FDI and Taxation in Asia

----From a Japanese Point of View---

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The "International Symposium on FDI and Corporate Taxation: Experience of Asian Countries and Issues in the Global Economy" took takes place on February 17-18, 2006. The papers in this volume are based on the reports presented by the participants of the symposium. These papers contain important information on FDI and taxation in various Asian countries, and it is hoped that these are useful in comparing corporate taxation in Asia in the international context and in examining tax policy issues toward FDI. This short note briefly discusses several basic issues on FDI and taxation from a Japanese point of view.

1. Introduction

With a rapid growth of the Asian economies, the amount of foreign direct Investment (FDI) in many Asian countries has been increasing, quite rapidly in some countries and gradually in other countries. FDI is generally believed to play an important role in the economic development, and many Asian countries seem to compete with each other to attract FDI. All of the country reports presented in the symposium provided very useful information and analysis on each country's policy and experience regarding FDI, particularly on various aspects of taxation of FDI. Many of the reports focused on taxation by the host country[1] and many of them are written from a viewpoint of tax policy makers of the host country.

In this note, I would like to comment on FDI and taxation issues from a "Japanese" point of view. I intend to use the word "a Japanese point of view" in two ways: a viewpoint from a home country and from a taxpayer. First, vis-à-vis FDI in Asia, Japan is usually a home country. FDI is taxed by both a host country and a home country. Therefore, a perspective from a home country should be incorporated in

[1] In this note, terms of "host country" and "home country" are used in quite a loose sense. A "host country" means a country that accepts FDI. For example, if a multinational enterprise (MNE) whose headquarter is located in Country A (a "home country") has established a subsidiary in Country B, Country B is called a "host country". Note that concepts of home country and host country are different from concepts of residence country and source country as used in the legal literature of international taxation.

examining effects of taxation on FDI. Second, Japanese companies that have established subsidiaries in Asian countries are taxpayers in these countries and it is important to discuss taxation issues from a viewpoint of taxpayers. Thus, I hope that my note could supplement other country papers that discuss host country taxation issues from a viewpoint of policy makers.

The structure of this note is as follows: after considering several conceptual issues in Section 2, a rough outline of the Japanese international tax system (both domestic laws and tax treaties) is explained in Section 3. Section 4 discusses effects of taxes on "real" investment, and Section 5 discusses effects of taxes on tax planning activities. Section 6 concludes the note.

2. Some Conceptual Issues

Before getting into substance, it might be useful to comment on some key concepts used in the discussion on FDI and taxation, in order to avoid unnecessary confusions in the discussion. In particular, some conceptual issues on FDI and on tax rates are briefly examined in this section.

What is "FDI"?

- FDI (distinguished from FPI or foreign portfolio investment) is usually defined as foreign investment in which the investor owns 10 % or more of the shares. A typical example of FDI is investment by MNEs in foreign branches or subsidiaries. Note that loans of MNEs to their subsidiaries are also included in FDI.
- Statistic figures on FDI are generally produced following the above definition of FDI, and these figures are used to descript and analyze the situation of FDI.
- However, it is important to recognize that FDI defined as above is a measure of financial flows and not a measure of "real" investment
- On one hand, FDI flow may not finance "real" investment. For example, FDI might finance M&A (merger and acquisition) activities that merely change ownership of the company[2]. In fact, a large part of FDI flow aims at M&A[3].

[2] Of course, "mere change of ownership" might sometimes causes substantial improvements through, for example, introducing more efficient management.
[3] According to an estimate by OECD, the share of FDI aiming at M&A reached almost 80% of all FDI in 2000.

- On the other hand, not all “real” investment by MNEs is financed by FDI. For example, a subsidiary of a foreign parent company might raise fund in the host country in order to build a new factory in the same country, but it is not counted as FDI. From the viewpoint of the local authorities of the host country, however, this kind of activity is as good as FDI that brings about “real” investment.

The concept of FDI could have direct implications on policy discussions toward FDI. For example,

- Generally, FDI is promoted by many counties. But why do many countries want to promote FDI?
- A country might want to increase domestic capital formation. In this case, the country might be interested only in FDI that brings “real” investment.
- A country might expect increase in employment. In this case, also, FDI that brings “real” investment is desirable, but FDI that merely changes the ownership might not be relevant. In fact, in some cases, M&A by a foreign company might result in a reduction of employment through drastic restructuring of the company.
- A country might expect positive spillover effects on the domestic economy. For example, if a country wants to introduce new technologies through FDI, the country might be interested in FDI in so-called “high-tech” industries.
- On the other hand, a country might want to restrict foreign participation in some industries, including communications, mass media, finance, or arms and weapons. In fact, in many countries, there are some restrictions on the foreign ownership in these industries.
- A country also might care about the competitive pressure coming from FDI on domestic (infant) industries. This concern might be serious particularly for larger countries with large domestic markets.
- A country might think that some FDI is just a means of tax planning by, for example, some international financial institutions. In this case, the country might not want to promote FDI.

Thus, situations could be different, depending on various conditions of the countries. Therefore, it is not surprising if we often find rather mixed attitude by a host country toward FDI.

Another related issue is how it is possible to distinguish FDI from other investment.

- International taxation system in many countries distinguishes non-residents from residents, not "foreign companies" (in a sense of companies mainly owned by foreigners) from "domestic companies." "Foreign companies" are generally treated as residents as long as they are established in the country or the place of the control and management is located in the country.

- Moreover, tax authorities do not necessarily have information on the ownership structure each company.
- In order to distinguish FDI and to apply special tax treatment to FDI, some procedures are necessary, for example, permissions from the authorities regulating investment activities such as BOI (board of investment) might be necessary. Thus, you might be able to say that in order to provide some special preferential measures to FDI, you have to impose some restrictions on FDI.

What is the relevant tax rate?

When we study effects of taxes[4] on FDI, we should recognize that there are many concepts of tax rates and each concept has both merits and demerits as a tool for analysis. Therefore, it is difficult to choose just one tax rate and we should refrain from judging tax effects on FDI based on studies using only one figure.

Some examples of relevant tax rates are as follows. Note that some of them are misleading and that some of them are difficult to obtain because of the lack of necessary data for calculating them.

- Statutory tax rate: corresponding to a marginal tax rate in some cases, but in general, tax treatment of FDI is complex and a statutory rate can often be a misleading indicator.
- Average tax rate: Taxes paid by firms divided by a measure of operating surplus. It measures actual tax burden, but it is a backward-looking indicator. Also, this indicator calculated on industry or country basis is often misleading because of the effects of companies in deficit.[5]
- Average effective tax rate: the wedge between the pre- and post tax return on a typical investment. It is s measure relevant for decisions regarding lumpy investment.
- Marginal effective tax rate: the wedge between the pre- and post tax return on a

[4] Here, taxes are considered to CIT or something like CIT. However, as is discussed later, other taxes than CIT, for example, VAT, have important effects on FDI as well.
[5] Note that for the company in deficit, its operating surplus is negative, but its tax burden is usually zero because no negative tax is refunded in most countries.

marginal investment. It refers to the incentive effects of taxes on marginal investment decisions.

- Marginal tax rate (in finance literature): the present value of current and deferred income taxes to be paid per unit of taxable income. It is a relevant measure for tax planning decisions. This indicator depends on various conditions including the taxpayer's expectation on the future profile of profits and losses. Thus, each taxpayer under the same tax system is faced with a different marginal tax rate.

3. Japanese International Taxation System

In this section, we review the Japanese international tax system very briefly.[6] In Japan, as in many counties, international tax system is composed of two elements.

(a) Relevant parts of domestic tax laws (in particular, relevant parts in Income Tax Law, Corporate Tax Law, and Special Taxation Measures Law.)

(b) Tax treaties between Japan and other countries. Currently, Japan has tax treaties 55 countries.

Under the Japanese legal system, treaties dominate over domestic laws. Therefore, the position of tax treaties in the international taxation system is very important.

The outline of rules in domestic tax laws are as follows:

- Income Tax and Corporate Income Tax (CIT): adopting worldwide (residence-based) taxation for residents.
- Corporations classified into two categories: domestic corporations, which are residents, and foreign corporations, which are non-residents. Domestic companies are subject to CIT on a world-wide basis. For foreign companies, only domestic source income is subject to the Japanese CIT.
- Domestic corporations: corporations established in Japan, including subsidiaries of foreign companies, as long as these subsidiaries are established in Japan.
- Foreign corporations: subject to CIT only for "domestic source income". (Business profits of foreign corporations without permanent establishments (PEs), for example, branches, are not subject to CIT.)
- In order to avoid "double taxation", foreign tax credit (FTC) is granted. There

[6] The Japanese international taxation system is described in detail at Chapter 24 of "An Outline of Japanese Taxes 2005", on http://www.mof.go.jp/english/tax/taxes2005e.htm.

is a limitation of FTC, which is the lesser amount of “foreign CIT” paid and “foreign source income” multiplied by CIT rate. Note that the amount of FTC cannot exceed the total amount of CIT to be paid.

- Consumption tax (VAT): imposed on destination basis.

Japan has tax treaties with all of the following countries[7]: China (1883), India (1960, 1989), Indonesia (1982), Korea (1970, 1998), Thailand (1963, 1990), Philippines (1980), Singapore (1961, 1971, 1994), and Vietnam (1995). The numbers after the country names are years in which tax treaties were singed. Some of the contents of these treaties relevant to FDI include:

(A) Withholding tax rates on dividends [dividends between parent and subsidiary: in many cases, 25% of share holding or more]

China 10%
India 15% (to be reduced to 10%)[8]
Indonesia 15% [10%]
Korea 15% [5%]
Thailand [15%, 20%]
Philippines 25% [10%]
Singapore 15%(J) [5%(J)]
Vietnam 10%

(B) Withholding tax rates on royalties

China 10%
India 20% (to be reduced to 10%)
Indonesia 10%
Korea 10%
Thailand 15%
Philippines 25%, 15%, 10%,depending on kinds of royalties
Singapore 10%
Vietnam 10%

Note that these withholding taxes are not CIT for the subsidiary imposed by the host country but taxes imposed by the host country on the income of the parent company.

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[7] Reports were presented on these countries at the symposium
[8] In October, 2005, Japan and India reached a basic agreement to revise the tax treaty.

(C) Tax sparing credit

- Tax sparing credit is granted for investment incentives of the following countries: China, India, Indonesia, Thailand, Philippines. (Japan and India have recently agreed to abolish the tax sparing credit.)
- Tax sparing credit no longer exists for Korea and Singapore.
- Tax sparing credit for Vietnam is to be expired in 2010.

4. Effects of Taxes on "Real" Investment

We would like to make five comments regarding how taxes affect "real" investment brought about by FDI. First, it is difficult to judge the effect of CIT (and incentive measures in CIT) of the host country on FID.

- Other than tax rates of CIT, deductibility of various costs, depreciation method, possibilities of carryover of losses, and tax credit are among important factors to determine tax burden.
- Also, dynamic profile of losses and profits of the project critically affects tax burden.
- Thus, it is quite difficult to design a proper tax incentive schemes. And in any case, it is important to recognize that to grant favorable tax treatment toward some specific sectors means to put other sectors in disadvantageous positions.
- In reality, reduced CIT rates or tax holidays might be an important signal of the policy stance of the host country, even if the economic or financial effects of reducing CIT rates or tax holidays are limited.

Second, we should recognize that effects of taxation of the home country should also be taken into account. It is necessary to look at how both taxes of the host country and the home country affect the profitability of FID.[9]

- If the home country adopts worldwide taxation system with FTC (foreign tax credit), tax reduction by the host country only produces tax deferral benefits as long as the FTC limitation is not binding. If the subsidiary retains the profit for a long time, it might virtually escape from home country taxation. However,

[9] However, if the taxpayer is interested only in the profitability of subsidiary in the host country, he or she might be interested only in taxes of the host country. In fact, it is often the case that a manager of a subsidiary sometimes worries about the immediate performance of the subsidiary and tends to aggressively require preferential tax treatments by the host country.

if the subsidiary immediately repatriates the profit to the parent company, there could be no merits from the reduction of the CIT burden imposed by the host country. Thus, in this context, tax sparing credit could be an important, if not desirable, system.

- If the home country adopts territorial taxation system, the parent company can fully enjoy CIT reduction by the host country.

Third, not only CIT, but also other taxes are relevant.

- Other taxes including PIT, VAT, excise, and customs duties also affects the profitability of FDI.
- In many cases, taxes other than CIT are more important than CIT, particularly when FDI need not worry about CIT because they do not have profits as yet.

Fourth, various non-tax factors are much more important for the profitability of FDI that tax factors.

- Factors as labor costs and infrastructure are among important factors that affects pre tax returns of FDI to a large extent.
- Other policies of the host country (e.g., regulation, license, patent policies) are often more important than tax policies. In particular, the transparency in the policies of the host country is essentially important for investors.
- Also, it should be recognized that governance structure of the parent company and the subsidiary sometimes critically affects the behavior of the subsidiary. For example, the subsidiary might be forced to repatriate profits to the home country even if to do so is disadvantageous for tax purposes, when, for example, the parent company suffers from losses.

Fifth, tax administration issues in the host country are very relevant for FDI.

- In many cases, taxpayers are faced with troubles in tax administration, and tax administration issues are often more serious than problems in tax system.
- It seems to be important for the central tax authorities to monitor behavior of staff in local tax offices and customs offices in order to prevent mal-conducts by the staff. In any country, it is important to establish an appropriate internal control system in tax administration.
- Dual subordination of local tax office to the central tax authorities and local governments (or BOI) could cause difficult problems in tax administration and raise compliance costs for taxpayers.

5. Effects of Taxes on Tax Planning

Sometimes, effects of taxes on MNEs might be stronger in their tax planning activities than in their "real" investment activities. In particular, globalization of economic activities, integration of international financial markets, and development of information and communication technology tend to reduce market frictions and transaction costs, thus enabling taxpayers engage in more efficient tax planning.

We could raise the following points on tax planning in the context of international taxation.

- The basic scheme of tax planning is to shift income from high-tax category to low-tax category (or to shift negative income from low-tax category to high-tax category). In this context, relevant tax rates are marginal tax rates.
- In international taxation, taxpayers can enjoy wider range of different categories of tax treatments (wider range of different marginal tax rates to be applied), thus, they can enjoy wider opportunities of tax planning.
- Tax planning might sometimes reduce tax distortion, but erodes tax base, particularly, of a specific country.

Regarding the relationship between international taxation system and tax planning:

- Under worldwide system with FTC, tax planning activities are stimulated particularly because of the FTC limitation system. Even the simplest case of FTC limitation (the lesser amount of "foreign CIT" paid and "foreign source income" multiplied by CIT rate) causes various tax planning schemes.
- Territorial system is not free from tax planning issues. For example, issues on transfer pricing and hybrid financial instruments might be more difficult under territorial system than under worldwide system.

Regarding the response of governments to the issue of tax planning:

- On one hand, tax planning itself is a rational response of taxpayers toward any tax system. It is impossible to prevent taxpayers from engaging in tax planning activities.
- On the other hand, each country has to cope with this situation. Particularly, some countries strongly feel the need to protect their tax base from the erosion caused by tax planning activities.

- One possible strategy might be accepting (and even using) tax planning. (e.g., preferential tax treatment for regional operating headquarter (ROH)) This kind of policies might be appropriate for smaller countries.
- Another strategy might be fighting against tax planning. (e.g., strictly enforcing transfer pricing regulations) This kind of policies might be appropriate for larger countries, although the enforcing power of the tax authorities is often quite limited in the international context.[10]
- In any case, the optimum response to tax planning issues could be different from country to country. We should refrain from judging the desirability of policies toward international tax planning by merely following "successful" policies introduced by other countries.

6. Concluding Remarks

This note has discussed some of the aspects of FDI and taxation. These issues have to be examined from various perspectives, including viewpoints of host countries, of home countries, and of taxpayers. Because the involved issues are so complicated and multi-dimensional, it is risky to jump into any straightforward conclusion on appropriate tax policy toward FDI. Before doing that, is indispensable to carefully examine the situation in each country from international perspectives. Thus, the papers in this volume could be a good starting point for further analysis and for further policy discussion.

[10] This implies the need for international cooperation in tax administration among tax authorities in different countries.