Bilateral Tax Treaty Formation with Tax Sparing

What is Tax Sparing?

Tax sparing is a provision specified in a bilateral tax treaty primarily between a developed and a developing country, in which the home country (normally the developed country) gives an income tax credit to its residential company for taxes which are "spared" by the host country as a result of the host country's tax concession.

Without tax sparing, the host country's forgone tax revenue is transferred to the home country's treasury when the resident company pays their annual income tax at home.

Should the home country agree to tax sparing?

Costs of tax sparing:

1. Reduction of home country’s tax revenue and effective tax rate.
2. Bias toward overseas investment (tax burden inequality)
3. Administrative difficulty
4. Home country’s sovereignty in determining its own tax rate.
5. Can be used as an aggressive tax avoidance tool.

Benefits of tax sparing:

1. As an economic aid to the host country.
2. Enhancing global competitiveness of multinational companies.
3. Expanding overseas investment opportunities for a small home country.
4. As a negotiating tool for tax rate reduction.
**Empirical evidence:** We observe bilateral tax treaties with a reduction in the host country’s tax rate.

**Question:** *When can we observe tax sparing?*

**Model framework**

- **Assumptions**
  1. A multinational company is a resident company of country X, with a parent company in X and a wholly own subsidiary in Y.
  2. The company’s profit functions in the countries are:
     - Profit in country Y: $\Pi(\lambda)$
     - Profit in country X: $\Pi(1-\lambda)$
     where $0 \leq \lambda \leq 1$ is the proportion of company’s production in country Y.
  3. The subsidiary repatriates all of its after-tax profit back to the parent company in country X.
4. Country X operates under the tax credit system and taxes the worldwide profit of its resident company.

5. We assume \( t_x > t_y \) and \( t_y^* \geq t_y \), where:

\( t_x \) is country X’s tax rate
\( t_y^* \) is country Y’s tax rate before tax concession
\( t_y \) is country Y’s tax concession rate

6. Tax sparing, \( 0 \leq a \leq 1 \), is given on income. If tax sparing is not agreed, \( a=0 \).

**Descriptions of the models**

**Stage 2:** The firm maximises global profit after taxes and credit by choosing \( \lambda \).

**Stage 1:**

**Competitive cases:** Each government maximises its tax revenue. Country Y chooses \( t_y \). Country X chooses \( a \).

**Co-operative cases:** Country Y chooses \( t_y \) before the negotiation. Both governments, then, maximise the Nash product of their tax revenue by choosing \( a \).

**Results**

1. **Competitive cases:**

Country X’s revenue decreases in \( a \). As a result, the equilibrium takes a corner solution where X chooses \( a = 0 \) and so there is no tax sparing agreement.

2. **Co-operative cases:**

2.1 **No limit on foreign tax credit.**

Tax sparing exists but does not reduce country Y’s tax rate. And the agreed tax sparing rate does not depend on the home country’s bargaining power.
2.2 Country X puts limit, \( 0 < \alpha \leq 1 \), on foreign tax credit.

The equilibrium with positive tax sparing and the reduction of country Y’s tax rate can exist. Moreover, the higher the home country’s bargaining power, the lower the equilibrium tax sparing rate.

Conclusion

The equilibrium tax sparing with the host country’s tax rate reduction can exist when the home country imposes a limit on how much its residential firm can claim foreign tax credit against tax liability at home.

Extensions

Working on agreements with competition for investment between host countries.