD Report suggests a reconsideration of tax sparing provisions. The OECD proposes that tax sparing is no longer good policy, based on a number of arguments. In contrast, it is interesting to observe that the United Nations still observes that 'it is of primary importance to developing countries to ensure that the tax incentive measures shall not be made ineffective by taxation in the capital-exporting countries using the foreign tax credit system' by means of the adoption of tax sparing clauses in their tax treaties.[11]

[9] See OECD Report, *supra* note 2, at 9–10.
[10] *Ibid.* 12.
[11] See United Nations Model Double Taxation Convention between Developed and Developing Countries, United Nations, New York, 2001, at 265.

The OECD Report states that a re-evaluation of the benefits of tax sparing is underway within both members and non-member countries of the Organisation. This statement, itself, must be put to the test. In an interesting analysis intended to verify the tax treaty practice since the publication of the OECD Report, Victor Thuronyi (himself an officer with the IMF) concluded that tax sparing provisions may be found in about one-third of tax treaties signed from 2000 until 2003.[12] Moreover, as Thuronyi verified in this research, half of the tax treaties with tax sparing provisions involved OECD member countries. Such a circumstance may be enough for one to debate to what extent the alleged 're-evaluation' regarding the granting of tax sparing would be underway both in and outside the OECD area.

The main argument of the OECD Report against tax sparing is the alleged view of most OECD member countries that tax sparing is not an effective way to promote foreign investments or to promote national economic growth. This view is reinforced, states the OECD, by a so-called 'overall disappointing experience of most Member countries and many economies in transition with the use of tax incentives', as well as the 'ample opportunities for tax planning and tax avoidance'.[13] From this point of view, therefore, negotiating tax sparing provisions is an 'illustration of good intentions leading to bad results', as their adverse consequences would outweigh their benefits.[14]

According to the OECD Report, the primary rationale for granting tax sparing has been the promotion of economic development in developing countries – the alleged development experienced by said countries in the last years would justify the reluctance of OECD Members in granting tax sparing in new or renegotiated tax treaties. Deeming tax sparing to be an instrument of foreign aid, the OECD Report also criticizes the mechanism on the basis that it lacks transparency when compared to direct aid, as the latter can establish, 'in relatively precise terms', the recipient, the amount and the anticipated use of the foreign aid.[15]

One should note at this point that there is no empirical evidence of 'bad results' from tax sparing. On the contrary, the continued use of tax

[12] See Victor Thuronyi, 'Recent Treaty Practice on Tax Sparing' (2003) 29(3) *Tax Notes International* 301.
[13] See OECD Report, *supra* note 2, at 12.
[14] See Kim Brooks, 'Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice?'(2009) 34 *Queen's Law Journal* 508.
[15] See OECD Report, *supra* note 2, 22.

sparing provisions in many countries' treaty policies suggests that negotiating parties consider that there may be good results from these provisions. It is, furthermore, not clear who should be entitled to evaluate whether results are good or bad. One might suggest that the contracting states involved in treaty negotiation should be deemed to be able to decide whether or not to provide for tax sparing.

A second reason for reconsidering tax sparing proposed by the OECD Report is based on the free-rider effect. The argument is that there is a misconception (presumably, by the contracting states) of the views of foreign investors, which would not depend or even be influenced by tax sparing provisions in taking investment decisions.[16] According to the OECD Report, multinational enterprises would base their investment decisions on a wide range of factors, linked to political, market and infrastructural conditions of the host country, with taxation being only one issue in a whole set of factors which are taken into account. If this is the case, any increase in foreign investment would be independent of the existence of tax sparing provisions, as they would be irrelevant to the multinational enterprises' investment decisions.[17] Thus, tax sparing provisions would not be justified in face of the supposed inappropriateness of the mechanism as a tool for economic development.[18]

If one were to take this argument seriously, however, one would need to know what is the overall effect of tax treaties on foreign investment decisions. There does not seem to be much research about this, and such research tends to be inconclusive, since one is comparing effective data (i.e., the amount of investments in a country) with prospective (wishful) information.

Showing the lack of a uniform conclusion on the matter, Barthel, Busse and Neumayer, after the analysis of several studies concerning the influence of tax treaties on foreign investments, concluded that while the researchers who use bilateral FDI data fail to find a positive effect of the treaties on FDI, the studies that use aggregate FDI data in a large and representative sample reach the opposite conclusion, i.e., tax treaties increasing the FDI.[19] Thus, it is not surprising that the said authors, in spite of concluding that tax treaties increase the bilateral FDI stock

[16] *Ibid.* 12.
[17] See Morvan Meirelles, 'Tax Sparing Credits in Tax Treaties: The Future and the Effect on EC Law' in *European Taxation* (IBFD, May 2009) 263.
[18] See OECD Report, *supra* note 2, at 25.
[19] See Fabian Barthel, Matthias Busse and Eric Neumayer, 'The Impact of Double Taxation Treaties on Foreign Direct Investments: Evidence from Large Dyadic Panel Data' in (2010) 28(3) *Contemporary Economic Policy* 366.

between 27 percent and 31 percent, allow that the debate is still open, 'as the empirical evidence of existing studies is anything but conclusive'.[20]

As an example of how this information cannot be considered reliable, one should take the Brazil-Germany Tax Treaty, revoked recently.[21] If one compares the level of German investment in Brazil five years before the said treaty revocation and five years thereafter, one would be surprised to see that the level of German investment has increased in this time.[22] This could lead one to a surprising (and wrong!) conclusion that the treaty was an obstacle to German investment in Brazil. Such a naïve understanding would ignore the fact that the worldwide economy increased in such period, and especially that the Brazilian economy has been attracting increased investments throughout the period. To obtain a full picture of German investment, one would also have to include German investments made through third countries. The author therefore argues that this is not an easy analysis and that the free-rider argument should not be considered for a reconsideration.

Third, the OECD Report refers to some developing countries' concerns as to 'whether the price of obtaining tax sparing is too high given the limited benefits of such provisions',[23] taking into account that residence countries require a lower taxation at source as a condition for agreeing with tax sparing. The argument is correct concerning the lower taxation at source. However, one should take into consideration that the OECD itself has always advocated that treaties should provide for lower taxation at source (except for cases where taxation on a residence basis would be very difficult and low taxation at source would increase harmful tax competition). Indeed, the level of taxation at source seems to be one of the most relevant differences between the OECD and UN approaches. An example may be found in the provision concerning royalties: while Article 12 of the OECD Model Convention provides for the exclusive right of the residence state to tax royalties, the UN Model Convention allows their taxation at source.

From such perspective, one may understand Tsilly Dagan's assertion that the tax treaties, especially those based on the OECD Model, were constructed by and for developed countries with mutual interests and

[20] *Ibid.* 366.
[21] The Tax Treaty signed with Germany in 1975 was revoked by the German authorities on 7 April 2005.
[22] See the reports on the FDI in Brazil published by Brazilian Central Bank, available at www.bcb.gov.br/?INVED.
[23] See OECD Report, *supra* note 2, at 13.

ideology.[24] To this effect, Dagan observes that the tax treaties, being based on a model primarily designed for developed countries, tend to allocate the revenues to the benefit of the residence state in such a way that the refusal of developing countries to enter into treaties which have no mechanisms to assure the improvement in the level of foreign investment would be justified.[25] Thus, before reconsidering tax sparing, the OECD should seriously reconsider its view concerning the limitation of taxation at source. Should the OECD agree that source countries should be granted a higher amount of taxation, then the OECD's argument about tax sparing may be more convincing.

The claim as to an increase in the standards of living in developing countries, pointed to by the OECD Report as a further reason for the reconsideration of tax sparing, may also be criticized. To this effect, one should follow Kim Brooks' argument, according to which the OECD's statements would not match the UN's conclusions in its 2000 Millennium Development Goals Report, which points to an 'ever-increasing inequality between countries'.[26] Something similar can be derived from an article written by Cristiane Coelho, who points out that the OECD Report does not rely on any specific data when listing countries like Russia, Singapore, China and India as countries which, due to a supposed economic development, would be able to implement their tax policies independently of external concessions.[27] Coelho's analysis of countries' GDP per capita evolution from 1985 to 2005 enables one to conclude that, due to the enormous gap between countries like the United States and the United Kingdom, and China and India, it is impossible to argue that the latter have the same economic condition as the former, which can implement their tax policies on their own.[28] In any event, the vulnerability of developing countries' economies would still justify the adoption of tax sparing provisions, since one could not say that the economic growth alleged by the OECD Report was shared by all developing countries.[29]

A fourth argument of the OECD against tax sparing concerns the allegedly burdensome concessions made by treaty negotiators in exchange for the obtaining of tax sparing provisions. With regard to this

[24] See Tsilly Dagan, 'The Tax Treaties Myth' (2000) 32(939) *Journal of International Law and Politics* 47.
[25] See Dagan, *supra* note 24, at 51.
[26] See Brooks, *supra* note 14, at 528.
[27] See Christiane Coelho, 'Tax Sparing and Brazil's Tax Treaties' (2008) 51(8) *Tax Notes International* 690.
[28] *Ibid.* 692.
[29] *Ibid.* 693.

argument, Brooks observes that it could be challenged by the mere fact the OECD Model Convention itself deprives the source state of 'much needed' revenue, e.g., by providing for no withholding tax on royalties at source.[30] As a matter of fact, it is not clear that treaty negotiators would grant fewer (or smaller) concessions if no tax sparing provision would be considered, or that such concessions would be smaller than the gains from such provision. The tax treaty Brazil has signed with Belgium in 1972, for instance, in spite of having a tax sparing clause, provides for withholding tax rates for dividends, interests and royalties which are similar to the ones in the treaty signed with South Africa in 2003, which does not contain such a clause. In summary, one should not generalize the idea that treaty negotiators would not be capable of deciding what to concede.

Fifth, the OECD suggests that there is now a greater awareness regarding the potential for abuse deriving from tax sparing provisions and the ineffectiveness of tax incentives in promoting economic development.[31] However, arguing that a review is necessary due to the potential for abuse of tax sparing provisions is not convincing. If one were to consider not including a provision in a treaty because it would be subject to abuse, sooner or later no single article of tax treaties would survive. A more consistent approach to this problem would be to discuss treaty shopping and treaty abuse in general, adopting clauses which could avoid both (e.g., limitation on benefits provisions in tax treaties). The mere fact that there can be abuse is not enough to reject a treaty provision which would otherwise be interesting to the parties.

Finally, the OECD Report suggests that a tax sparing provision would have a counterproductive effect as a tool to attract foreign direct investment, since it would encourage an excessive repatriation of profits to the residence state.[32] To this effect, when faced with the existence of a tax sparing credit on the distributed profits of their subsidiaries, the foreign investors would be encouraged to return the said profits to the residence state rather than re-investing them in the source state. This would only be a valid argument if tax sparing provisions would be time conditioned. Provided benefits are the same, investors' decisions to repatriate profits should not be dependent on those provisions.

In conclusion, given the above reasons addressed in its Report, the OECD recommends that the granting of tax sparing should be considered

[30] See Brooks, *supra* note 14, at 528.
[31] See OECD Report, *supra* note 2, at 21.
[32] *Ibid.* 22–3.

by member countries only in regard to countries whose economic level is considerably below that of the countries within the OECD. Member countries should, then, employ objective economic criteria to define countries eligible for tax sparing.[33] At least in the case of the GDP per capita criterion, one could argue the absence of reasons for the denial of tax sparing, as the suggestion that developing countries have achieved a GDP per capita higher than many OECD member countries is misleading.[34]

IV. RECONSIDERING THE OECD'S RECONSIDERATION

As one can see from the previous section, the OECD's reconsideration of tax sparing is based fundamentally on the idea that tax sparing would be a mechanism for developed states to assist developing states. From an historical perspective, one should confirm that assumption. In the case of Brazil, its first tax treaties were signed with Sweden and Japan because both countries were prepared to grant tax sparing provisions as part of their policy to assist developing countries. This seems to be the view of treaty negotiators to date. However, matters now have changed for some countries, as suggested by the OECD Report. The Brazil–Germany treaty revocation is an example thereof: German authorities would require a revision of the treaty due to the fact that Brazil would allegedly no longer be a developing country and therefore tax sparing provisions would not be acceptable.[35]

In the previous section, the author has outlined the OECD Report's arguments for a reconsideration of tax sparing and has identified the problems or weaknesses in these arguments. Even so, the author accepts that if tax sparing provisions are considered only as a development mechanism, it is understandable that the OECD has suggested a reconsideration. From the residence state's perspective, tax treaties aim at avoiding double taxation. On the basis of capital export neutrality, the residence state is supposed to reduce its taxes in an amount equivalent to the taxes charged in the source state. If taxes are not collected by the source state, there would be no reason for a credit by the residence state. From this point of view, tax sparing appears to offend one of the main principles of the so-called international tax regime: tax neutrality. As tax neutrality is recognized as an important principle, this suggests that tax sparing clauses should be avoided. Developed states should instead choose direct mechanisms to promote state aid to developing states.

In this section, the author proposes a different way of viewing tax sparing that enables a reconsideration of the OECD's reconsideration. This different approach is based on several arguments: (1) capital export neutrality is not the only target for international taxation; (2) tax sparing clauses are not a favor (or aid) granted by the residence state; and (3) exemption by the residence state does not increase the source state's prerogative.

A. Capital Export Neutrality

The main argument against tax sparing mechanisms seems to be based on capital export neutrality. States adopting the credit method argue that investors should be subject to the same level of taxation in their inbound and outbound investments. This would avoid a distortion in their decisions and the most efficient allocation of resources would be achieved.

The author argues, however, that there is no international consensus regarding this perspective. On the contrary, it seems convincing that capital export neutrality does not bring efficiency. Should the tax credit mechanism work according to its stated aim – i.e., to neutralize the tax burden – then the effect of this is not to generate neutrality in investors' decisions. On the contrary, equalization of tax rates operates as a mechanism to convince investors not to invest in developing countries but, instead, to focus their investment on developed countries. To understand this, first one can make an assumption that there is, in general terms, some relationship between tax rates and services provided by states. Although some jurisdictions demand high taxes and do not offer their taxpayers a corresponding level of services, due to the states' own deficiencies, it is generally true that a state will not be able to offer good services if its taxation is too low. Therefore, one can generally say that if the jurisdiction charges lower taxes, taxpayers must be prepared to supplement some services which could otherwise be offered by the state.

Applying this perspective to developed and developing states, one can consider that developed states will usually impose higher taxes, but on the other hand, their taxpayers will have a stronger state. Developing states may have lower taxes, but one will easily note some deficiencies, including in infrastructure. In this scenario, neutralizing the tax burden

[33] *Ibid.* 42–3.

[34] See Coelho, *supra* note 27, at 693.

[35] Besides the tax sparing clause, the qualification of income derived from technical services in Art. 21 ('other income') by the Brazilian authorities and issues derived from the Brazilian transfer pricing rules should also be pointed out as reasons for the revocation of the Tax Treaty with Germany.

would require taxpayers to pay the taxes on the same level, independent of whether they invest in their own residence state or abroad. This is not a neutral outcome. Under the same level of taxes, investors will prefer to invest in an environment where infrastructure corresponds to the level of tax the investor is paying. It does not make sense to invest in a jurisdiction which offers less infrastructure (unless there are other factors, such as non-renewable, immobile resources, at play), since investors will have to pay for services which would otherwise be offered by the state. In sum, when a developed state adopts capital export neutrality, it invites its taxpayers to invest locally (or in another developed state); investors will only dare to invest in developing states if their remuneration is high enough to make such investment attractive in spite of the gap between (developed state) tax level and (developing state) infrastructure. One should not be surprised, therefore, if one notes a divergence in the interest rates derived from investments made in developed states vis-à-vis those made in developing states.

At an international level,[36] capital export neutrality is even more unacceptable, since it implies keeping relevant resources in developed states, while developing states need such means for their development. Furthermore, residence states can tax the income of their resident taxpayers upon consumption but source states can only tax the income upon payment.

Finally, one should note that capital export neutrality is not an aim in itself. Accordingly, if residence states really consider that taxes should be neutral, then they would not only tax the (positive) difference between their taxes and source state taxes: where the latter would be higher, residence states should be prepared to reimburse their taxpayers on the (negative) difference. In reality, no state would reimburse taxes paid to foreign states. However, this analysis shows that the capital export neutrality argument of developed states is not applied equally across all contexts.

B. Tax Sparing is Not a Favor Granted by Developed Countries

As already explained, behind the OECD's reconsideration of tax sparing, there seems to be a view that tax sparing is a concession granted by residence countries to multinational investors, to provide a subsidy to developing states. This is why tax sparing, in the OECD analysis, should

[36] See Vogel, *supra* note 3.

only be applicable to tax treaties between developed and developing countries, and should be seen as an exceptional measure.

This argument has been made by David Rosenbloom and Daniel Hora do Paço, according to whom review of the 'Brazilian insistence' as regards tax sparing would be 'imperative', as it would have forbidden 'serious negotiations' within the last 40 years.[37] Under the said authors' understanding, the Brazilian policy regarding the adoption of tax sparing clauses would be 'contradictory' vis-à-vis the position currently occupied by the country in the international scenario, i.e., tax sparing should only be granted to developing countries, what would no longer be the Brazilian case.[38]

On the other hand, if one takes into account the fact that tax treaties share taxing power between two jurisdictions, then one would immediately recognize that tax sparing is not a favor granted by the residence state. Tax treaties are only negotiated (or applicable) when two jurisdictions are simultaneously entitled to levy tax on the same event due from the same taxpayer. Tax treaties apply where double taxation would otherwise occur. When a country agrees to sign a tax treaty and therefore agrees to limit its own jurisdiction, it recognizes that its treaty partner also has jurisdiction in respect of the same event. In other words, by means of a tax treaty, the two states limit their own taxing jurisdictions, recognizing their treaty partners' jurisdiction. Upon signing a tax treaty, a state accepts that it will not trespass upon some material limits, which are granted to its treaty partner.

Considering an item of income which may be taxed at source up to a certain limit, one can see that both countries have shared their jurisdiction, determining that the source state's jurisdiction reaches said limit and the residence state's jurisdiction begins from that point on. This is very important to update the discussion concerning tax sparing: one must keep in mind that the very same item of income would be subject to two jurisdictions, but they have shared their taxing powers; one jurisdiction is not supposed to tax beyond its own limits, or it would otherwise tax an item of income which was reserved by treaty to the other jurisdiction. Thus, if the source state taxes foreign residents up to the limit foreseen in the tax treaty, the residence state will grant a credit equivalent to such tax. In other words, the residence state's jurisdiction begins at the very same point where the source state's jurisdiction ceases to exist.

[37] See H. David Rosenbloom and Daniel Hora do Paço, 'Considerações sobre a negociação de um tratado para evitar a dupla tributação da renda com os EUA' in 174 *Revista Dialética de Direito Tributário* (São Paulo: Dialética, 2010) 25.
[38] *Ibid.* 18–19.

When, however, the source state decides not to tax said item of income, the residence state claims that no credit should be granted. One can understand that, as a matter of practice, the residence state would tax an amount originally under the jurisdiction of the source state.

In other words, the basic credit mechanism only works as a tool to share taxing jurisdictions if the source state exercises its taxing power in a positive way, i.e., if it fully taxes the item of income granted to it. If, however, the source state decides to exercise its taxing jurisdiction in a negative way, i.e., if it decides not to tax the item of income, then the residence state claims its right to tax the same item.

As the basic credit mechanism is currently structured, therefore, the residence state does not seem to be prepared to recognize that it has originally shared tax jurisdiction with its treaty partner. It does not recognize its treaty partner's right to fully exercise its jurisdiction on the amount reserved to it. The credit method does not work as a mechanism to share jurisdictions between two equally entitled jurisdictions. On the contrary, the residence state keeps a 'gun to the head' of the source state, forcing it to tax the amount which was granted to it. The source state's sovereign right to exercise its jurisdiction is therefore disregarded: the residence state believes that taxation by the source state would be a concession under the treaty, but where the source state decides not to tax, then the residence state would keep its tax jurisdiction on the full amount.

The author argues that, from this perspective, one can see that tax sparing (especially the matching credit approach) is a mechanism aimed at correcting the distortion in the basic credit mechanism. By means of a tax sparing clause, the residence state recognizes the source state's right to tax or not to tax an item of income which was granted to its jurisdiction.

Thus, a tax sparing clause (matching credit) is not a favor granted by the residence state. By means of its adoption, the residence state simply confirms that it has no taxing right on an item of income which was granted to the source state.

C. Exemption by Residence State

When the residence state claims that tax treaties aim to avoid double taxation and therefore no credit should be granted where the source state exempts an item of income, one should also ask whether the same principle should be applied in the opposite case, i.e., if the residence state exempts an item of income which would be taxable in the source state.

By means of tax treaties, source states usually limit their own taxing power to a level established therein, which tends to be less than the amount which would normally be due from non-residents under domestic source state tax law. A good explanation for this is that the source state's limits are necessary in order to grant a (residual) taxing power to the residence state.

If one were to apply the same arguments against tax sparing in this situation, then one would claim that where a residence state does not tax an item of income, then no limit should be applicable to the taxation of the source state, since there would be no risk of double taxation.

Thus, if a country rejects tax sparing provisions, it should also accept that the source state's limitations are only applicable if the residence state taxes the same item of income. In other words, since residence states usually argue that tax treaties' sole objective is to avoid double taxation, then tax treaties should not limit source states' taxation if residence states do not tax an item of income (or if they tax such item of income up to a level lower than the one which would be applied by the source state). This would imply a complicated reverse credit mechanism, whereby the source state would be entitled to tax the item of income (or to complete the taxation) if the residence state would not do so.

Of course, such a mechanism, besides being very complicated, has never been considered in any known tax treaty. It is only presented here as an argument to show that the residence state's claim to tax an amount reserved to the source state has another side, which should be taken into account. Although it seems absurd to consider a 'residual' tax power of the source state, the argument is not different from the one employed by residence states when they claim the prerogative to tax an item of income reserved by the treaty to the source state.

V. CONCLUSION: TAX SPARING, JURISDICTION AND TERRITORIALITY

This chapter shows that there has been a misunderstanding when countries discuss the adoption of tax sparing in their treaties. From a traditional (residence state) perspective, tax sparing is perceived to be a concession given by developed states to developing states. If this analysis is correct, then it makes sense to reconsider such a mechanism and its efficiency, as is proposed in the OECD Report.

However, the author has argued in this chapter that tax sparing (especially if a tax matching provision is adopted) may be seen, instead,

as a mechanism of (partial) recognition of territoriality.[39] That is, by this mechanism, residence states would recognize source states' sole jurisdiction over (part of) the income. If source states decide to grant a tax incentive, this is to be considered a unilateral sacrifice made by the latter, which does not affect residence states, since the subject is beyond their jurisdiction.

It is therefore argued that it is time to reconsider tax sparing, but not in the sense of the OECD's reconsideration. Instead of simply rejecting tax sparing provisions, the author argues that they should be reinvigorated and expanded to treaties between developed countries as well. Not only developing, but also developed countries should be granted the prerogative of deciding their tax policy within the jurisdiction reserved to them by the treaty. Tax sparing would be a step forward in the direction of the recognition of each state's tax jurisdiction. The exercise of said jurisdiction may be equally done by means of taxing or not taxing an item of income.

From a practical perspective, it is further argued that matching credit provisions are more convenient than tax sparing *sensu stricto*, since the latter would depend on the analysis of internal legislation of the source state (usually states list the benefits to be observed). Matching credit provisions, on the other hand, simply respect the jurisdiction of the source state, establishing the point where the jurisdiction of the residence state begins.

[39] See Vogel, *supra* note 8, Art. 23, Rz 195, 1648.

PART III

In search of 'searchers' to find unique solutions to common tax challenges