resident corporations have a substantial interest; (often defined as 10 percent or more of the share capital of the foreign affiliate))
- the type of income that qualifies for the exemption or indirect credit; (usually, these rules distinguish between active business income and other types of income)
- the source of income;
- allocation of expense rules; (see section 4.3.5 below)
- the current or accrual taxation of passive income of foreign corporations controlled by residents; (CFC rules, which are discussed in Chapter 7, section 7.3 below)
- the treatment of foreign losses; and
- the computation of the income of the foreign affiliate in accordance with domestic tax rules.

The most important difference between the exemption and indirect credit methods is that the indirect credit method requires a definition of creditable foreign taxes, whereas the exemption method requires rules to determine when foreign source income is subject to a level of foreign tax that is comparable to domestic tax (assuming that the exemption system is a proxy for an indirect credit system).

As noted above, many countries achieve the benefits of simplification with respect to their participation exemptions for dividends from foreign affiliates only by sacrificing the integrity of the exemption. In many participation exemptions, the exemption is available for dividends received from foreign affiliates that have not been subject to foreign tax rates comparable to domestic tax rates. Sometimes this appears to happen by inadvertence rather than intentionally. For example, a country may provide an exemption for dividends from foreign affiliates resident in countries with which it has entered into tax treaties. If the country enters into tax treaties with low-tax countries or countries that provide preferential low-tax regimes, the dividend exemption will be available for dividends from foreign affiliates in these countries, even though the income out of which the dividends are paid is not subject to foreign tax rates that are comparable to domestic tax rates.

Several countries have intentionally adopted participation exemption systems that do not even attempt to ensure that the income of the foreign affiliates is subject to foreign tax rates comparable to domestic tax rates. For these countries, the exemption method is not a proxy for the credit method. The underlying policy of such an exemption system is not just to eliminate international double taxation (although it accomplishes that result) but also to promote the international competitiveness of a country's resident multinational corporations. Thus, several countries have adopted exemption systems under which all dividends received by resident corporations from foreign affiliates in which they have a substantial interest are exempt from residence country tax. As a result, multinationals resident in such countries are able to compete in other countries with corporations resident in those countries and in third countries because they are subject to tax only by the country in which the business is carried on.

For example, assume that a multinational corporation, MCo, is resident in Country A, which imposes corporate tax at a rate of 35 percent. MCo has a wholly owned subsidiary that is resident and carries on business in Country B, which imposes corporate tax at a rate of 12.5 percent. If Country A taxes dividends received by MCo from its subsidiary in Country B, that tax represents a cost to MCo of carrying on business in Country B (although the cost is deferred until the dividends are paid) that corporations resident in Country B and resident in other countries that carry on business in Country B do not bear (assuming, of course, that those other countries exempt dividends from foreign affiliates from tax).

4.3.5 Treaty Aspects

As mentioned above, both the credit and exemption methods are authorized by Article 23 of the OECD and UN Model Treaties. The deduction method is not authorized by these model treaties. Article 23 of the OECD and UN Model Treaties establishes the general principles of exemption and credit, with each country left to establish detailed rules in its domestic law for the implementation of the general principle.

Some countries provide an exemption for foreign source income or a credit for foreign taxes paid (and paid by a foreign affiliate) under their domestic law in addition to providing relief in any treaties that they enter into. Treaty relief is still important, however, because it may be more generous than the unilateral relief provided in domestic law and because it constrains a country's ability to amend its domestic law to withdraw the double taxation relief afforded to its residents.

For example, assume that Country A provides an exemption in its domestic tax law for certain foreign source income earned by residents of Country A. Country A enters into a treaty with Country B that incorporates the same exemption. If Country A subsequently repeals the exemption in its domestic law, it must nevertheless continue to provide the exemption to its residents that earn income in Country B unless the treaty with Country B is modified or terminated.

4.4 ALLOCATION OF EXPENSES

Whether a country uses an exemption method or a credit method to provide relief from international double taxation, it should have rules for allocating a proper portion of the expenses incurred by its resident taxpayers between their foreign source gross income and their domestic source gross income. Most countries recognize the need for such rules for the purposes of taxing nonresidents on their domestic source income. Thus, expenses incurred by nonresidents will be denied unless those expenses are properly related to the earning of the domestic income subject to tax. Similar rules are necessary to properly apportion the expenses of resident taxpayers between domestic source and foreign source income for purposes of the foreign tax credit.

For countries that exempt foreign source income, expenses incurred by a resident taxpayer to earn that income should not be deductible. This result follows from the fundamental principle of tax law that expenses incurred to earn exempt income should

not be deductible. For example, a taxpayer should not be allowed to deduct interest expense on borrowed funds used to earn exempt foreign source income. A country that allows such interest expenses to be deductible provides its resident taxpayers with an incentive to earn exempt foreign source income rather than taxable domestic source income. In effect, the country is providing an exemption not only for foreign source income but also for a portion of the domestic source income of its resident taxpayers.

Most countries lack specific rules for attributing expenses to foreign source income. Two approaches that might be used for that purpose are tracing and allocation or apportionment. A tracing approach involves a factual inquiry into the connection between the expenses and the foreign source income. In contrast, allocation or apportionment involves the attribution of expenses to foreign source income by formula, either on the basis of the proportion of the taxpayer's foreign assets to its total assets or the proportion of its gross foreign income to its total gross income. Unlike tracing, allocation or apportionment is based on an assumption that the relevant expenses were incurred to support all of the taxpayer's assets or income-earning activities equally.

Countries that have a foreign tax credit system should allow resident taxpayers to deduct expenses incurred to earn foreign source income because those taxpayers are taxable on their worldwide income. As explained above, however, the foreign tax credit is invariably limited to the amount of a country's domestic tax otherwise imposed on foreign source taxable income. For this purpose, the amount of a taxpayer's foreign source taxable income must be computed properly or the limitation on the credit will be improperly inflated. In order to compute foreign source income properly, the taxpayer should be required to deduct from its gross foreign source income the expenses incurred to earn that income.

The need for expense allocation rules can be illustrated with a simple example. Assume that a resident corporation borrows 1,000 with interest at 8 percent annually and uses the loan proceeds to finance the business activities of a foreign branch. The foreign branch produces gross income of 280. After deducting the interest payment of 80, the branch's net income is 200. The net income of 200 is subject to foreign tax of 50 percent, resulting in a tax of 100. If the corporation's domestic source net income is 2,000, the corporation's total net income is 2,200. Assuming that the domestic tax rate is 40 percent, the tax payable, prior to subtracting the allowable foreign tax credit, is 880 (40 percent of 2,200). Subject to the limitation rules, the corporation is entitled to a credit for the foreign taxes paid. The credit is limited, however, to the lesser of 100 (the foreign tax paid) and 80 (880 × 200/2,200) (the domestic tax on the foreign source income).

Table 4.7 Allocation of Expenses

Gross foreign income	280
Interest expense	80
Net foreign income	200
Foreign tax (50%)	100

Net domestic income	2,000
Total income (200 + 2,000)	2,200
Domestic tax of 40%	880
Credit for foreign tax	80
Total tax	800

In the above example, the interest expense of 80 was applied or allocated totally against the foreign source income. If it had been applied against domestic source income, the entire amount of foreign taxes (100) would have been creditable against the domestic tax because the credit would be limited to the lesser of 100 and 112 (880 × 280/2,200). Assuming that the interest is properly attributable to the foreign source income, it should be allocated to that income in computing the limitation on the credit because otherwise the domestic tax system would be giving a credit for foreign taxes in excess of the domestic taxes on the foreign source net income. Therefore, in order to protect the domestic tax base, it is crucial for interest and other expenses to be allocated properly between domestic source and foreign source income.

An appropriate amount of expenses should also be attributed to foreign source income for purposes of computing the limitation on the indirect foreign tax credit, discussed in section 4.3.3.3. In addition, the indirect credit raises the issue of the timing of the deduction of expenses incurred by a resident parent corporation to earn foreign source income through a foreign affiliate. Residence country tax on foreign source income earned through a foreign affiliate is generally postponed or deferred until the resident parent receives a dividend (or other taxable distribution). Interest and other expenses incurred by the resident parent to earn that deferred income should not be deductible, at least theoretically, until the income to which the expenses relate is subject to residence country taxation. These payments should be deductible when the resident taxpayer receives a taxable distribution out of the related income from its foreign affiliate. Few countries currently attempt to deal with this timing issue because of its complexity.

4.5 TAX SPARING

Some tax treaties provide for "tax sparing", typically through a tax sparing credit. A tax sparing credit is a credit granted by the residence country for foreign taxes that, for some reason, were not actually paid to the source country but that would have been paid under the source country's normal tax rules. The usual reason for the tax not being paid is that the source country has provided a tax holiday or other tax incentive for foreign investors to invest or conduct business in the country. In the absence of tax sparing, the actual beneficiary of a tax incentive provided by a source country to attract foreign investment might be the country in which the investor is resident rather than the foreign investor. This result occurs whenever the reduction in source country tax is replaced by an increase in residence country tax.

The shifting of the benefit of an incentive from the foreign investor to its home country's treasury in the absence of tax sparing is illustrated by the following example. Country A, a developing country whose normal corporate tax rate is 30 percent, offers foreign corporations a ten-year tax holiday if they establish a manufacturing enterprise in Country A. BCo, a resident of Country B, establishes a manufacturing plant in Country A. Country B imposes corporate tax at a rate of 40 percent and uses a foreign tax credit system to provide relief from international double taxation. BCo earns income in Country A of 1,000 in the first year. In the absence of the tax holiday, Country A would impose a tax of 300 on BCo and Country B would impose a tax of 100 on BCo, determined by subtracting from the tax of 400 otherwise payable a foreign tax credit of 300. The tax holiday eliminates Country A's tax of 300. Therefore, BCo's tax liability to Country B becomes 400 minus the allowable credit, which is zero because BCo did not actually pay any tax to Country A due to the tax holiday. Thus, the tax revenue of 300 forgone by Country A in granting the tax holiday to BCo goes to the benefit of Country B and not to BCo.

If Country B were willing to give a tax sparing credit to BCo for the taxes forgone by Country A, then BCo would get the benefit of the tax holiday. Its income in Country A would be 1,000, and it would pay no tax to Country A. It would have an initial tax obligation of 400 in Country B but would be allowed to reduce that amount by the 300 of tax forgone by Country A, for a total tax liability of 100. The results are shown in the following table.

Table 4.8 Example: Tax Sparing

Country A	
Income from Country A	1,000
Country A tax before holiday	300
Tax holiday credit	300
Country A tax	0
Country B	
Income from Country B	1,000
Country B tax	400
Tax sparing credit	300
Total Country B tax	100

As the example shows, in the absence of the tax sparing credit, Country A's tax holiday will not have any impact on potential investors resident in Country B because their residence country tax will increase to offset the benefit of the tax incentive provided by Country A.

Tax sparing is primarily a feature of tax treaties between developed and developing countries. In the past, many developed countries granted some form of tax sparing to developing countries by way of treaty as a matter of course, with some voluntarily granting tax sparing in their treaties with developing countries as a way of encouraging investment in those countries, but others granting tax sparing credits only

reluctantly. Some developing countries traditionally have refused to enter into a tax treaty with a developed country unless they obtain a tax sparing credit.

The US is adamantly opposed to tax sparing and has not granted it in any of its tax treaties. Consequently, for many years it concluded very few tax treaties with developing countries. The US position is that the grant of a credit for phantom taxes – taxes not actually paid – is inconsistent with the efficiency and fairness goals of its foreign tax credit and encourages developing countries to engage in beggar-thy-neighbor bidding wars through their tax incentive programs. This position has been characterized as "arrogant", "imperialistic", and "patronizing", but it is a defensible assessment of the effects of tax sparing. In recent years, the hard-line view of many developing countries has softened, and the number of US tax treaties with developing countries is growing rapidly. Several other developed countries have recently agreed to tax sparing provisions in their treaties with developing countries only under stringent conditions.

The merits of tax sparing credits cannot be divorced from the merits of the tax incentives that they encourage. Although tax incentives have some enthusiastic supporters in the political arena, they are difficult to justify on the basis of tax policy principles. Certain targeted incentives aimed at achieving some identified goal may be justified, but those incentives are so narrowly drawn to prevent abuse that they tend to generate little political support. The general conclusion to be drawn from the voluminous tax literature dealing with tax incentives is that the costs of tax incentives are typically large, the benefits are always uncertain, and only rarely do the potential benefits justify the likely costs.

A developing country wishing to use tax incentives to attract foreign investment is not stymied by a failure to obtain a tax-sparing article in its tax treaties. Tax sparing obviously is not needed if the country of residence of the potential investors uses the exemption method to avoid double taxation – for investors resident in an exemption country, the source country tax is the only tax. Thus, any reduction in source taxation automatically accrues to their benefit. Even investors from credit countries may benefit from a source country incentive with a little tax planning, as the example below illustrates.

BCo, the investor resident in Country B in the preceding example, wants to obtain for itself the benefits of the tax holiday offered by Country A. To that end, it organizes ACo, a wholly owned subsidiary, in Country A. ACo engages in manufacturing activities that qualify for the tax holiday. ACo earns 1,000 from its manufacturing activities in Country A, which is not taxable by Country B because ACo is not resident in Country A and the income is not earned in Country A. BCo would be taxable by Country B on any dividends received from ACo, but ACo has no obligation to pay such dividends. Indeed, Country A may benefit more from its tax holiday under this arrangement than it would from tax sparing because the potential tax on dividends paid to BCo will provide a strong incentive for ACo to reinvest its profits in Country A. However, BCo may be reluctant to invest in Country A if it cannot repatriate any profits generated by its investment without paying tax.

The above example illustrates only one of several ways that tax incentives may benefit residents of countries using the credit method in the absence of tax sparing. Many US multinationals benefit from host country investment incentives because of

the way the US overall limitation on the foreign tax credit operates. Under this overall limitation, US corporations that pay high foreign taxes to one country can use what would otherwise be excess foreign tax credits to offset the US tax otherwise imposed on foreign business profits that are subject to low foreign taxes in another country. Assume, for example, that PCo, a US corporation, has an excess foreign tax credit of 35 from operations in Country A. PCo earns profits of 100 in Country B that ordinarily would be subject to tax in Country B of 35, but that tax is eliminated because of a tax holiday provided by Country B. PCo benefits from that tax holiday because it can eliminate the US tax of 35 that would otherwise be imposed on its profits in Country B with the excess credit of 35 from Country A.

Another problem with tax sparing is the potential for abusive tax avoidance. For example, generous tax sparing credits in a particular treaty often encourage residents of third countries to establish conduit entities in the country granting tax sparing. Tax sparing also puts pressure on the enforcement of a country's transfer pricing rules because taxpayers are encouraged to shift profits to the country providing the tax incentives.

In 1998 the OECD published a report, *Tax Sparing: A Reconsideration,* which suggests that the case for tax sparing is not persuasive. It recommends that tax sparing be restricted to countries whose economic development is at a considerably lower level than that of OECD member countries. It also sets out some best practices for the design of tax sparing provisions to ensure that the provisions are limited to genuine business investments and are not susceptible to abuse. See paragraphs 72-78.1 of the Commentary on Article 23 of the OECD Model Treaty.