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Tax Incentives, International Commitments, and Tax Sufficiency

Another Impossible Trilogy

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In memory of Juan C. Gómez Sabaini and Francisco de Paula Gutiérrez

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Abstract*

The countries of Latin America and the Caribbean (LAC) use significant cuts in the corporate income tax rate (CIT) or tax holidays to promote investment. In turn, this incentive must comply with the condition of not discriminating between export operations and those destined for the local market, according to commitments made to the World Trade Organization (WTO) and Base Erosion and Profit Sharing (BEPS) project.[1] This can give rise to significant tax arbitrage,[2] when firms that benefit from a lower corporate tax rate (CTR) sell with inflated prices to firms subject to the standard rate in the local market, thereby transferring revenues to the subsidized firms from the general tax regime. This has significant and growing negative impacts in terms of revenue and equity between beneficiary firms and those subject to the general tax regime in the same sector, especially in the services currently enjoying spectacular growth (such as the digital or telecommunications segments). To mitigate such arbitrage, some practical options, such as the ones presented in this paper, will need to be applied. This can make tax rate benefits viable as a policy tool and compatible with such international agreements, and can reduce tax revenue losses. In addition, the paper includes tables that summarize the main tax incentive regimes and presents a peer review of possible harmful fiscal regimes in Latin America (BEPS Action 5).

JEL codes: H25, K34
Keywords: BEPS, fiscal incentives, income tax, tax avoidance, WTO

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[1] The initiative, implemented by the OECD starting in 2013, is known as the Base Erosion and Profit Sharing (BEPS) project. It seeks to combat tax avoidance practices at the international level. It is comprised of more than 135 countries and 10 multilateral organizations with a plan consisting of 15 actions. Its aim is to combat the aggressive tax planning strategies used by multinational groups to take advantage of the discrepancies and inconsistencies of fiscal systems and transfer their profits to jurisdictions with little or no taxation in which practically no economic activity is carried out and, thereby, reduce the corporate tax paid in certain jurisdictions. The Inclusive Framework on BEPS, alongside the Global Forum on Transparency and Exchange of Information for Tax Purposes (comprised of nearly 161 jurisdictions and 19 organizations) represents the most important and successful international tax coordination effort in history.

[2] Tax arbitrage is the possibility of exploiting differences in fiscal treatment, whether between two subjects or the same one, when applying different tax treatments according to the transactions conducted by the subjects, the sectors of activity in which they work, the locations from which they operate, etc. The concept differs from tax avoidance, since this necessarily implies a forced application of the rule (which can sometimes be punishable), whereas arbitrage can be entirely legal.

Introduction

The coexistence in the same country of entities that benefit from reduced income tax rates—either due to the nature of their activity or to their location in business promotion zones—alongside others that are linked to them but subject to the general tax regime offers many possibilities for aggressive tax planning or tax arbitrage. Box 1 provides an example of such arbitrage.

Box 1
Example of Arbitrage, or Price Manipulation

The firm *Lambda Inc.*, non-resident in country A, has two subsidiaries in said country, Lambda Services and Lambda Distribution. Lambda Services (LS) is established with a corporate tax rate (CTR) benefit, for example, in a free zone of country A and, therefore, totally or partially exempt from income tax. In contrast, Lambda Distribution (LD) is established outside of the free zone and subject to the standard rate, levied at 25 percent.

In this situation, LD will be a customer of LS, because the services it receives from LS will constitute a deductible cost for LD, which will reduce its CIT contribution by 25 percent in all the payments that it makes. For its part, LS will not pay any CIT, as already mentioned.

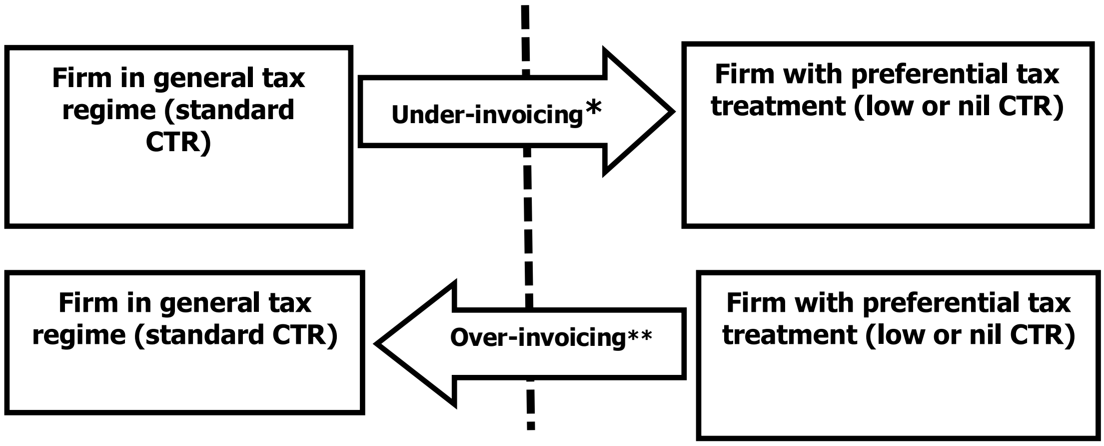
If LS carries out real economic activity, it could provide LD with computing, technology, marketing, communications, accounting, and auditing services, or legal advice—the list is endless. Taken to an extreme, LS could provide as many services as were necessary, within the regulated exempt activities, to reduce LD's tax base to zero. Similarly, if the company subject to the standard rate (LD) had a client outside of the country, it could also save part of the tax by selling part of the service at a lower price to its subsidiary firm (LS) with a reduced CTR (in the free zone). LS, in turn, would invoice the foreign client with the earning included.

In any event, it is fair to say that, especially in the latter case, the existence of effective control of transfer prices and the application of other measures to prevent abuse can reduce these possibilities.

* In the case of under-invoicing, the company with preferential tax treatment thereafter exports or resells at the market price and captures (almost all) of the benefit.
** In the case of over-invoicing, there may also be resale in the local market at a loss, but the usual practice is to generate a higher cost per service (sometimes fictitious) or for a good that is integrated into the firm's productive process that pays tax at the standard CTR.

Figure 1 reveals that prices of sales from the subsidized firms to those under the general tax regime (internal transfer prices), and vice versa, can be manipulated. This can be done by undervaluing the sales of the goods and services from the firms under the general tax regime (standard CTR) to those receiving preferential tax treatment (low or nil CTR), leaving the subsidized firm with the earning that would correspond to the regular treatment (at the top of the figure). Likewise, (lower part of the figure), in cases where there is no ring-fencing and the enterprise in the preferential tax regime can also sell in the domestic market while paying tax at the same reduced rate, prices can be manipulated allowing subsidized firms to appropriate the gain.

Figure 1
Arbitrage (manipulation) of Prices of Goods and Services



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All Latin American and Caribbean (LAC) countries lower the CTR (see Annex 1). For their part, the World Trade Organization (WTO), for manufacturing; and the Forum on Harmful Tax Practices (FHTP) of the Organisation for Economic Co-operation and Development (OECD), for services, eliminate the possibility of discriminating between domestic sales and exports. That is, essentially the same reduced rates of income tax must be applied to the subsidized firms, whether they export or sell to the domestic market. This creates significant opportunities for price manipulation within each jurisdiction between firms in the preferential tax regime and those in the general regime, which reduces tax revenue. To put it another way, if governments do not wish to forego tax revenue, they must choose between applying tax incentives or accepting the aforesaid international commitments. It is not possible to do all three things at once (trilogy).

The opportunities for arbitrage are significant and varied, especially with respect to services, since these are provided across all economic sectors (as already mentioned, computing, technology, administrative and similar services, as well as design, security, marketing, etc.). In addition to being extremely dynamic—particularly due to the growing development of the digital economy and its applications, but also to biotechnology, leisure, and internet gaming—services have become even stronger during the pandemic and are expected to contribute to the subsequent recovery (see Box 2 in section 3).

Additionally, in the majority of cases, this arbitrage is nearly impossible to control, either through legislation, by limiting subsidized activities (see Annex 1) or chiefly through auditing in practice. This is mainly due to service provision, since the nonmaterial nature of services makes it very complex to verify their existence, their size, and their real uses. Therefore, auditing them is very complex and expensive for the administration. Furthermore, it is very difficult to estimate the loss of revenue, either caused by this avoidance/evasion scenario or, consequently, by determining the "true" tax expenditure of these incentives regimes.

In their desire to attract investment and foster employment and regional development, governments have given tax benefits (low or nil CTR) to both traditional activities (efficient) and those involving more technology, with a significant and growing loss of fiscal revenues.[3]

To summarize, on top of the substantial fiscal revenue forgone, already granted to the most competitive sectors of the economy, there will be a significant loss of additional revenue owing to the erosion of revenue in the domestic market. This will occur because of the elimination of the possibility of discriminating between subsidized sales (e.g., exports) and those levied at the standard rate (internal). Last but not least, these opportunities for arbitrage are a source of unfairness in the competition between beneficiaries and the rest of the taxpayers.

In the first section of this document, a brief discussion is offered about the differential CTR-based benefits applied in the region. The second section is an analysis of the WTO trade rules for manufacturing and the commitments assumed under the framework of the OECD's BEPS project aimed at avoiding harmful tax competition (see Annex 2), especially with reference to differential treatment given to exports and sales to the domestic market. By having to comply with the former, significant opportunities for arbitrage arise via internal transfer prices,[4] with negative impacts on revenue and fair competition among suppliers in the market. Section 3 presents three possible solutions for this. Section 4 concludes.

1. Tax Incentives

1.1 Brief Introduction

LAC has almost always used tax benefits to attract investment, especially foreign direct investment (FDI). Therefore, two types of income tax incentives that aim to encourage investment predominate (Roca, 2011): (i) reductions in the CTR for certain segments (regions, sectors, activities or firms)[5] and (ii) those that reward the amount of the investment in a wider sense.[6] This paper will focus on the first type, which is the more usual one in the region (see Annex 1), as well as the more relevant one due to its economic and tax revenue effects. It will focus on the aspects related to their use and

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[3] For further analysis and evaluation of tax incentive regimes in the region, see the country studies: Artana and Templado (2012 and 2015), Auguste et al. (2015), Azuero et al. (2019), and FIEL (2016).

[4] There are 11 countries that have regulations covering the operations between local subsidiaries (CIAT, 2018) However, in addition to being complex and exceptional, their application is difficult to control effectively.

[5] An extreme example is so-called tax holidays, on which the tax rate is zero.

[6] These are applied through two main mechanisms: (i) a deduction of a fraction of the investment of the tax due for CIT; i.e. a tax credit of a percentage of the investment over the CIT that is payable, and (ii) accelerated depreciation, in which the incentive consists of establishing a timetable (various methods) of faster depreciation for certain investments or sectors. There are others of less material relevance, such as personnel training expenses linked to investment, or other expenses for the public benefit (for example, education or recreation centers or public works for populations living close to the investing company).

the possible harmful consequences of arbitrage between beneficiaries and the standard tax regime.

Presently, the dominant position in the economic literature is that the structural factors (regulations on FDI, trade openness, size and potential of the market, geographical distance and access, and provision of resources) are more important than tax benefits as determinants of the amount and the quality of investment (Devereux and Griffith, 2002; Mistura and Roulet, 2019; and Nicoletti et al., 2006). The non-tax factors usually highlighted are political stability, legal certainty, non-distortionary macroeconomic policy, quality of the workforce, and infrastructure condition. However, in the case of developing countries, there are arguments that can justify tax benefits, without failing to recognize their disadvantages (for more details, see IMF et al., 2015).[7]

1.2 Advantages and Disadvantages of Corporate Tax Rate Incentives

There are five main arguments that justify stimuli (or subsidies) for investment: (i) compensation for market failures;[8] (ii) compensation for regional disparities in terms of provision of mobility-restricted resources[9] (Haapanem, Ritsila, and Tokila, 2005); (iii) compensation for a country's institutional weaknesses;[10] (iv) the fact that the high mobility of capital in the actual global economy makes it necessary to offer an effective tax rate low enough to attract external investment (and to avoid the flight of domestic savings), that is, tax competition,[11] especially in developing countries (Bolnick, 2004);[12] (v) a political economy argument, expressed as the strategic interaction of public agents (incentives) on the decisions of the private sector to achieve changes in the

[7] IMF et al. (2015) discusses best practices for the design, implementation, and administration of tax incentives for investment in developing countries. This study recognizes that, among other things, fiscal coordination offers opportunities for addressing indirect positive effects (such as the impact on knowledge and technology), but also runs the risk of inducing other harmful responses.

[8] Market failures generate inefficiency in its operation. Therefore, a series of shortcomings are identified that mean that markets, left to themselves, are incapable of reaching levels of efficiency or ensuring a process of convergence between least developed and developed countries. Examples of failures are the lack and the asymmetry of market information, the difficulties of access for certain activities to basic services (utilities), banking and insurance, and so on. These failures are amplified by the greater influence of the economic cycle, in particular in LAC (the commodity-linked cycle), and extreme income and wealth inequality with the consequential influence of lobbies in preserving privileges to ensure that these markets persist in being inefficient, for their own advantage.

[9] There are differences in infrastructure or historical factors that have led to a concentration of population and production that generate economies of agglomeration, and also of scale, for the firms located in such regions, with consequent regional heterogeneity in terms of structure and the dynamics of production (Porto, 2011).

[10] "Institutions are the rules of the game and the rules of conduct that facilitate or hamper transactions and exchanges. The key role of institutions is to reduce uncertainty by establishing a stable structure for human interaction. Starting with codes of conduct and involving laws and contracts, institutions are constantly evolving, and therefore constantly altering the choices open to us" (North, 1991). Briefly, the capacity of the country (the State) to enforce a group of norms of conduct with respect to personal and property rights (rule of law) perform a crucial role when it comes to the decision to invest. The weakness of effective regulation or the lack of protection from unfair or illegal competition, or the lack of efficient credit markets (of money and capital) or insurance markets are examples worth mentioning.

[11] Assuming perfect capital mobility (infinitely elastic supply) for small open economies would imply an optimal policy of not taxing capital gains, by eliminating corporate income tax (Bucovetsky and Wilson, 1991). This would justify competing (from the tax point of view) for mobile capital by the concession of tax incentives. Klemm (2009) analyzes other possible responses to tax competition.

[12] Bolnick (2004) maintains that developed economies have become more homogeneous in infrastructure, workforce training, macroeconomic management, and effectiveness of the regulatory framework, which means that differences in tax treatment become more significant as an explicative factor of the flows of investment towards emerging countries.

productive structure in line with the government's development objectives (Porto, 2011).[13]

There is also a series of theoretical and practical arguments regarding the problems generated by each type of fiscal incentive, as well as about the methodologies and empirical evidence regarding their effectiveness, which are beyond the scope of this paper. Here, the disadvantages of the benefit of establishing a low (or nil) statutory rate of corporate income tax (Roca, 2011) will be discussed.

In terms of administration, first, opportunities are opened up for aggressive fiscal planning when, through the management of "internal transfer prices," revenues are diverted to the subsidized firms. Second, if there are barriers to sales in the domestic market (either sectors or regions), problems of international taxation may arise, since multi-jurisdictional cooperation agreements tend to reject these barriers along with, in general, any form of ring-fencing of the corporate tax base for certain firms or activities relative to others (this will be further analyzed below). Third, identifying the subsidized sectors with a reduced rate is complicated, since they are not always easily and objectively determined. This can lead to problems of lack of transparency and discretionality in their concession, given the existing variety of business models and types of companies. Finally, there is an extra administrative cost of monitoring the exemption, which must be borne by the tax administration. These changes affect the simplicity of taxation and even the very stability of the tax system. This is much appreciated by the business community, due to the changes and the possible discretionality by the administration.

As far as economic factors are concerned, distortions are generated in resource allocation: by granting the incentives for set periods, as often occurs with tax holidays or a 0 percent CTR, short-term investments are encouraged, with low sunk costs, which are businesses that are easy to open and close (so-called footloose firms), which can rapidly pull up stakes and move to another jurisdiction (Díaz de Sarralde et al., 2007).[14] Second, the principle of neutrality in the allocation of capital between sectors is violated, affecting the economy's competitiveness by biasing the redistribution of resources to the subsidized sectors, even if their pre-tax rate of return is lower. Third, there is a loss of revenue cost—although only partial, in the event it is assumed that the investment will not be made—as some or all of the resources that would have been applied will be used in another activity and, therefore, would have been taxed normally.[15] Additionally, the financing of public goods (infrastructure or education) is postponed. Finally, the benefits may be redundant if the new investment would have been made anyway without the presence of the tax benefit.

[13] This gives rise to multiple possible equilibria between the behavior of the private sector and government objectives (investment, employment, technological change, regional development or environmental protection) according to the public policies developed during its management.
[14] The authors indicate a bias that implies discrimination against small and medium-sized enterprises (SMEs), which have limited access to credit, and also against firms with significant sunk assets, which are less acceptable as collateral.
[15] There are other particular cases, such as investments in the extractive sector, in which the low tax rate does not compensate the high environmental impact and can lead to a negative cost/benefit result, both in the economic analysis for the country and from the financial point of view for the State.

2. The WTO and OECD Restrictions on Tax Incentives: Theory and Practice

2.1. Incentives and Free Competition

Markets use the price mechanism to find an equilibrium between supply and demand. The prices at which products are supplied in a market should reflect their final value, adding to the costs, a reasonable profit. But this does not always happen, as there are a range of public policies that can alter a product's public sale price. One of those policies consists of providing incentives for the production of certain goods or services, or simply the policy of encouraging productive investment in a country or region. One possible way of fostering such production is through tax incentives.

Artificial price manipulation provides advantages for the subsidized products and makes the possibility of international trade entirely artificial, as the prices no longer reflect the true value of the goods or services exchanged, and the most interventionist States place their own firms at an advantage, thereby breaking the rules of free competition. Tax incentives have therefore always been considered with certain reticence within the framework of international trade, at various levels. Of these levels, only two are examined here, as they are of special interest for our study: the WTO rules and the rules of the so-called Inclusive Framework on BEPS (see below, Section 3) established by the OECD.[16] Although they contain notable differences in terms of scope and even effectiveness, both sets of rules have in common that their vocation is quasi-universal, applicable to nearly all countries.[17]

2.2. Restrictions on Tax Incentives in the World Trade Organization Framework

The multilateral rules on subsidies focus on the possible distortion of trade flows that they can cause. Any subsidy has been subject to restrictions that take into account its potential to distort trade.

Nonetheless, in the first years of the General Agreement on Tariffs and Trade (GATT), the rules on subsidies, established in Article XVI, were neither precise nor strict. The Agreement on Subsidies and Countervailing Measures (SMC) (Uruguay Round, 1994) recognized these initial shortcomings and introduced substantial modifications in the disciplines relative to subsidies, essentially in two aspects: (i) subsidies were defined for the first time and their limitations were described in greater detail, classifying them into three categories: prohibited, actionable, and non-actionable; and (ii) the new Agreement was applied to all WTO members, which imposes considerable additional obligations on developing countries, especially on those that had not been present at the negotiations of the Tokyo Round Code.

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[16] There is also a considerable number of regulations to preserve a level playing field at the regional level (for example, within the framework of the European Union [EU], in regional trade agreements such as the Free Trade Agreement between the United States, Central America, and the Dominican Republic [DR-CAFTA], etc.), and even within certain countries, specifically when they are politically decentralized and there is strong taxation autonomy at the sub-central level (for example, the jurisprudence of the United States Supreme Court over the Interstate Commerce Clause of the U. S. Constitution, or the fiscal harmonization framework between the autonomous "foral" territories (the Basque Country provinces and Navarre) and the "common" territory in the case of Spain, etc.).

[17] The WTO Agreements are applicable to the members of this organization, a total of 164 States, while the BEPS agreements comprise a commitment that is today assumed by more than 135 States, members of the Inclusive Framework on BEPS.

Ad (i). Article 1 of the Subsidies and Coutervailing Measures (SCM) agreement establishes that a subsidy is deemed to exist when it has the following three basic elements:

a) A financial contribution is provided.
b) A government or public body within a member-country's territory grants the contribution.
c) This financial contribution confers a benefit.

It can therefore be deduced that tax exemptions may constitute subsidies. Subsidies by themselves are not prohibited according to the WTO SCM Agreement, but only when they are considered specific subsidies. There are four types of specificity contained in the SCM: (i) relating to the enterprise, (ii) relating to the branch of industry, (iii) regional specificity, and (iv) prohibited subsidies. Any of these specific subsidies exert an influence on prices and consequently on trade, which means that they may have adverse effects on the interests of member countries and may be prohibited according to the WTO rules, following an established procedure.

For the purposes of this study, the prohibited subsidies are especially significant. They are contained in Article 3 of the SCM, which identifies two types:

a) Those contingent either *de jure* or *de facto* on an export, either as a sole condition or among various other conditions; and
b) Those contingent on the employment of national products with preference over imported products, as a sole condition or among various other conditions.

It is clear that the existing tax incentives in Latin America are often of the first type (see Annex1), which means that they are prohibited subsidies.

Ad (ii). To mitigate the impact of applying the rules on subsidies to all members, the SCM Agreement contains arrangements regarding special and differential treatment for the least developed countries (LDCs)[18] and even for other developing countries. In order for the elimination of the prohibited subsidies not to apply to LDCs, the other developing countries must take the necessary actions to eliminate the prohibited subsidies in a period of eight years following the entry into force of the SCM Agreement, which occurred in 2003. Nonetheless, in 2007, the WTO decided to grant an extension period to developing countries until December 31, 2015. Ultimately, as things stand today, and for more than four years, no country other than an LDC should apply prohibited subsidies.[19] However, the subsidies that were considered to be prohibited, but temporarily acceptable in relation to a group of countries that exceeded

[18] So called by the United Nations (Section (a) of Annex VII of the SCM) and containing only one LAC country: Haiti. The full list is available at: https://unctad.org/en/pages/aldc/Least%20Developed%20Countries/UN-list-of-Least-Developed-Countries.aspx

[19] The SCM set out in Annex VII a list of the countries that, by surpassing the US$1,000 per capita GDP limit, should comply as developing countries, that is, by progressively eliminating their subsidies. The following countries appear in the list: Bolivia, Cameroon, Congo, Dominican Republic, Egypt, Philippines, Ghana, Guatemala, Guyana, India, Indonesia, Ivory Coast, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, Senegal, Sri Lanka, and Zimbabwe.

US$1,000 per capita gross domestic product (GDP) in relatively recent times, have continued to be applied (or even reinforced with still more generous ones).

From points (i) and (ii) above, it is easily inferred that the applicability of subsidies (tax exemptions) in developing countries other than LDCs is currently sustained only *de facto*. In other words, they have no legal basis in accordance with the SCM Agreement. Moreover, there are also incentives for agricultural activities[20] and services[21] that are not analyzed in this brief review.

Another noteworthy issue is the growing concern of some members over generalized noncompliance with the obligation expressed in Article XV of the General Agreement on Trade of Services (GATS) to enter into a bilateral or multilateral dialogue with respect to subsidies for services (of course, there is no obligation whatsoever to report these possible subsidies). Finally, there are difficulties that prevent the WTO Agreements on subsidies from being effectively applied, particularly in terms of actionable subsidies, although this ineffectiveness is also seen in terms of prohibited subsidies.[22] In practice, it is not easy to determine whether a subsidy is in fact linked to an export, as the ample jurisprudence on this issue demonstrates.[23]

2.3. Restrictions on Tax Incentives within the Framework of the BEPS Exercise

In September 2013, the OECD and the G-20 countries adopted a plan comprised of 15 lines of action (known commonly as actions) to provide a response to the BEPS problems and ensure that profits are taxed where the economic activities are effectively carried out. Other countries have joined in with the development and implementation of these actions, participating in the Inclusive Framework on BEPS established by the OECD in 2016.

One of the 15 lines of action, Action 5, focuses on the restriction of tax incentives and offers solutions for fighting against harmful tax regimes more effectively, to counteract harmful fiscal practices related to geographically mobile activities, such as financial

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[20] In agricultural matters, there are also limitations on State support, consistent with Article VI of the WTO Agreement on Agriculture. Although the way they must be calculated is complex, one can conclude that a support or subsidy to agricultural products of more than 10 percent would not be permitted. Given the extension, in some cases, of tax-free zones to agricultural production, such as, for example, certain greenhouses, this question is pertinent and could even become significant. Nor is any regional trade agreement mentioned, which may contain specific rules in this regard. For example, Article 3.4 of DR-CAFTA prohibits certain tariff exemptions.

[21] In terms of services, Article XV of the GATS, which deals with subsidies, is fundamentally a mandate for negotiation rather than a set of rules. The debates about possible approaches with respect to the disciplines relative to subsidies have made little progress, in contrast with the issue of goods, although it has been suggested that it might be acceptable to use the definition of subsidies contained in the SCM Agreement, duly modified, as a working basis for conducting the negotiations.

[22] In the case of a prohibited subsidy, during the resolution of the dispute, it is not necessary to prove the existence of unfavorable effects. The sole requirement is to prove that the measure adjusts to the definition of a prohibited subsidy. The multilateral mandatory action in the case of a prohibited subsidy is that the Member that grants the subsidy must withdraw it without delay (whether or not it does so is another matter). However, when dealing with an actionable subsidy, the unfavorable effects for trade in relation with a specific product in a specific market in which the subsidized products compete must be proven.

[23] For example, in the Canada Aircraft dispute, both the Special Group and the Appeals Body considered that a measure should not be classified as an export subsidy merely because it is a financial contribution to a firm with a high propensity to export.

activities or other service provision, including licensing of intangible assets. The nature of such activities makes it very easy to transfer them from one country to another and, in recent years, globalization and technological innovation have further encouraged such mobility. By concentrating on these types of activities, BEPS ensures the integrity of fiscal systems, reducing the existence of preferential regimes that can potentially distort the location of capital and services.

The reactivation of the fight against harmful tax competition in 2013 took as its starting point the work initiated by the OECD in 1998 and added some additional criteria, among them transparency and the substance of the economic activity, as a basic prerequisite for obtaining benefits or incentives from any preferential tax regime. Currently, the Forum on Harmful Tax Practices (FHTP), ascribed to the OECD's Committee on Fiscal Affairs, sets out the guidelines for tackling this question.

According to what countries agreed to in the Inclusive Framework on BEPS, for a regime to be included in the FHTP sphere of study, two conditions must first be satisfied:

a) The regime must apply to revenues from geographically mobile activities; and
b) The regime must include taxation of the revenue from such geographically mobile activities, concentrating on corporate taxation, whereas consumption tax is explicitly excluded.

If the above two assumptions are satisfied, an analysis is conducted to determine whether it is a preferential tax regime. To consider a regime as such, a fiscal privilege must be offered in comparison with the general tax principles of a given country.

Nonetheless, the existence of a preferential tax regime does not mean that it is necessarily harmful or that the tax incentives must be restricted. To determine whether a regime is potentially harmful, there are five key factors and eight complementary elements[24] that help explain with greater detail the application of those key factors (OECD, 2016). The five key factors that a preferential tax regime must fulfill to be considered in that category are the following:

a) Existence of a low or a zero effective tax rate for revenue from geographically mobile activities: This factor is the essential starting point for examining whether a subsidized tax regime is potentially harmful. A harmful preferential tax regime will be characterized by a combination of a low or a zero effective tax rate and one or several of the other key factors.
b) Ring-fencing from the national economy: These are regimes that are totally or partially isolated from the national markets of the country that establishes the regime.[25]

[24] The eight elements mentioned (OECD, 2016) are: (a) artificial definition of the tax base; (b) non-compliance with international principles in terms of transfer prices; (c) fiscal exemption in the country of residence for incomes from a foreign source; (d) negotiable tax base or type of tax; (e) existence of confidentiality or secret clauses; (f) access to an extensive network of fiscal agreements; (g) promotion of the regime as a vehicle of fiscal minimization; and (h) encouragement of operations and agreements by the regime, whose motive is merely fiscal and does not imply substantial activities.
[25] According to Action 5 of BEPS (Paragraph 158), ring-fencing happens: "(i) when a regime implicitly or explicitly excludes resident taxpayers from taking advantage of its benefits; or (ii) when an entity that

c) Lack of transparency: The details of the regime or its application are neither clear nor evident, or there is inadequate regulatory supervision or financial declaration or communication.
d) Lack of effective exchange of information: when a country is unwilling to share information about the taxpayers who benefit from the operation of a preferential fiscal regime, this is taken as an indication that it is engaging in harmful tax competition.
e) No substantial activities: A nexus approach is applied for intellectual property (IP) regimes and, in the case of non-IP regimes, the main income-earning activities must be carried out in the same jurisdiction. The main income-earning activities must be carried out by full-time, fully qualified employees, and a reasonable amount of operating expenses should be incurred by such activities.

A preferential tax regime that has been identified as potentially harmful according to analysis of the key factors may be considered as not actually harmful if it seems not to have caused negative economic effects. The FHTP is responsible for determining whether the regime is actually harmful, by considering economic effects such as, for example, whether the relocation to the country offering the regime took place before a substantial volume of new activities was created, whether the presence and the level of the activities in the country are in accordance with the level of investment, or whether the regime itself is the fundamental reason for locating the activity in that country.

Countries that harbor actually harmful regimes are given the opportunity to abolish or modify them, according to the commitment they acquired when agreeing to be part of the Inclusive Framework on BEPS. The other countries are justified in taking defensive measures to counteract the effects of any harmful regime. The possibility of taking defensive measures does not justify the adoption of harmful preferential regimes, as this would in itself encourage harmful tax competition.

It is interesting to compare briefly both processes. The first stark contrast with the WTO framework is the effectiveness of the oversight measures in identifying and imposing change on the fiscal regimes that are considered harmful. In fact, it is paradoxical that a measure of soft law such as BEPS—whereby countries make a political commitment but there is no binding legal framework (either international or domestic)–ends up being more effective than other agreements where a legal international framework and a strong institutional structure exist, such as the WTO itself.

The second element of reflection is that being a member, or not, of the Inclusive Framework is highly significant. Several LAC countries have yet to make that commitment. Nonetheless, a mechanism exists whereby the FHTP can examine the incentive regimes of countries that remain outside the Inclusive Framework. Until now, this mechanism (review *in absentia*) has not been used by regimes in the region. To a large extent, this is due to what has been indicated above, that a large part of the region's free zones and special zones (FZs/SZs) are not threatened by this monitoring mechanism as they are dedicated to assembly and light industrial activity. Nonetheless, it is well known that FZs often also admit commercial or logistic activities that are being

benefits from the regime, is explicitly or implicitly prohibited from operating in the local market." The elements or circumstances that can affirm whether implicit ring-fencing exists can vary; for example, they may be practices of the tax administration itself that are not reflected in the rules.

reviewed, and that there are even FZs/SZs that admit or that are expressly designed to accept service activities.

In fact, the reviews carried out of the LAC countries that are also members of the Inclusive Framework and that already have been reviewed (see Annex 2) allow some interesting conclusions to be drawn. Three countries (Chile, Colombia, and Uruguay) opted to abolish regimes with harmful characteristics. Another seven regimes (belonging to Costa Rica, Panama, and Uruguay) have been maintained due to their importance in attracting FDI to their countries, but have been modified to eliminate the characteristics that made them potentially harmful. Several countries, such as Honduras and the Dominican Republic, are recent members and the FHTP is studying their regimes. Because of the similarity of the regimes in these countries with others already studied, mainly in Central America, it is possible to determine that they contain harmful characteristics. If this were the case, they would face pressure from the Inclusive Framework to abolish or modify their regimes to avoid harmful tax competition.

3. Policy Alternatives for Reducing Arbitrage

For this subsection, willingness to comply with the WTO rules for manufactured goods, as well as the commitments undertaken under the BEPS project, is assumed.[26] The latter should be considered the result of the overall "negotiation" of the exercise, which is already a tremendous success. However, the prohibition of tax regimes (preferential) that are ring-fenced from the national economy (Action 5), that is, based on the discrimination of tax rates for revenues arising from operations of domestic sales or exports, should be evaluated in light of the agreements effective in other BEPS actions (see footnote 24). This will allow a certain margin of autonomy to be preserved in tax policies for developing countries. This flexibility in applying the agreements would be similar to the process that occurred in the regulations described for the WTO rules and would be in consonance with what the previously analyzed economic theory establishes.[27]

The first alternative, and the most evident, is to eliminate the income tax rate differential incentives , over the long term as there are acquired rights, to achieve horizontal equity between taxpayers and sectors. But if it is assumed that countries wish to maintain incentives based on differential treatment in the income tax rate, for the technical and economic policy reasons discussed previously, the possible solutions for avoiding arbitrage arising from this situation must be different.

Furthermore, bearing in mind the wide definition that is given for the concept of "ring-fencing" for the purposes of Action 5 of BEPS (see footnote 21), it is arguable whether the measures that are detailed below should be considered as an implicit ban on operating in the national market for any firm that benefits from the incentive. Unless certain flexibility can be allowed, as we point out, this would lead to the idea of an

[26] The FHTP as such has not acquired commitments. It is merely the body that was charged with carrying out the peer reviews of tax incentive regimes that can be harmful for competition.

[27] This claim is realistic insofar as the OECD/G-20 have already proved themselves open to accepting alternative approaches to tax policy proposed by emerging economies, such as admission of the so-called "sixth method for commodities" (Argentina) regarding transfer prices, or the possibility of not abolishing bearer shares when there is an alternative way of identifying their holders (Cayman Islands).

impossible trilogy: providing the incentive, complying with international commitments and not generating arbitrage. We therefore propose the following options:

1. Apply the "rule of proportionality," which consists of allowing the firm in the domestic market only to deduct from its purchase the proportion between the rate corresponding to the seller with preferential treatment and that of the purchaser (general rate in the case of the local buyer). This mechanism, a practical example of which we can find applied, *mutatis mutandis*, in Uruguay,[28] does not solve the competition between the subsidized sectors and the general tax regime with respect to the final consumer within the same jurisdiction, since it only mitigates the impact of the transfer price between firms.

2. A second alternative consists of a final withholding tax on the sales of goods or services to the domestic market, via an "effective tax rate" (ETR), i.e., the quotient between the tax on accrued income over the sales of the fiscal period. This ETR could be general or, if possible, adjusted to the branch of activity calculated on the basis of the tax returns of the previous period from the entirely internal operations of that branch of activity or, in the absence of significant internal operations, a general weighted ETR for the economy as a whole could be applied. Such a system, a notional rate of fiscal profitability over sales, is also a mechanism that is currently used in the Dominican Republic. As in the previous mechanism, it fails to achieve equal treatment between the taxpayers enjoying preferential treatment and the rest of them, but it does reduce arbitrage, and does not present great difficulties of implementation. Beyond this, operating the ETR as a substitute for taxation by the CTR with regard to the domestic operations carried out by the subsidized enterprise, would oblige the latter to keep two separate accounts, one for domestic operations and another for foreign operations (assigning a proportion to each when shared costs are involved).

> A further possible use of a notional effective tax rate (ETR) might be that it constitutes a contribution from the preferential regimes toward post-COVID-19 pandemic economic sustainability, considering that the reduction in such activity (measured in terms of sales, whether domestic or from imports) has not been reduced by more than a certain percentage. These activities have benefited indirectly from the closure of others and, therefore, they should also contribute toward the general recovery.

3. A third possibility would consist of imposing the rate applicable to non-residents (percentage withheld on the value of sales) that corresponds to the contracted services in each case, although this usually coincides with the rate applied to technical assistance. The logic of this lies in the fact that, frequently, for these types of services with a risk of arbitrage, there is competition between non-resident suppliers and domestic suppliers (equality of treatment). In the case of goods and services, on top of CIT, a value added tax (VAT) should also be

[28] Article 20 of Law 18.083 (Tax Reform), of December 2006, by which diverse rules of the tax system are repealed, created, or modified. The Decree of April 16, 2019, however, contains an exception for all IT services (which allows a deduction of 60 percent of the expenditure).

levied, as well as any specific taxes corresponding to them, such as those recommended by the Task Force on the Digital Economy (TFDE) for the operations of electronic trading platforms.[29] These treatments do not ensure horizontal tax equity or fair competition within the country, but they do reduce the possibilities of arbitrage and they are easy to administer.[30]

It is obvious that these proposed measures are not exhaustive and can even be improved upon, but they constitute a possible solution to a significant problem due to the sufficiency and simplicity of the CTR vis-à-vis international coordination of tax systems (Barreix et al., 2005). Moreover, it is public knowledge that options for corporate taxation are being considered within the Inclusive Framework of BEPS that are adapted to technological advances and their attendant new business models (see Box 2).

[29] The Task Force on the Digital Economy (TFDE) is comprised of more than 100 countries and nine multilateral organizations, and also coordinates with representatives of the private sector. The OECD acts as secretariat (2018).

[30] Additionally, greater control of internal operations could be sought with specific plans of action for tax administrations, bearing in mind that the existing institutional weaknesses in them, the complexity of monitoring for a large number of operations and firms, and the enormous strength of the groups that back the subsidized firms are a very poor starting point from which to ensure success.

Box 2
Mechanisms for a Minimum Corporate Income Tax Rate

Mechanisms are currently being considered to introduce a minimum corporate income tax rate. The OECD/G-20 Inclusive Framework on BEPS is currently deliberating the so-called “Pillar Two” or the Global Anti-Base Erosion (GloBE) proposal. This seeks to establish a minimum global level of taxation on the revenues of multinationals that limits the incentives for aggressive fiscal planning. It consists of a package of interrelated measures that would be implemented through changes in domestic and agreed legislation. At the local level, the GloBE proposal promotes two rules, which are:

i) The Income Inclusion Rule (IIR). This is a kind of rule for controlled foreign corporations (CFCs), although it adopts an additional or top-up tax approach. In essence, when a subsidiary effectively pays tax below the minimum level established, the country in which the parent company resides would allocate the proportion that corresponds to profits generated in that period by the subsidiary to the parent company, and calculate the tax rate using the differential between the effective rate paid by the subsidiary and whatever minimum rate is eventually set.
ii) The Undertaxed Payments Rule (UTPR), which is apparently complementary to the above rule and consists of not allowing the deduction of expenses or the application of a withholding tax in the jurisdiction of the paying related entity. This would avoid the undertaxing of intra-group payments (which are expenses of the payor and would therefore reduce the tax base subject to CIT), which achieve no or very low taxation on the payee (where it is, or should be, considered income).

At the level of Double Taxation Agreements (DTAs), the incorporation of a switch-over rule (SOR) was analyzed for permanent establishments to which the conventional method of exemption would be applied in order to avoid double taxation, and an effective subject to tax rule that eliminates the conventional tax benefit if this results in no or very low final taxation; in this way, the GloBE could continue to be effective even if a DTA is applicable.

The proposal to avoid incorporating exceptions, or carve-outs, into the regime, an aspect currently under discussion, would certainly neutralize the tax incentives granted to a large extent and, ultimately, their use as an instrument for attracting investments, which is of fundamental importance in relation to the issue addressed here, because the taxation and economic policy scenario would have undergone a radical transformation.

Source: The authors acknowledge the contribution of Andrea Riccardi and Ubaldo Gonzalez de Frutos.

4. Conclusions

The combination of two types of policies leads to the possibility of tax arbitrage and, thereby, to the loss of revenue from corporate income tax. On the one hand, countries have a right to use reduced tax rates as a fiscal incentive for certain activities or regions. On the other hand, there are the regulations approved by the WTO in pursuit of a fairer trading of goods[31] and the commitments assumed to help combat harmful tax competition in the Inclusive Framework of BEPS for services.

As the acceptance of these commitments implies eliminating the restriction of sales operations at differential rates for goods and services, whether for export or for the domestic market (that is, ring-fencing is disallowed), significant opportunities for arbitrage are created within each jurisdiction, which can be very important in terms of revenue. In effect, these arbitrages can be used to transfer the benefit, manipulating the prices of sales by firms with subsidized treatment to the firms (via the costs of those purchases) that operate in the general tax regime. Due to the growth of services, especially those provided remotely, unfair competition is generated in the market and, worse still, inequity, due to the capacity of some of the larger and more powerful firms in the market to access more infrastructure and planning options to carry out the arbitrage.

To avoid such transactions, assuming the incentives must be maintained, three options are available. The first is the rule of proportion, by which the purchaser may only deduct as a cost of the purchase the quotient between the tax rate of the subsidized seller and the statutory (general) tax rate. The second consists of imposing an effective tax rate (ETR) on the subsidized seller, based on the tax payment-to-sales ratio imposed, whether general or, whenever possible, adjusted to the branch of activity calculated on the basis of the tax returns from the previous period. One variation currently being implemented is to impose a fixed rate (notional) withheld on the sale. Finally, in the case of services, it is worth considering assimilating them to technical assistance provided from outside the country, applying the final withholding rate to the services provided by taxpayers receiving the subsidized CTR.

Ultimately, since an incentive by differential tax rates will be very difficult to eliminate in the medium term and the WTO and BEPS measures will also last over time, arbitrage is considered and can have substantial and growing negative impacts in terms of revenue and equity that should not be ignored. Fortunately, the international fora on the relevant tax issues, with the participation of various multilateral agencies and the OECD leadership, have been successful in promoting international coordination while at the same time being receptive to these challenges, which means that special solutions have been contemplated for certain groups of countries.

[31] These focus on direct competition through tariff measures and other fiscal restrictions and incentives (the latter is analyzed in this paper).

Therefore, to save the impossible trilogy, a range of solutions must be applied that, on top of the BEPS proposal in its entirety (that is, Action 5 and GloBE),[32] adds some of the aforementioned practical options in the short term. This would enable tax incentives to be used as a policy tool, as long as they are accompanied by the corresponding cost-benefit evaluations.

[32] GloBE is the result of the so-called Pillar 2, which seeks, by establishing a minimum global tax rate, to resolve the pending questions of BEPS.

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Annex 1

Detail of the Content of the Table A1 Regarding Incentives in the Free Zones of Latin America

Based on the analysis of the preferential regimes of Latin American jurisdictions, by May 2020, 16 jurisdictions had been identified to have established preferential free zone regimes relevant for this analysis. These are: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Paraguay, Peru and Uruguay [33] Some of the jurisdictions indicated have more than one preferential tax regime that can be characterized as a free zone for goods, industry, or services.[34]

The majority of the FZs identified grant fiscal benefits to export trading activities and/or industrial activities. In some jurisdictions, mainly those of Central America, there are also FZs for services. With regard to the latter, it is worth highlighting the regimes set up in the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, and Panama, where the benefits are granted for a wide range of services—in some cases to any service that is offered—but only to the extent that they are offered for export. This characteristic, of granting corporate income tax incentives only when the service user is located outside of the country, is known as a form of ring-fencing and, as has already been mentioned, is one of the criteria currently under review by the Forum on Harmful Tax Practices (FHTP)[35] to analyze whether a preferential tax regime that impacts on geographically mobile activities (e.g., services) is potentially harmful. Until now, of these countries, only Panama and Dominican Republic are part of the FHTP.

The free zone service regimes of Costa Rica and Uruguay, as well as the regime in the Panama Pacific area (Panama), like those referred to above, granted the tax incentive only when the services were provided outside of the country. However, regulatory changes to the regimes were made which coincided with the adherence of these jurisdictions to the Inclusive Framework on BEPS project and to the FHTP (which implied a review of their preferential services). As a consequence of these regulatory changes, the corporate income tax benefit is applied regardless of whether the services are provided for the local market or for the external market.

[33] Many of the countries limit the incentives to a specific territory in the country, with a view to favoring regional development. This mainly happens in countries with extensive land areas, such as Manaus in Brazil, the Special Economic Zones in Mexico, the export, transformation, industry, commercialization and services centers (CETICOS) and the Free Zone of Tacna (ZOFRATACNA) in Peru, and various others situated in Argentina, etc. They are also present in smaller countries (e.g., the border free zone in the Dominican Republic).

[34] Most of the countries began with incentives for industrial production activities, within the conceptual and regulatory framework of the traditional free zones (FZs): areas that are closed and controlled by the customs services, with a closed list of charges for possible activities. But the incentive was gradually extended to commercial activity (logistics and distribution) and, more recently, to pure services. As things stand today, many of the so-called “free zones” are not traditional limited zones anymore, and they admit intangible and extremely mobile activities, such as management of patents, financial activities, and other administrative tasks (accounting, database management, call centers, etc.) known collectively as the “back office.” There are also regimes for entities known as holding companies, which deal with the ownership and management of securities.

[35] Preferential regimes for manufacturing activities, such as the FZs that include these activities, are not considered within the FHTP sphere of review.

In a more restricted way in terms of services, the regimes of the jurisdictions of Chile, Colombia, Ecuador, Paraguay, and Peru only grant benefits to services related with (or complementary with) trade and/or industrial activities, or to a limited range of services foreseen in the regulations. Also, some jurisdictions have special regimes applied to centers of intra-group services of the same business group (Panama and Uruguay).

In terms of benefits, one of the main incentives granted by all the jurisdictions is applied to the corporate income tax. More than a few jurisdictions opt to provide total exemptions; some offer a temporary exemption which thereafter become a lower tariff, while others opt to offer only reduced tax rates. One particular case is seen in the Dominican Republic, which maintains the exemption for services offered in another country, and a lower tariff, applied to sales, when the services are provided locally.

Likewise, it is noticeable that some regimes grant the tax benefit on a open-ended basis, in contrast with others where the incentive is subject to a specific time period. In this respect, free zone regimes have been identified in Chile, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Paraguay, Peru, and Uruguay, which grant a total exemption or a lower tariff as an income tax benefit, in some cases only for a certain number of years, to thereafter become a lower tariff, or one subject to renewal.

Whereas all the regimes analyzed grant income tax benefits, there are few that apply the incentive, at the same time, at the level of dividends; that is, when the profits of companies operating in the FZs are distributed. A tax benefit applicable to dividends[36] has been identified only in the free zone of Iquique (Chile), the FZs of Costa Rica, El Salvador, Panama, Paraguay, Peru, and the ZOLIC regime in Guatemala. With the exception of the free zones of Panama and Peru, which establish a lower tax rate on dividends, the other regimes apply a similar exemption to the one they apply to the CTR for firms operating in the free zone.

In relation to taxes on goods and services, the analysis focused on identifying whether there had been any tax benefit for the goods introduced into the free zone to be consumed inside the local market or for the services provided to the local market. With the exception of the Panama Pacific area regime (Panama), which includes situations of tax exemption for services entering the local market, none of the FZ regimes analyzed grants this type of fiscal benefit. For the most part, if there is a benefit for the taxes on goods and services, it is deployed when the goods are introduced into the zone, either to be re-exported or consumed within the free zone itself.

Finally, some of the regimes analyzed are currently under review by the FHTP (e.g., the Dominican Republic free zone and the regimes of Honduras), which means that they might be subject to modifications in the future. Likewise, some jurisdictions (Bolivia, Ecuador, and some Central American countries) have yet to submit their regimes for review within the BEPS framework because they are not part of the Inclusive Framework on BEPS or the FHTP.

[36] Exemptions to the distribution of dividends by a company in the free zone, on the basis of the general regime, are not considered as incentives. This is the case, for example, of the jurisdictions under whose general regime the dividends paid or accredited that arise from revenues already subject to income tax are taxed, whereas the dividends that arise from exempt profits are not taxed.