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„Asian Tigers: comparison of their tax systems' attractiveness for foreign direct investments“

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1. Introduction

1.1. Research question

As clearly indicated by its title, this research paper will be predominantly dealing with the tax systems (as a whole as well as their particular components) in reference to the foreign direct investments flows within the four regions located in East Asia, commonly called Asian Tigers. There has been made an attempt to answer the question, which region (Hong Kong, Taiwan, Singapore or South Korea) has the best constructed tax system, when it comes to the attraction of the foreign direct investments (FDI). Therefore, throughout the paper there will be crystallized suitable criteria (in the section Analytical Framework) allowing the appropriate analysis of the existent fiscal policies within the aforementioned regions. It will be followed by the trial to find some patterns with regard to the amount of inward FDI and consequently there will be made final comparisons and conclusions. When answering the main research question, there will also be investigated the qualitative aspects of FDI, meaning how specific tax mechanisms determine the type of inflowing FDI.
To sum up, the main research question reads as follows:

- Which one of the four Asian Tigers has the most investors-oriented/friendly tax system?

The other aspects that will be analyzed throughout this paper are:

- Do the specific tax mechanisms attract particular types of investments?
- Do the host countries respond to the tax avoidance strategies of the companies and how effective such counteracting is?

1.2. Outline

This paper is compounded of two main parts: theoretical and analytical. The chapter titled "Theory and methodology" is intended to facilitate reader's understanding of the theory underlying the aspects analyzed in the further parts. Firstly there has been broadly presented the topic of foreign direct investments (FDI), which includes some basic statistics regarding their amount, size, location etc., their categorization, factors influencing the attraction of FDI and meaning of the inflowing investments for the receiving country. The following subchapter addresses the issue of taxes. Similarly to the preceding part, there is lengthily presented the topic of taxes. This chapter includes the general introduction into the tax theory, their meaning for the economy and influence on the taxpayers. Subsequently, there is provided a more detailed explanation of the particular tax forms and tax strategies such as: fiscal system (and especially the concept of the effective tax rate), corporate tax (embracing following aspects: tax holidays, tax allowances and investment tax allowances), custom duties, local indirect taxes, write-offs for investment expenditures, tax havens, Export Processing Zones, harmonization of tax systems, transfer pricing and bilateral tax treaties (with emphasis put on the mechanisms of granting tax credits, exemptions, deductions, allocation of expenses and tax sparing to avoid the double taxation). In the subsequent section there is presented a review of the recent findings regarding the influence of tax systems on the attraction of FDI. In the last subchapter of the theoretical part of this paper, there is an elaboration on the methodology that has been used, resulting in a detailed analytical framework which should facilitate the understanding of this research process. The second, analytical part, is compounded of four main areas of focus. In each subchapter, there is analyzed a region (Hong Kong, Taiwan, Singapore and South Korea). Firstly, there is presented a profile of each region, including its geo-political and economic statistics as well as concisely put recent history, in case it is indispensable for understanding its current state. Next sections within each chapter are dedicated to the thorough analysis of the region's fiscal policies, the amount and type of inflowing of FDI and, if detectable, relation between those two matters. In the end of each section there is provided a short summary, emphasizing the most important findings of the preceding analysis. In the last part of this research paper, there is included a longer conclusion, which aims to make necessary comparisons between all the regions under scrutiny and to provide final inferences. There is also made an attempt to conclude on the relatively superior tax system of one region over another. In the end there are provided references, followed by the list of tables and figures.

2. Theory and methodology

2.1. FDI

In a globalized world the flows of capital between distant regions and various entities have become normality. Companies and governments compete among each other in different ways to get funds which are indispensable for the realization of a broad spectrum of projects. When talking about investment flows on a bigger scale than just within one country's boarders, FDIs as a form of capital allocation, have great appeal among both businesspeople who want to expand their scope of activities to another countries and also among the receivers of such investments. The idea lying beyond that concept is very simple. The person allocating capital in a potentially beneficial enterprise abroad can earn profits and simultaneously retain some degree of control, while the host country derives advantages such as technological spillovers, decrease in unemployment and sustained economic growth. Companies are the most frequent entities to make foreign direct investments, nevertheless there are cases when countries' governments engage themselves in this kind of businesses too.[1]

According to the official definition provided by the Organization for Economic Co-operation and Development (OECD) foreign direct investment is a "(…) cross-border investment by a resident entity in one economy with the objective of obtaining a lasting interest in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the enterprise. Ownership of at least 10% of the voting power, representing the influence by the investor, is the basic criterion used".[2] Translating it into more simple form, it means that a company or entrepreneur invests capital abroad, specifically in a foreign enterprise. To put such investment in one's portfolio under the category of foreign direct investment, an investor must retain some degree of control over the targeted enterprise, thus owning no less than 10% of the ownership rights.[3] Additionally there must be an intention of the lasting relationship between investor and the enterprise receiving foreign capital. It is important for the creation of stable conditions for the future cooperation between parties involved. Nevertheless, it also entails higher investment risk, because in case when the situation in the host country dramatically changes to the detriment of an investor, he cannot withdraw the business as rapidly and without extremely high costs, as in case of other portfolio investments. Notwithstanding, FDI remain popular among businessmen and it is clearly confirmed by the statistical data.

[1] Financial Times, *Definition of foreign direct investment*, ft.com/lexicon, last accessed 27.02.2015 <http://lexicon.ft.com/Term?term=foreign-direct-investment>

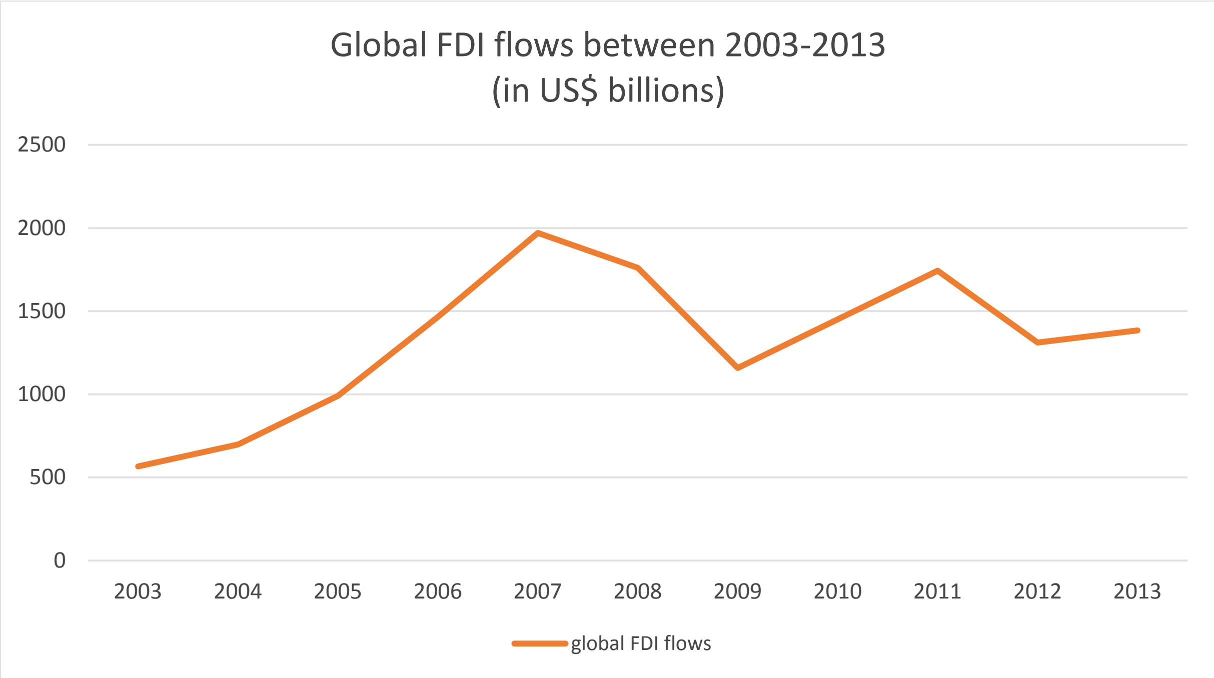
[2] OECD Factbook 2013: Economic, Environmental and Social Statistics, *Foreign direct investment*, OECD iLibrary, last accessed 27.02.2015 <http://www.oecd-ilibrary.org/sites/factbook-2013-en/04/02/01/index.html?itemId=/content/chapter/factbook-2013-34-en>

[3] Economy Watch, *Definition of Foreign Direct Investment (FDI)*, Economywatch.com (29 June 2010), last accessed 27.02.2015 <http://www.economywatch.com/foreign-direct-investment/definition.html>

2.1.1. FDI statistics

In 2013 the global FDI flows totaled $1.45 trillion, what is slightly more than Spain's GDP (World Bank) in the same year. UNCTAD reports forecast further growth in FDI net flows, with the net flow of $1.8 trillion to be reached in 2016.[4] For comparison, FDI in 1980 equaled only $207 billion[5], meaning that during approximately two decades its net value increased more than sevenfold. In the near future the further growth in the FDI flows is believed to be owed mainly to the investors allocating their capital in the developed economies, which momentarily prevail against the emerging markets, characterized by increased risks caused by uncertain governments' policies. Nevertheless, economies in transition and also the developing ones will be not exposed to the sharp decline of the inward FDI, further receiving much foreign capital. Among those developing economies, top FDI destinations embrace China and other countries in the Southeast Asian region.[6]

Figure 1: Global FDI flows between 2003-2013



Source: OECD

In the graph above, it can be observed that the total amount of FDI flows has been systematically growing, with sudden reversals in this trend only two times: during the financial crises, which started at the turn of 2007 and 2008 and temporarily in 2012. As the world was struggling with economic crises, resulting in shrinking resources and growing uncertainty, the level of FDI has significantly dropped. Interestingly, during that time of the decreasing level of investment flows, there has taken place a change regarding not only volume, but also the structure of FDI. In 2009 developed countries were receiving fewer foreign direct investments than the rest of the world (meaning developing countries and the ones in transition). Happening for the very first time, it did set new trend where developing economies were gaining much of an importance as the FDI host countries, with China

[4] UNCTAD, World Investment Report 2014 Overview, United Nations, New York and Geneva (2014): vii http://www.un.org/apps/news/story.asp?NewsID=48123#.VPC3ZvmG89w

[5] Taccone, Juan José, *MERCOSUR Report number 4*, IDB-INTAL (January-June 1998): 16

[6] United Nations, *UN reports foreign direct investment hit $1.4 trillion in 2013, upward trend to continue*, UN News Centre (24 June 2014), last accessed 27.02.2015 <http://www.un.org/apps/news/story.asp?NewsID=48123#.VPC3ZvmG89w>

being the unprecedented leader among such nations. At this time however, the United States of America were still reckoned as the FDI top receiver.[7] Already in 2011 there have been recorded first signs of the recovery in FDI volumes worldwide after the drop caused by the financial crisis. As mentioned earlier, the strongest contributors of the returning popularity of FDI were located mainly in Asian region, but also Latin America started to play an important role in propelling investment flows. Except for the United States, the more modest, but still to be reckoned input came from the developed countries. Unfortunately in 2012 the situation deteriorated again. Nevertheless after a short while the rate of FDI flows has been again steadily growing.[8]

At the moment developed countries take the 40% share of the global FDI. The slow economic recovery is contributing to the gradually increasing inflows to those regions, nevertheless not all the countries belonging to the developed world enjoy this growth. And so, as for instance European Union and Japan managed to grasp the part of the growing FDI flows in 2013, the United States, Australia or New Zeeland, with the last one recording drop as high as 75% compared to the previous year, has been still struggling with the decreasing FDI flows. In terms of the FDI flow growth rate, the one for the developed countries was 100% higher than the one ascribed to the developing economies. Nevertheless it was still too little to take over the title of the biggest FDI receiver from the developing countries. Within the European Union, the top FDI destinations turned out to be Belgium, Ireland, the Netherlands and Luxembourg, owing their success to the favorable fiscal systems encouraging investments. They are followed by Germany, Spain and Italy. Nevertheless, in over than half of all EU members, with France and Hungary at the front, FDI flows have been declining. Outside European Union, the countries managing to recover in terms of FDI flows were among other Canada, Israel or Japan. However, the region receiving the most FDI is Asia with the dominance of its Western part (above all China). Although the Association of Southeast Asian Nations recorded some slowdown in investment flows, there have been made optimistic forecasts for the near future. Considering the other parts of the world, Latin America and the Caribbean (due to British Virgin Islands) have enjoyed uninterrupted and intensified FDI flows. South America, although investing a lot, did not receive as much in return. The region characterized by increasing FDI flows is Africa, mainly benefiting from the strong performance of Southern African countries in attracting foreign capital. This region made up for the decline in investment flows occurring in the rest of the African continent (the cause might have been ascribed to the uncertain political and social environments), thus contributing to the positive final balance overall. Another region which manages to successfully attract FDI is the Russian Federation, being classified as the third top receiver worldwide. When considering other entities, the statistics show that APEC (Asia-Pacific Economic Cooperation) accounts for approximately 50% of FDI flows. Same applies for G20, however the dispersion among its member states is vast. Substantial rise in investments (nearly 50% growth rate) has taken place only in half of the G20 nations. BRICS (Brazil, Russia, India, China and South Africa) turns out to be extremely successful in getting foreign capital. At the moment they possess over one fifth of the total global flows share, with the fastest growth rate (exceeding 120%) recorded in South Africa. NAFTA (The North American Free Trade Agreement) has also recorded an increase, though considerably smaller, oscillating around 15%. On the contrary, the level of FDI flows within MERCOSUR (Southern Common Market) has dropped and its global share account for only 6%.[9] When considering solely the outward FDI, only 4 countries constitute 50% share of the global outflows. Those are United States (occupying the first place with the one third of the total outward

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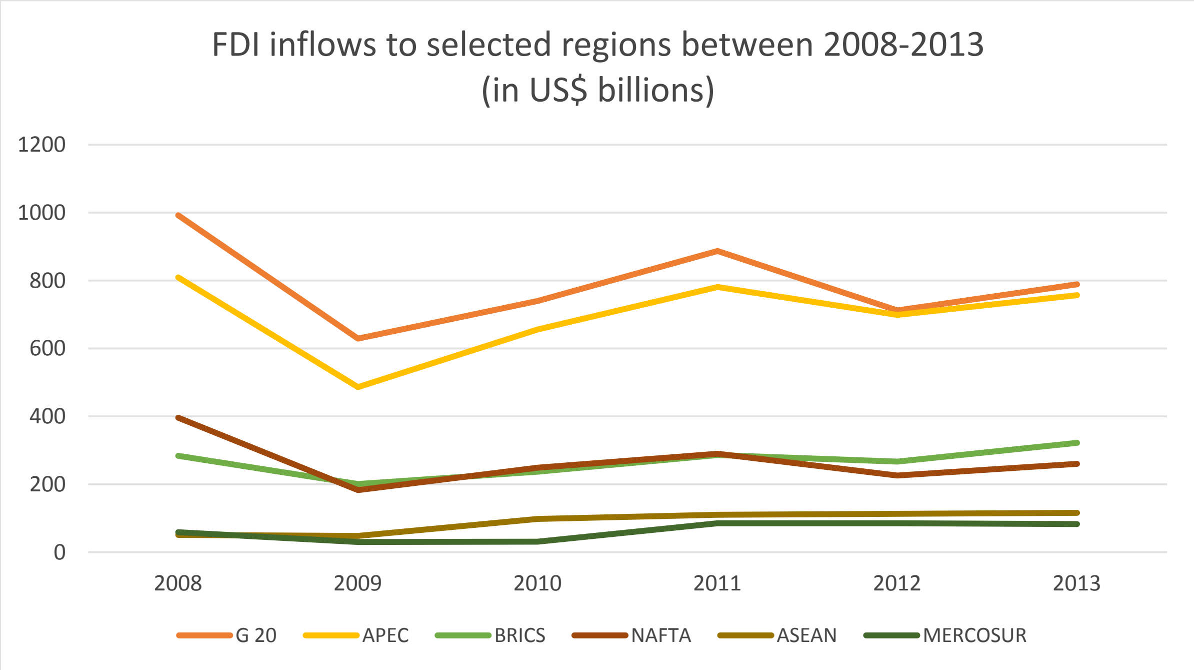
[7] The Economist, *Foreign direct investment*, The Economist Newspaper Limited (20.01.2011), last accessed 27.02.2015 <http://www.economist.com/node/17967018>

[8] Pasquali, Valentina, *Foreign Direct Investments by Country and Region*, Global Finance Magazine (14.03.2013), last accessed 27.02.2015 <https://www.gfmag.com/global-data/economic-data/fdi-flows>

[9] United Nations UNCTAD, *Global FDI rose by 11%; developed economies are trapped in a historically low share*, Global Investment Trend Monitor, No. 15, (January 2014): 2-10

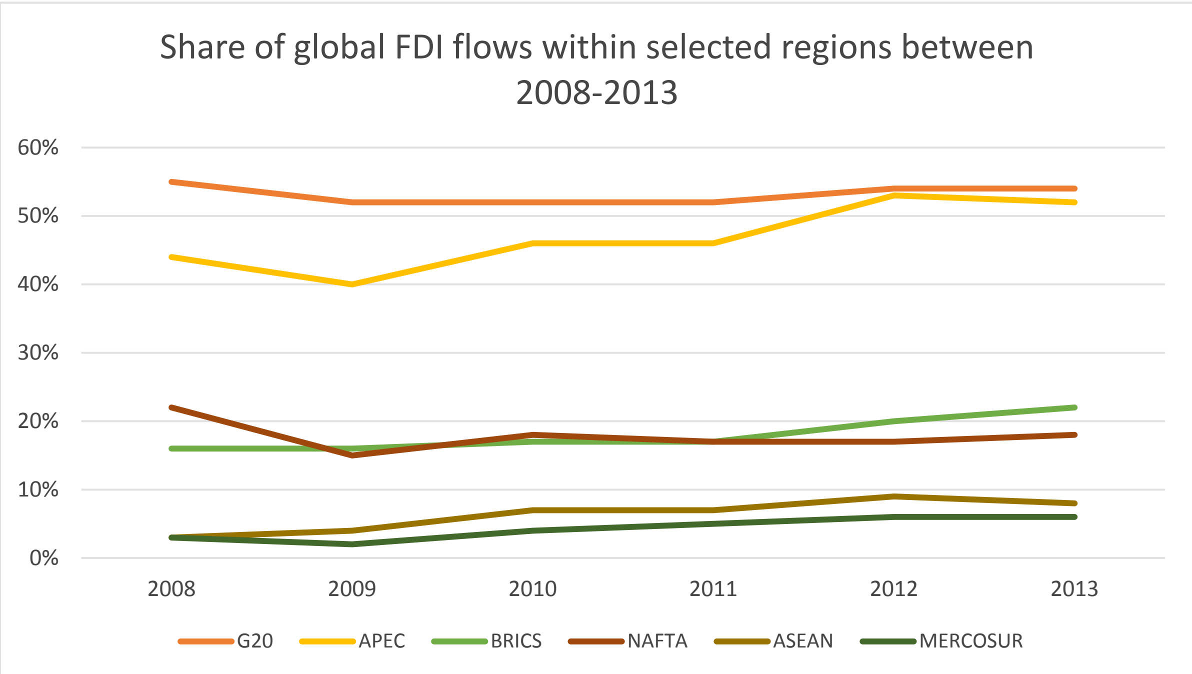
investments) followed by Japan, China and Russia ranked as the second, third and fourth respectively.[10] The main trends regarding the FDI flows in regard to countries membership in international organizations are presented in the graphs below.

Figure 2: FDI inflows to selected regions between 2008-2013



Source: UNCTAD

Figure 3: Share of global FDI flows within selected regions between 2008-2013



Source: UNCTAD

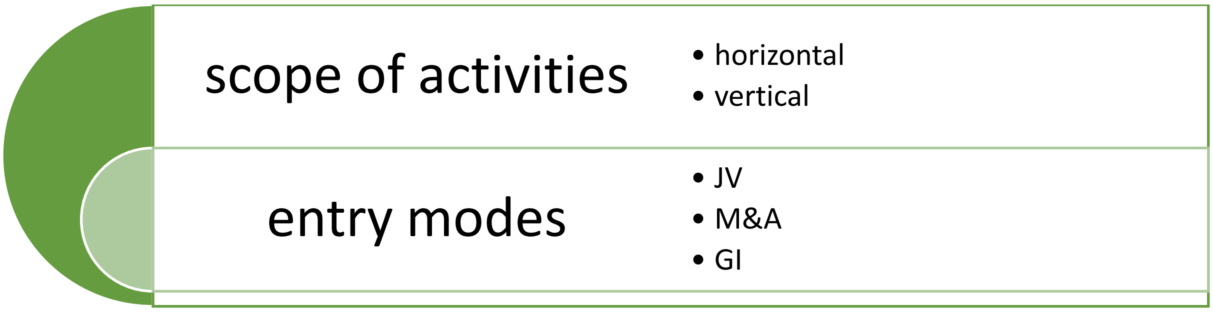
[10] OECD, *International investment stumbles into 2014 after ending 2013 flat*, FDI in Figures (April 2014), last accessed 27.02.2015 <http://www.oecd.org/daf/inv/FDI-in-Figures-April-2014.pdf>

As showed in the previous section, the popularity of the foreign direct investments is remarkable when considering it in terms of volume and geographical reach. Obviously, investing in different regions requires from the entrepreneurs undertaking appropriate adjustments, because one form of investment will not fit everywhere.

2.1.2. Categorization of FDI

The categorization of FDI can be split according to the scope of activities or entry modes. The graph below shortly summarizes the main categories.

Figure 4: Basic categorization of FDI



The first categorization of FDIs embraces its division into horizontal and vertical investments. Horizontal FDI occurs when a foreign company decides to operate the same activities in the host country as it does at the domestic market. Therefore such firm will not change its position in the value chain, meaning, it will produce the same kind of products or offer identical type of services in every region to which it relocates part of its business. Clearly, although the company's offering does not change, it needs to be adjusted to the local requirements (for instance changing the language on products' labels/packages).[11] It seems that the main driver for undertaking the horizontal FDI is to gain access to new markets (therefore expanding the company's geographical reach), especially when other forms of serving foreign markets turn out to be unprofitable (for instance export) due to factors such as high transportation costs or the need to be physically present while selling the company's product (mostly valid for services). Thus it is important that above all there exist two conditions: those are possible savings in trade costs and existent economies of scale for the company. The decision making process whether to launch a horizontal FDI is mainly influenced by the question, if it is more profitable than the exporting mode. In FDIs favor act reduction in transportation costs and tariffs, gained proximity to the new markets, improved delivery time and more apt responsiveness to the local needs. There have been made assumptions, that horizontal mode will appear mostly in host countries with large consumer markets, as it allows the spread of fix costs incurred to establish new production facilities. The horizontal FDI are supposed to be undertaken in countries that do not differ much between each other (especially in regard to the factor endowments).[12] Also, it has been proven that in case of high volatility (uncertainty regarding the future profitability and also the possibility of sovereign risk) in the host country, this type of investments will be the preferred one.[13]

[11] Knowledge Blog, *What is Foreign Direct Investment, Horizontal and Vertical* (11.01.2011), last accessed 28.02.2015 <http://guidedocstab.com/2011/01/what-is-foreign-direct-investment-horizontal-and-vertical/>
[12]Protsenko, Alexander, *Vertical and Horizontal Foreign Direct Investments in Transition Countries*, PhD diss., Ludwig-Maximilians-UniversitatMunchen (2003): 16-22
[13]Aizenman, Joshua and Marion, Nancy, *The Merits of Horizontal Versus Vertical FDI in the Presence of Uncertainty*, Working Paper 8631, NBER Working Paper Series (December 2001): 2-23

The second type of foreign direct investments is the vertical form. In comparison to the horizontal FDI, this type of investments is characterized by the fact, that the company will change its position within the supply chain when expanding to another country. It means that such firm decides to fragment and relocate the particular stages of the manufacturing processes into the regions where it can decrease the production costs to the biggest extent. Hence the underlying premise of undertaking the vertical investment is the cost minimization and search for the location with low-cost endowments (the exploitation of the differing factor costs in various countries).[14] This process is fully justified in its logic, as different stages of production mostly do not require same inputs and hence the investor should look for the places when it can acquire those particular factors at the lowest price. While making a decision whether to enter another country with vertical FDI, a company will weigh the benefits derived from input savings and costs ascribed to process fragmentation embracing transportation and high trade costs as well as other expenses connected to operating in a foreign country. It has been also proven that the big size of the host country act to the detriment of the vertical FDI.[15] There are also under circumstances (not directly bound to the input costs) that affect the decision making process. It seems that investors decide to undertake vertical FDIs mostly when the country risk (uncertainty understood as sovereign risk resulting in foreign company's nationalization or expropriation) is low[16] and the host market is smaller in size than the domestic one (most often developed country invest into the developing one).[17] If the benefits outweigh the potential costs, the company relocating its production process can move either upstream or downstream the supply chain. In the first case the firm will produce components for the further processes taking place within its structure (a company becomes its own supplier). In the latter case, the company will engage itself into distribution of products it manufactures (it will establish own distribution network, for instance new dealerships).[18] When comparing very generally the horizontal and vertical forms of FDI, the first one has the goal to serve the host market, while the second one the domestic market. Currently horizontal FDI account for the bigger share of total investments made.[19]

Foreign direct investments can be also categorized according to entry modes into new markets. The main forms FDI can take are Joint Ventures, Mergers & Acquisitions and Greenfield Investments. Less commonly known but also important are Brownfield Investments, Strategic Alliances and Wholly Owned Subsidiaries.

Joint Ventures (JV) are a form of arrangement between at least two parties, in which they agree to pool their resources (financial, physical assets etc.) in order to execute a given task. All the parties involved share benefits of this cooperation (such as revenues) as well as risks and costs. There must be established a new separate entity for the needs of such enterprise.[20] Companies entering JV do not have to bring in the same type of resources. While one party can provide necessary financial means, the second one might be responsible for the input in the form of know-how, machinery etc. Members of JV, while signing contract with each other, oblige themselves to act in Good Faith, meaning, to follow common interest and to achieve specific goals.[21] Therefore involved parties

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[14] Knowledge Blog, *loc. cit.*
[15] Protsenko, *loc. cit.*
[16] Aizenman and Marion, *loc. cit.*
[17] Knowledge Blog, *loc. cit.*
[18] Phung, Albert, *Why would a multinational corporation conduct a vertical foreign direct investment?*, Investopedia, LLC (2015), last accessed 28.02.2015 <http://www.investopedia.com/ask/answers/06/verticalfdi.asp>
[19] Knowledge Blog, *loc. cit.*
[20] Investopedia, *Joint Venture – JV*, Investopedia, LLC (2015), last accessed 29.02.2015 <http://www.investopedia.com/terms/j/jointventure.asp>
[21] The Free Dictionary, *Joint Venture*, Farlex Inc. (2003-2015), last accessed 28.02.2015 <http://legal-dictionary.thefreedictionary.com/Joint+Venture>

become the so called fiduciaries, whose duty is to act exclusively in the interest of the newly established enterprise.[22] After accomplishing set goals the JV is terminated. There are also other circumstances allowing earlier ending of the cooperation than it is specified in a contract. Those are for instance death of an active member or court's decision based on serious premises indicating that further existence of JV is unjustified/impractical. This kind of FDI might contribute in a country that it operates to the decrease in market competition and hamper the new market entrants. Therefore JVs are the subject to strict Antitrust Laws.[23] The reasons for creating JVs are numerous. Through joining such enterprise businesses aim at gaining access to new foreign markets (where the local partner has necessary knowledge to guarantee better responsiveness to the region's needs) and resources, increasing capacity, dispersion of risk or cost saving. Another potential benefit is broadening the customer base and getting access to another's party distribution channels.[24] Nevertheless, once entering the JV, following problems must be taken into consideration. Establishing a trustworthy relationship among partners might be problematic, especially when there occur cultural differences (it must be ensured that aim and rules are clearly communicated), practiced management styles are unlike or the actual goals are divergent. Problems might also arise in the situation, when there exists disproportions in the possessed expertise level[25] or when one party will strive to take over the actual control and thus gain total dominance.[26] Generally, small companies will strive to get from the cooperation in form of JV financial resources, distribution channels and expertise, while big firms value partner's flexibility and innovation.[27] JVs enjoy growing popularity. Forecasts are unanimous, that this type of foreign direct investment will be further increasing in number, especially due to the progressive globalization resulting in obliterating national identities. Organizations such as International Monetary Fund, World Bank or the World Trade Organization foster the expansion of JVs by gradual elimination of trade barriers or by setting clearer regulations regarding foreign ownership in host countries. The implementation of such policies aim at the creation of favorable business environment as the benefits coming from JVs (such as technology spillovers) are of a great importance to propel further economic growth. The leading regions in ensuring friendly climate for JVs are at the moment NAFTA, ASEAN and EU.[28]

Mergers & Acquisitions (M&A) are another popular form of FDI. Generally, the term M&A is used to describe the consolidation process of enterprises. It can be either establishing a new entity after pooling the existing resources (merger) or acquiring one firm by another one (acquisition).[29] Although the mentioned processes are no identical, the very similar level of expertise is necessary for executing them and they are often treated as one area of interest.[30] Basically, M&A entail changes in the control structure and reduce the number of actively and independently operating business

[22] Legal Information Institute, *Fiduciary Duty*, Cornell University Law School, last accessed 28.02.2015 <https://www.law.cornell.edu/wex/fiduciary_duty>

[23] The Free Dictionary, *loc. cit.*

[24] Free Legal Information, *Joint Ventures: Types, structure and reasons for joint ventures as well as the problems with them*, In Brief.co.uk, last accessed 28.02.2015 <http://www.inbrief.co.uk/company-law/joint-ventures.htm>

[25] Info Entrepreneurs, *Joint Ventures and Partnering*, Canada Business Network, last accessed 28.02.2015 <http://www.infoentrepreneurs.org/en/guides/joint-ventures-and-partnering/>

[26] Free Legal Information, *loc. cit.*

[27] Info Entrepreneurs, *loc. cit.*

[28] *Joint Ventures*, Encyclopedia of Business, 2nd ed. (2015), last accessed 28.02.2015 <http://www.referenceforbusiness.com/encyclopedia/Int-Jun/Joint-Ventures.html>

[29] Investopedia, *Mergers And Acquisitions – M&A*, Investopedia, LLC (2015), last accessed 01.03.2015 <http://www.investopedia.com/terms/m/mergersandacquisitions.asp>

[30] Financial Times, *Definition of mergers and acquisitions*, ft.com/lexicon, last accessed 01.03.2015 <http://lexicon.ft.com/Term?term=mergers-and-acquisitions>

entities, by creating the bigger one.[31] The circumstances allowing the clear classification whether the acquisition or merger is taking place can be sometimes very volatile. As said before, acquisition occurs when one entity assumes control (hence ownership rights) over the other and when the latter one formally ceases its existence (as an independent enterprise). Stocks of a sizing company remain in circulation. Merger is executed when two enterprises (usually of equal size) come to an agreement and form a brand new company, consisting of all contributed resources. In this case there have to be issued new securities. In reality, the acquisitions are the ones to take place more often than merges. The company assuming the control over the latter one might agree to officially call it merger (of equals) due to rather negative associations bounded to the act of seizure of another firm. The same kind of bypass is applied when managerial staff of both companies is eager to combine their businesses (beneficial for both parties). Nevertheless, except for such friendly acquisitions, termed then commonly as mergers, there take place also hostile acquisitions, meaning that the smaller company is taken over, although it does not want to be incorporated into the bigger ones. Therefore, it seems that in practice it is not the technical aspect that differentiates mergers from acquisitions but rather whether it is a friendly or hostile process of transformation.[32] The categorization of acquisitions is rather not varied. In one type, the company purchases the other firm's stocks, therefore seizing the effective control. This kind of acquisitions entails much risk, as the entity is purchased as a still operating business with its all obligations and liabilities. The second type refers to the process of assets purchase. The bigger firm can gain the valuable resources it lacks and leave out those it does not need. The main motivations behind carrying out this form of consolidations are among others synergy effects (increasing the activity scope while excluding the same departments, what diminishes fix costs), increasing market power (by capturing former competitor's market share), possibility of cross-selling, economies of scale, some tax related advantages (losses made by acquired company decrease the taxable revenue of the seizing firm), transfer of rare and valuable assets or last but not least the strategy of the so called empire building by gradually pushing out competitors from the market.[33]

Mergers can be categorized into three main types: horizontal, vertical and conglomerate. Belonging to one of those categories is mainly conditioned by the competitive relationship between involved parties. Horizontal merger occurs when firms manufacture same products.[34] This type entails the serious problem for the market regulators as there is a justified anxiety, that merging companies will contribute to the diminished competition, resulting in gaining more power by the newly established entity and hence its capability to limit output and raise prices. There is also a risk of engaging in unofficial arrangement with other market participants regarding price levels coordination (the fewer companies, the easier such settlements are).[35] The second type of mergers is termed as vertical. In this case, involved parties operate in the same industry/manufacture the same product, but in the different stage of the supply chain.[36] This embraces the forward and backward integration. The forward one results in a purchase of a company's customer, while backward – of its supplier. Vertical mergers are driven by the desire to decrease transaction costs in the supplier-customer relationship as well as to gain better synchronization, relationship and control, resulting in

[31] Woods, Carol, *What Are Mergers and Acquisitions? - Definition, Examples & Quiz*, Education Portal (2003-2015), last accessed 01.03.2015 <http://education-portal.com/academy/lesson/what-are-mergers-and-acquisitions-definition-examples-quiz.html>
[32] Giddy, Ian, *Briefing Mergers & Acquisitions: Definitions and Motivations*, Giddy.org (2009), last accessed 01.03.2015 <http://pages.stern.nyu.edu/~igiddy/articles/mergers_and_acquisitions.html>
[33] Ibid.
[34] Ibid.
[35] The Free Dictionary, *Mergers and Acquisitions*, Farlex Inc. (2003-2015), last accessed 01.03.2015 <http://legal-dictionary.thefreedictionary.com/Mergers+and+Acquisitions>
[36] Giddy, *loc. cit.*

more effective performance overall.[37] The last type, conglomerate merger, refers to the companies which are active in different industries on different stages of supply chain. There is a commonly shared view, that such mergers have the least negative impact on the market competition distortion. Because there are no pure synergies in the newly established entity, the fear of the potential hostile acquisition by the stronger market participant enforces the merged companies to heighten the efficiency. The benefits come mostly from the possibility in capital cost reduction and (when expanding to a certain level) from having an advantage over other companies. Unfortunately, therefore it may result in gaining some political power and impeding the market entry for small firms.[38] Generally, the successful execution of a merger process will not necessarily guarantee the further prosperous existence of a newly established company. Experience has shown that many merges fail to succeed. The underlying reasons for such state of affairs are inter alia divergences in the technological levels, equipment, corporate cultures and inefficiency cause by excessive number of employees.[39]

M&A are subject to numerous regulations, especially to Antitrust Laws, due to their potentially negative impact on the market competition. Nevertheless, policy makers face a serious dilemma while imposing strict regulations, as M&A are source of numerous social benefits, such as enhancing the managerial standards, technology transfers, better quality and efficiency.Before the financial crises of 2008, the number of M&A was constantly rising. As the recession hit the world there was a need to withhold executing new operations of this kind.[40]

Greenfield Investments (GI) are another type of popular FDI forms. In this case, a parent company that decides to establish a new entity abroad has to build up new facilities from scratch. The parent company often provides only managerial staff. This fact entails employing local workers, thus reducing the unemployment rate in a given region[41], what is the underlying reason of appeal among host countries' governments toward such investments (resulting in offering special tax treatments and other incentives).[42] The parent company has the full ownership over its subsidiary and therefore it is more convenient to transfer technologies, core competencies and other valuable assets, as they are less exposed to the potential leakages. Among main benefits coming from owning GI there are decreased transaction costs, better coordination and heightened efficiency, already well established brand names, cheaper labor force, fewer conflicts resulting from the cultural differences[43], achieving economies of scale and better conditions for setting long-term strategies. On the other hand, GI are more expensive in realization (no possibility of pooling resources) or the entry to the market might be somehow hampered by either governments or competition.[44] The investor will be considering GI as an entry mode (especially when deciding between GI and M&A), when there are no competitors on the market that could be possibly taken over or even under the presence of competition and when (and only then) the parent company possesses specific organizational competencies that can be successfully transferred. Such decision would be also strongly justified, if

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[37] The Free Dictionary, *Mergers and Acquisition, loc. cit.*
[38] Ibid.
[39] Giddy, *loc. cit.*
[40] The Free Dictionary, *Mergers and Acquisitions*
[41] Investopedia, *Greenfield Investment*, Investopedia, LLC (2015), last accessed 02.03.2015 <http://www.investopedia.com/terms/g/greenfield.asp>
[42] InvestorWords, *green field investment*, WebFinance, Inc. (2015), last accessed 02.03.2015 <http://www.investorwords.com/11625/green_field_investment.html>
[43] BusinessLeadershipManagement, *Greenfield Investment, Acquisition, or Joint Venture?*, International Business (10.06.2013), last accessed 02.03.2015 <https://businessleadershipmanagement.wordpress.com/2013/06/10/should-you-do-a-greenfield-investment-or-acquire-outright/>
[44] Irwin, Terry, *Acquisitions and greenfield investments – the pros and cons*, TCii (23.10.2013), last accessed 03.03.2015 <http://www.tcii.co.uk/2012/10/23/acquisitions-and-greenfield-investments-the-pros-and-cons/>

the transferable resources are in form of tacit knowledge, hence difficult to codify. GI also excludes problems of cultural dissonance within the organizational structures.[45]

The descriptions regarding the types of foreign direct investments clearly show, that each of them can have different consequences for the host region. Although some forms of FDI are less frequent than the others, governments of the receiving countries compete with each other to attract any kind of FDI. The underlying reason is that generally FDIs have a positive impact on the local markets (for instance in 2010 FDI contributed to the creation of over 80 million jobs worldwide[46]). There have been conducted numerous researches investigating which factors do contribute to the creation of the more favorable investing climate as well as what are the impediments to FDI.

2.1.3. Factors attracting FDI

Above all, investors are very keen on allocating their capital abroad, when they spot the so called business opportunities, reflected in the first place (in most cases) by both market size and its growth potential. Regions endowed in strong institutions and policies favoring investments are also of a critical importance in creating an appropriate investment climate. Nevertheless, there can be distinguished several other factors which do matter for different types of investors and in which cases the pro-investment environment is not the most important condition (although still matters). This state of affairs is characteristic for companies aiming to get natural resources abroad (that they lack in the home country), the companies looking for new markets (as the domestic ones are already saturated), investors aiming at improving efficiency by minimizing their production costs in the low-wages regions or firms looking for strategic assets such as unavailable technologies at home countries. On the contrary, the favorable investment climate, backed up by appropriate regulations counts a lot for enterprises involved in service sector.[47]

As mentioned in the first lines of this subchapter, considering the factors commonly thought to be the most important, one cannot ignore the market size. Host countries that possess such, are potentially very lucrative for the investors.[48] Consequently, the 10 biggest economies in the world, accounted for the nearly half of the total global FDI flows in 2010.[49] Sticking to this way of reasoning, foreign companies are also eager to invest in regions where there exist large concentrations of industries such as finance, insurance and real estate, though for some reason it does not hold for manufacturing sector.[50] The other factor, market potential growth, is very relevant for the developing and in transition countries. The steadily rising number of population combined with the growing income levels are for the foreign companies almost as a promise for high returns on investments.[51]

The next condition, among most important ones to attract FDI, is the investment climate reflected by the overall business regulations and governmental support. Where such climate is existent, the other measures implemented to heighten the region's attractiveness are significantly more effective. The incentives, as for instance lowering tax rates for investors, can be 8 times as

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[45] Wang, Aiwei, *The Choice of Market Entry Mode: Cross-Border M&A or Greenfield Investment*, International Journal of Business and Management, Vol. 4, No. 5 (May 2009): 239-245

[46] Hornberger, Kusi and Battat, Joseph and Kusek, Peter, *Attracting FDI, How Much Does Investment Climate Matter?*, Viewpoint, note number 327, The World Bank Group (August 2011): 1-4

[47] Hornberger et al., *loc. cit.*

[48] Puget Sound Regional Council, *Attracting Foreign Direct Investment To Your Community* (January 2009): 1-10, last accessed 03.03.2015 <http://www.psrc.org/assets/5764/FDIsmallreport.pdf>

[49] Hornberger et al., *loc. cit.*

[50] Puget Sound Regional Council, *loc. cit.*

[51] Hornberger et al., *loc. cit.*

efficient as in the absence of favorable investment environment.[52] Proper investment climate also makes it possible to derive benefits coming from FDI (e.g. technological spillovers, social welfare) to higher extent than in its absence. Public policies that want to create a favorable environment play a remarkably important role, as they also affect human capital, quality of infrastructure and overall stability, which are typical drivers for FDI. In comparison to country's endowments in natural resources, those factors can be influenced in the long haul, though it may be costly.[53] Same applies for ensuring stable development, healthy market competition or in some cases trade liberalization. On the other hand, the governments can implement reforms, which consequences are observable already in the short run and are less expensive than long-term changes, thus having also very positive effects on FDIs. Those are among others enhancing the quality of regulations, enhancement of intellectual properties and rights of investors and improving bureaucracy efficiency.[54]

What also matters for investors is the so called ease of doing business. Here can be distinguished factors such as starting and closing a business, getting credit and the extent of protecting the investors. It has been empirically proved, that except for the BRICS states, countries characterized by high level of ease of doing business, attract significantly more FDI.[55] Closely connected to this concept are the so called hassle costs. Those are basically reflected by the administrative costs, thus heightening the expenses incurred for establishing and doing business (not to confuse with previously mentioned ease of doing business) and are proven to substantially decrease FDI inflows.[56] Another costs influencing the level of inward FDI are the taxes and other expenses that need to be incurred as a result of the host country's fiscal system. Particularly strong competition in the financial and tax incentives has been recorded within East Asian economies, typically manifested by the so called fiscal wars.[57]

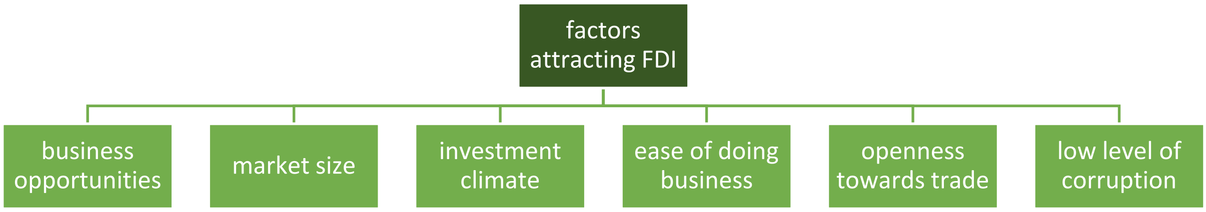
Another factor influencing the level of inward FDI is openness towards trade, meaning not impeding the goods or services exchange by harmful regulations and fiscal measures, as for instance tariffs or protectionist policies. Political systems in a host country also plays a significant role in determining the level of inflowing FDI. Investors tend to allocate more capital in countries with the presidential systems, democratic traditions and characterized by decisiveness in policy making. They rather avoid regions with excessive governmental spending on military and single parties ruling for a longer period of time (however it seems contradictory to the reality since China with its Communist Party and expanding army is receiving plenty of FDI). It has been even empirically proven that investors prefer left-wing executives over right-wing and are particularly negatively oriented towards centrists (who are lacking both predictability and credibility).[58]

Closely connected to the previous factor in attracting FDI is the issue of corruption. Empirical researches show, that in most countries, the 1% in the corruption level, decreases the return on investment in a range of 1% up to 6% (values rounded up). Therefore it is in the host country's best interest to undertake measures aiming at the reduction of corruption.[59] In order to attract FDI, governments decide to initiate programmes targeting investment promotion. The goal is to either

[52] James, Sebastian, *Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications*, FIAS, World Bank Group, Washington, DC (January 2009): 1-35
[53] Hornberger et al., *loc. cit.*
[54] Ibid.
[55]Bayraktar, Nihal, *Foreign Direct investment and Investment Climate*, Procedia Economics and Finance 5 (2013): 83–92
[56]Rajan, Ramkishen S., *Measures to Attract FDI, Investment Promotion, Incentives and Policy Intervention*, Economic and Political Weekly (January 2004): 12-16
[57] Ibid.
[58]Wiśniewski, Tomasz and Pathan, Saima K., *Political environment and foreign direct investment: Evidence from OECD countries*, European Journal of Political Economy 36 (2014): 13–23
[59] Delgado, Michael S. and McCloud, Nadine and Kumbhakar, Subal C., *A generalized empirical model of corruption, foreign direct investment, and growth*, Journal of Macroeconomics 42 (2014): 298–316

provide necessary information for the potential investors about the favorable conditions within the host country or in some cases to correct false perceptions. Therefore, there can be observed a growth in a number of the investment promotion agencies worldwide.[60] Generally, despite all the differences in the investors' motivations to allocate capital abroad, the host country needs to improve its overall attractiveness towards FDI.[61] It must be noted, however, that the strategies that the government will be using must be well suited to its current state and possibilities (other measures and emphasis on different aspects will be put by small and big countries)[62].

Figure 5: Factors attracting FDI



2.1.4. FDI effects on the host country

As pointed out above, governments need to undertake numerous ventures so as to attract FDI. Though it might be really costly in some cases, they realize how many benefits they can derive from the presence of foreign investments in their countries. Above all, most of the researchers agree on the fact, that FDIs are positively impacting the economic growth of the host country. Additionally, this effect is much stronger when there occur the following conditions: there must be guaranteed an appropriate level of human capital, already well established and developed financial markets and openness towards trade. However, divergences in the technological levels and government's too strong dependence on investments are diminishing the FDI positive effects on the economic growth.[63] As FDI affects GDP growth, some research findings show that also GDP growth directly influences the level of inflowing FDI (although only in short term).[64] Foreign investments are assumed to be more productive than the domestic ones. It is justified by the theorem that since local companies are endowed in higher level of knowledge regarding local conditions and hence are more responsive to the market demands, the foreign company, in order to gain some competitive advantage, must somehow compensate for this lacking knowledge with other factors, most frequently such as high efficiencies, unique managerial skills or advanced technologies not available in the host countries. It results in technological spillovers, propelling total factor productivity growth and enhancing human capital.[65] Regarding technology spillovers, it has been further proven, that the main beneficiary of those are the low-efficiency companies, active in the same industry as the foreign

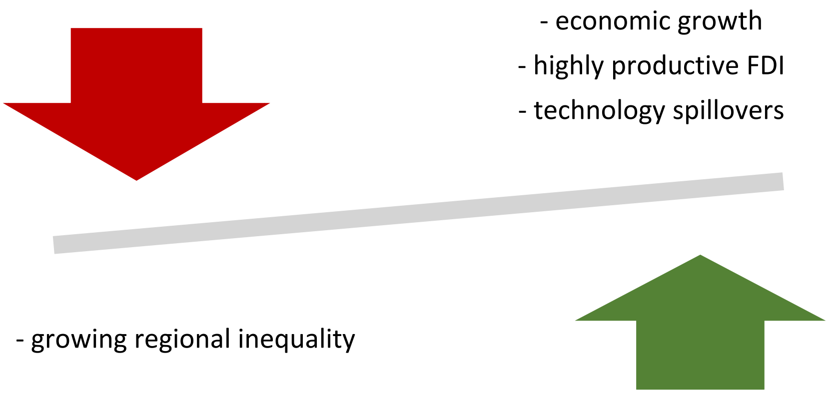
[60]Rajan, *loc cit.*
[61] Ibid.
[62] United Nations Conference on Trade and Development, *Best Practices in Investment for Development, How to attract and benefit from FDI in small countries, Lessons from Estonia and Jamaica*, Investment Advisory Series, Series B, no. 6 (2011): 1-87
[63]Almfrajia, Mohammad Amin and Almsafirc, Mahmoud Khalid, *Foreign Direct Investment and Economic Growth, Literature Review from 1994 to 2012*, Procedia - Social and Behavioral Sciences 129 (2014): 206–213
[64] Chana, Luke M.W. and Houb, Kegiang and Lic, Xing and Mountaina, Dean C., *Foreign direct investment and its determinants: A regional panel causality analysis*, The Quarterly Review of Economics and Finance 54 (2014): 579–589
[65]Borensztein, E. and De Gregorio, J. and Lee, J-W., *How does foreign direct investment affect economic growth?*, Journal of International Economics 45 (1998): 115–135

enterprise. Less advanced firms have more absorptive capacity as opposed to the high-efficiency companies, which might occasionally suffer from negative spillover effects.[66]

FDI might act to the detriment of a host country, in a way that they foster regional inequality. Frequently, foreign capital is allocated in specific areas of a country, hence bringing benefits to those and neglecting the other not directly involved regions. Unless there is ensured high degree of the interregional mobility and implemented appropriate policies counteracting this state of affairs, the uneven redistribution of profits coming from the FDI might lead to increasing social welfare gaps and even conflicts. This problem concerns mostly low and medium income countries, while having much more negligible effects on economically better developed nations.[67] In case of poorer countries, the inflow of FDI exacerbates the inequality especially in regions where population due to its low level and income has the restricted access to the technology spillovers.

In general FDI present number of benefits for the host country. It is one of the main factors contributing to the region's GDP growth (hence social welfare) as well as it significantly propels country's transition into the more developed one. Hence the role of FDI should be not underestimated nor skipped when creating policies by governments that support economic development.

Figure 6: Pros and cons of FDI for the host country



2.2. Tax systems

All governments around the world have to incur substantial expenditures in order to either sustain or develop their countries. One of the measures to finance such expenses are different kinds of taxes. The entirety of all the taxes that a country imposes, together with the adhering regulations, is commonly known under the term fiscal system. This chapter provides the explanations what taxes are, the exhaustive review of their main categories (particularly those which are necessary for answering the main research question of this paper), what kind of influence they exert on the companies and how they can be used in order to manipulate the behavior of business entities that are taxed.

[66] Suyanto and Salim, Ruhum and Bloch, Harry, *Which firms benefit from foreign direct investment? Empirical evidence from Indonesian manufacturing*, Journal of Asian Economics 33 (2014): 16–29

[67] Lessmann, Christian, *Foreign direct investment and regional inequality: A panel data analysis*, China Economic Review 24 (2013): 129–149

2.2.1. Definitions of tax and tax system

According to OECD "(…) the term "taxes" is confined to compulsory, unrequited payments to general government. Taxes are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments."[68] Although this definition is very concise, it conveys few particularly important messages. First of all, as a rule, everybody that undertakes taxable activities or receives income, has to pay taxes (unless there are granted some exceptions by the regulatory frameworks). Such payments are unrequited. As already mentioned, it means that a taxpayer should not expect getting any direct equivalents from the government. Nevertheless, in case that somebody tries to avoid paying taxes and is caught "red-handed", he will be liable to a penalty (ranging from fines to imprisonment).[69]

Governments levy taxes mainly on products, incomes and activities. Those can be either direct or indirect taxes. Because of establishing a broad spectrum of different tax bases and high rates, in theory, states can receive much income, which they usually use for the financing of public goods and services.[70] It is important to note, that this statement is valid only in theory, because if a government imposes too much of a tax burden on the taxpayers, the taxed entities will try to either hide their taxable activities (and hence income) or to shift their businesses (incomes) to countries with more friendly fiscal policies, thus leaving the home country with fewer and fewer sources of the necessary income derived from taxes[71] (which mostly accounts for the bulk of the total governmental revenue). The relationship between the imposed tax rate and the corresponding state's revenues is aptly reflected by the Laffer curve. It is clear, that there is a point, when excessive taxation inevitably leads to the gradual decrease of governmental earnings, with no income at the 100% tax rate.[72] Interestingly, in favor of tax avoidance speaks the fact, that the probability of audit is really low (discovering that somebody is not paying taxes) and therefore the so called rate of return on such avoidance for an average tax payer can be as high as 98%. Nevertheless, according to the prospect theory people tend to be loss averse when it comes to their incomes and substantially overestimate small risks. Hence, although not paying taxes could appear as an attractive option for the profit maximizers, individual's risk averse attitude dominates in most cases and leads to the systematic tax payments.[73] Usually taxes are paid in form of cash, though they might be also collected in-kind.[74]

Tax system (also known as fiscal system) is the entirety of all tax instruments within a state that a government uses in order to raise money necessary for financing country's expenditures and also to influence to some extent the behavior of the tax payers. Depending on how well the tax system is constructed, the governments are able to earn much revenue or they have to struggle with the constantly occurring undesirable evasion of tax payment. Nevertheless, not only the governments can experience the negative consequences of the ill-considered tax systems, as their wrong design can also foster the unequal distribution of income and thus contribute to the increasing

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[68] OECD, *Definition of Taxes*, Negotiating Group on the Multilateral Agreement on Investment (MAI), Expert Group No.3 (19 April 1996): 3

[69] Rorbach, Piotr, *Kara za niezapłacenie podatku w terminie*, Infor.pl (2015), lastaccessed 09.03.2015 <http://www.infor.pl/prawo/prawo-karne/przestepstwa-skarbowe/304744,Kara-za-niezaplacenie-podatku-w-terminie.html>

[70] InvestorWords, *tax*, WebFinance, Inc., (2015), last accessed 09.03.2015 <http://www.investorwords.com/4879/tax.html>

[71] Ibid.

[72] The Laffer Center, *The Laffer Curve*, The Laffer Center at the Pacific Research Institute (2014), last accessed 09.03.2015 <http://www.laffercenter.com/the-laffer-center-2/the-laffer-curve/>

[73] Dhami, Sanjit andal-Nowaihi, Ali, *Why do people pay taxes? Prospect theory versus expected utility theory*, Journal of Economic Behavior & Organization, Vol. 64 (2007): 171–192

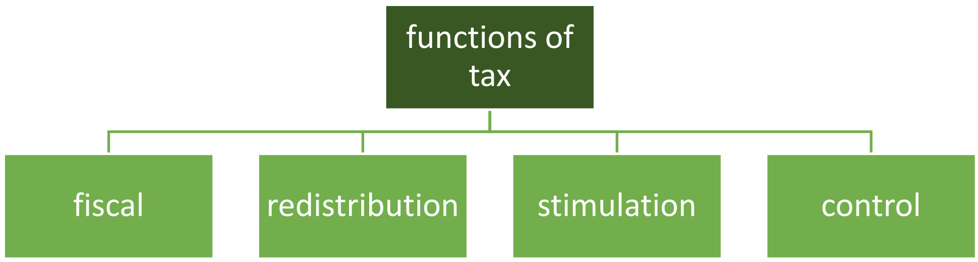
[74] OECD iLibrary, *17. Taxes*, OECD (2009), last accessed 09.03.2015 <http://www.oecd-ilibrary.org/sites/9789264067981-en/05/02/index.html?contentType=&itemId=/content/chapter/9789264075108-19-en&containerItemId=/content/serial/22200444&accessItemIds=/content/book/9789264067981-en&mimeType=text/html>

levels of poverty within a country (by imposing a disproportionally high financial burden on citizens/business entities with the very low disposable income). The governments should strive towards the establishment of the optimal fiscal systems. It means that the imposed taxes should enable the reconciliation of the state's interests (reflected by gathering necessary funds for providing for instance public goods) with the tax payer's expectations, that tax burdens are imposed in a way that is fair and strongly justified. Welfare economics, with regard to tax systems, postulate the maximization of the social welfare, based upon the premise of the Pareto efficiency. It means, that the existing tax system is efficient, when there is no alternative to be chosen, that could improve the situation of at least one entity, without worsening the situation of somebody else. The verification whether the current tax system corresponds to the Pareto efficiency is problematic though, as the objective evaluation of the individual situation of each citizen is technically impossible. Hence, there have been used criteria such as income or revenue, to at least partially reflect the level of individual's welfare, constituting the base for taxation.[75]

2.2.2. Functions of tax

Taxes, as a tool in government's hands, have four main functions. Importantly, in the tax-related literature there can be found different examples and especially diversified nomenclature for those functions, however, the most frequently occurring are the ones described below.

Figure 7: Functions of tax



The first function, which has been already mentioned before and is the first one to be associated by the majority of tax payers, is the fiscal one. It is also considered to be the most important one. Fiscal function is reflected in a government's task to collect funds in a form of taxes, which account for the basic form of the budget revenues. It allows the realization of the state's basic tasks and programmes (e.g. national defense).[76]

The second function of taxes is the regulation (redistribution). In this case, the tax should influence the level of incomes and property (wealth) of the citizens. Therefore, the state is collecting taxes and then redistributing those funds between specific social groups (especially with distinction to citizens with higher and lower income levels). This is mainly achieved through the construction of taxes, based on the progressive tax scales which impose more fiscal burden on wealthier entities and less on those with low incomes. In theory, this function is responsible for diminishing the existing social inequalities and thus contributing to the social stability within the nation.[77]

The third function of taxes is stimulation. Through either implementation of specific tax mechanisms or through their construction, governments can have a significant influence especially

[75] Zbroińska, Barbara, *Pozafiskalne funkcje podatku dochodowego w praktyce gospodarczej*, Gospodarka Narodowa Nr 1-2 (2008): 91-108

[76] Abey, Francis, *Functions of Taxation*, MBA Knowledge Base (14 January 2011), last accessed 14.03.2015 <http://www.mbaknol.com/business-taxation/functions-of-taxation/>

[77] Buczek, Andrzej and Dzwonkowski, Henryk and Etel, Leonard and Gliniecka, Jadwiga and Glumińska-Pawlic, Jadwiga and Huchla, Andrzej and Miemiec, Wiesław and Ofiarski, Zbigniew and Serwacki, Jerzy and Zdebel, Marek and Zgierski, Zygmunt, *Prawopodatkowe*, C.H. Beck, Warszawa (2006): 69-70

on the business entities. An impact is exerted particularly on the direction and pace in which entrepreneurs develop. The main mechanism involved in this process is the diversification of the tax burdens as well as granting tax exemptions and tax reliefs.[78] In this way, state as an active player in shaping the economic layout of the country, can either stimulate or destimulate particular activities. On the one hand, the governments make use of allowances, exemptions, lower tax rates and other similar mechanism in order to propel the activities, which it finds as either lacking or favorable for the further economic development. This function is very relevant for the considerations about attracting foreign direct investments into the host country. On the other hand, when some activities seem to be potentially detrimental for either the economic growth or for the society itself, the governments will increase particular tax burdens or levy brand new taxes if necessary. This way, it becomes more expensive to undertake such activities and hence there are chances that some entities will give them up. Such de-stimulating policies may also refer to the entrepreneurs outside the given country's borders, when the country is following protectionist policies (which allegedly should protect local companies from the foreign competition).[79]

The last function of taxes is the controlling one. With the aid information gathered by the tax authorities it is possible to estimate the directions in which the economy as a whole is developing, to locate the areas which need to be improved and in some cases even to conclude whether the established tax system is well perceived by the society (for instance by discovering the mass tax avoidance and analyzing its underlying reasons). Therefore, taxes do not only serve as the mechanism of gathering funds by the state as often mistakenly assumed, but are a valuable tool of managing the process of economic development and also possess high informative value.

2.2.3. Taxes as governmental tools

When establishing a tax system, the governments face dilemma, in what proportions to derive revenues from the direct (e.g. corporate tax) and indirect (e.g. VAT) taxes, meaning which type should be the prevalent one. The government's decisions with regard to those aspects have numerous implications for the country's economic growth or the inflow of foreign capital. It cannot be unambiguously stated that relying more on direct taxes is better for the state's well-being or vice versa. Both types have the advantages and disadvantages. As relying more on indirect taxes propels economic development and contribute to attraction of more FDI, in case of some distortions the efficacy of automatic stabilizers is much decreased, as opposed to the situation when the state relies mainly on the direct taxes. Constructing the potentially optimal tax system is though not just a government's decision based on the purely economic considerations. Introduction of new taxes or changes to the existing ones (e.g. heightening their rates) might encounter many objections from the tax payers' side as they are discontented with the fact that they will have to sacrifice bigger share of their hitherto disposable incomes or that they have to constantly face changing tax regulations (what entails lack of clarity and thus cause mass frustration). It seems as if the state of tax systems at a given point of time is the result of bargaining political powers and lobbing groups. Hence, the fiscal system is not necessarily based upon economic and rational premises.[80]

2.2.4. Global trends in taxation

As already pointed out many times in the earlier parts of the text, taxes are one of the main tools that governments possess to collect funds, information and to steer the economic growth. Each state has its own concept on how it should arrange its fiscal system, based on the priorities and domestic problems it has to face. Therefore there can be observed an enormous diversification of

[78]Mruk, Witold, *Podatek*, EncyklopediaZarządzania (27.01.2014), last accessed 14.03.2015 <http://mfiles.pl/pl/index.php/Podatek>

[79]Abey, *loc. cit.*

[80] Albi, Emilio and Martinez-Vazquez, Jorge, *The Elgar Guide to Tax Systems*, Edward Elgar Publishing Limited, Cheltenham (2011): 1-11

regulations and structures of fiscal systems within specific regions. Nevertheless, there can be detected some common global trends in this area.

First of all, as the globalization process has been rapidly progressing, the liberalization of trade has become a natural state of affairs. This fact entails the considerations regarding the non-taxation of international trade. Already after WWII, there has been questioned the rightness of imposing trade barriers in a form of tariffs (and other similar) from the very economic point of view. Although these kinds of taxes constituted a significant source of revenues for states, they were also causing many distortions, thus preventing economic growth through the decreased efficiency. Currently, in spite of the fact that many governments incline towards the total eradication of such trade barriers, the point where tariffs and similar tax burdens would be completely abandoned, has not been reached yet (particularly in the less developed countries). Resigning from the use of such taxes is also likely to result in imposing new taxes or heightening the existing ones in order to compensate for the loss of revenues from trade-related taxes. The other global trend regarding tax systems is a direct consequence of the trend described above. The liberalization of trade followed by the efforts to abolish tariffs significantly contributes to the economic growth worldwide. Logically, freeing other activities (that are undertaken on a global scale) from the tax burdens, would possibly also increase the overall efficiency. The matter that came under close scrutiny is the cross-border income taxation, which is believed to hamper the free flows of capital. Nevertheless, experts have not come yet to the general consensus whether this form of taxation indeed cause distortions, especially with regard to the foreign investments. However, those governments which find this theorem as legitimate, make use of a broad range of tax incentives (such as lower corporate tax rates or exemptions) to attract foreign capital by offering more favorable investing environment than the other countries do (as pointed out in the earlier parts of the paper, inflow of FDI is particularly important for the country's development and therefore many states will involve themselves in a tax competition). The main patterns are the tax rate reduction together with decreasing the range of possible tax bases. Taking into consideration those two global trends, the clear consequence is that states consciously give up a vast share of their tax revenues. It is obvious however, that they have to sustain the level of funds they are collecting to be able to finance their expenses and hence to compensate those abandoned sources of income. At this point, there can be observed the third global trend, manifested by the increased taxation of the consumption. This state of affairs is reflected by the growing interest in the use of the value added tax (VAT). In numerous countries VAT has become the main channel of generating tax revenues. It is believed that imposing VAT with the simultaneous cancellation of the tariffs and the decrease of the corporate tax rates can compensate for the fewer sources of revenue while also foster the economic growth. Additionally to those three global patterns in the arrangements of the tax systems, there has been observed one more phenomenon. Namely, it seems that developed countries are the "trend setters" or "benchmarks" in terms of fiscal systems. As they have competitive advantage over developing countries in many other aspects than taxes, the latter ones see their chance in establishing tax systems characterized by fewer constraints than the developed countries so as to attract foreign capital. If a developed country is to ease its fiscal policies, the developing one will react correspondingly by easing it but to the greater extent. This type of behavior leads to the so called tax competition rather than to cooperation (for instance manifested by complete harmonization of tax rules).[81] There are also some other observable tendencies and though they are smaller in scale that the four described above, are still worth mentioning. Nowadays, countries in their efforts to create an optimal tax systems, tend to take into consideration long-term perspectives and therefore to minimize the frequency of changes regarding tax regulations' (what used to very effectively frighten off the foreign investors as they could not count on the country's stability and predictability). Similarly, governments are cutting on the tax rates, so as to appear more attractive to foreign investors and compensate the lost share of revenues by the broadening of the tax bases range. Also being related to the attraction of FDI, there

[81] Christians, Allison, *Global Trends and Constraints on Tax Policy in the Least Developed Countries*, , TaxBlog (06.02.2014), last accessed 15.03.2015 <http://taxblog.com/achristians/global-trends-and-constraints-on-tax-policy-in-the-least-developed-countries/>

is a tendency of shifting the emphasis from direct taxes to the indirect taxes (however as mentioned earlier, it is not sure whether focusing more on indirect taxes is a superior solution to relying mostly on the direct taxes, as it heavily depends on other conditions and priorities within a given country). The other tendency is the adaptation of fiscal policies to deal with both global and domestic environmental problems. Therefore, environmental taxes have become one of the crucial factors affecting the companies' decisions whether to expand their businesses and simultaneously they are gaining much importance as the governments' strategic tool in addressing environmental issues such as excessive emission of polluting wastes. Regarding other tax trends across the globe, countries seem to involve themselves more and more into the cooperation aiming at decreasing the extent of tax avoidance. Governments are becoming more willing to exchange information among each other that would help fighting this undesirable business practices. Hence, numerous states are considering the implementation of the so called general anti-avoidance rule (GAAR) and are inclined towards applying tougher transfer pricing rules (which should disable profit shifting in order to pay lower taxes), resulting in more transparency within companies' structures. To make it easier for both sides (states and enterprises), the growing number of countries is constantly improving the processes of gathering data and tax payments through the implementation of the online systems (it also brings other benefits such as decreasing the time needed for the companies to carry out the settlement of accounts).[82] All the described global trends in the arrangement of the tax systems seem to pursue the aim of fostering economic growth and ensuring transparency. Despite the fact, that those goals have not been fully realized yet, it seems that getting closer to the creation of optimal tax systems is slowly becoming within reach.

2.2.5. Relationship between taxes and FDI flows

Tax systems, except for fulfilling the functions enumerated in the previous section such as regulation or stimulation, are also a tool (when arranged in a proper way) for signaling the investor-friendly environment and therefore to attract the increased FDI inflows. There are many different (sometimes even contradictory) opinions on how taxes affect the level of the incoming foreign capital (as shown in the next chapter "State of the art"). Nevertheless, it is clear, that as the process of globalization steadily progresses, the companies aiming at the internationalization strategy, are given many opportunities and choices regarding the destination of their capital allocation. Therefore, countries are put under a lot of pressure regarding their strategies for winning the investors' interest. Globalization also entails the increased opportunities for the companies to implement their international tax planning strategies, for instance to shift the earned incomes (via the mechanism of transfer pricing) to the locations where the tax rates are lower and therefore enabling enterprises to retain more of their profits. It has been gradually becoming more and more difficult to determine where the international company should pay their taxes, hence those who can afford hiring professional tax advisers can benefit from savvy tax strategies. As a result, the development of the more unified tax policies of an international reach should be of a great interest for countries wanting to avoid losing tax revenues. Nevertheless, as the countries want to be competitive and boost the inflow of foreign direct investments, they should incline towards decreasing the overall tax burden that companies are being imposed. As it might curtail the state of the big share of state's revenues, there must be made an attempt to balance this loss by finding some other sources of finance. A compensation could be found in the broadening the tax bases, which embrace less mobile sources than, for instance, companies' incomes.[83]

As it might seem that direct taxes (the ones targeting income) are the main concern for the entrepreneurs, there are also representatives of the view, that in case of some countries, not direct taxes, but specifically non-income taxes are the ones to influence the investors' decisions. The underlying reason is the fact that for corporate income taxes paid abroad, companies might be

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[82]Pricewaterhousecoopers, *Trends*, Tax Policy and Administration: Global trends (June 2012): 2-31

[83] James, Simon and Sawyer, Adrian, *International trends in taxation and the taxation of investment*, University of Exeter, Discussion Papers in Management, No. 04/05 (2005): 1-22

granted tax credits, which decrease the extent of taxes, they need to pay in the home country. However, this mechanism does not embrace other kind of taxes (non-income). Hence the big share of financial burden for a company in a host country is caused by those. Notwithstanding, despite the discrepancies in the views which kinds of taxes affect FDI to a more extent, there is a firm consensus, that generally high tax rates (regardless whether direct or indirect taxes) act as deterrence for the foreign investors.[84] From the provided statements it can be inferred, that while considering the potential locations by foreign entrepreneurs, tax systems will be always included as a part of the decision making-process (although sometimes to a lesser and sometimes to the greater extent). For the needs of this research paper, that has been created an analytical framework based on the assumptions presented by Jacques Morisset and Neda Pirnia, who state that tax systems and especially some of their components, exert a substantial impact on the investors (particularly when other circumstances within the possible locations are very similar). Below there are be provided detailed descriptions of each of factors distinguished by Morisset and Pirnia.

2.2.6. Corporate tax

All the companies are obliged to pay the so called corporate tax, which is levied on their net income (revenues reduced by the incurred costs). It is a kind of an equivalent to the income tax imposed on the individuals, because corporations are treated by the lawmakers as the legal entities.[85] Under the term corporation there is understood a business organization acting as an artificial person. It has similar rights as the individual does and therefore is capable of signing business contracts, conducting business activities, both lending and borrowing money as well as suing and being sued, being an employer and owing assets or even issuing shares. It is also liable to pay taxes. The most important feature of the corporation which is an important driver for entrepreneurs to establish such organization is the limited liability. It means that the owners of the company (stakeholders) are not personally responsible for the corporate obligations and debts[86] (unless there appears a case of fraud, there are given personal guarantees or a corporation fails to pay taxes[87,88]).

Corporate taxes are mostly levied on the company's income but can be also imposed in some cases on the revenue. Although the rules regarding the functioning of the corporate tax is similar across the countries, its rate can vary extremely. United states have the highest corporate tax rate (39.1%) when considering countries constituting OECD. Globally the first rank belongs to the United Arab Emirates (55%) and second one to Chad (40%). Among the regions with the 20 highest tax rates dominate Africa, Asia and both Americas.[89] Some experts point out, that except for the United States, most of the places where there has been imposed a high corporate tax, struggle economically.[90] On the second end of this broad spectrum are regions with the 0% of the corporate tax rate and those are mostly small island nations such as Bahamas, British Virgin Island or Bermuda. Bahrain is a unique case, as the corporate tax is not levied on firms, except for the oil companies.

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[84] Desai, Mihir A. and Foley, Fritz C. and Hines Jr., James R., *Foreign direct investment in a world of multiple taxes*, Journal of Public Economics 88 (2004): 2727– 2744

[85] The Free Dictionary, *Corporate Tax*, Farflex Inc. (2003-2015), last accessed 28.03.2015 <http://financial-dictionary.thefreedictionary.com/Company+tax>

[86] Investopedia, *Corporation*, Investopedia LLC (2015), last accessed 28.03.2015 <http://www.investopedia.com/terms/c/corporation.asp>

[87] Mancuso, Anthony, *LLC or Corporation?: How to Choose the Right Form for Your Business*, NOLO, United States, 6th ed. (January 2015): 49

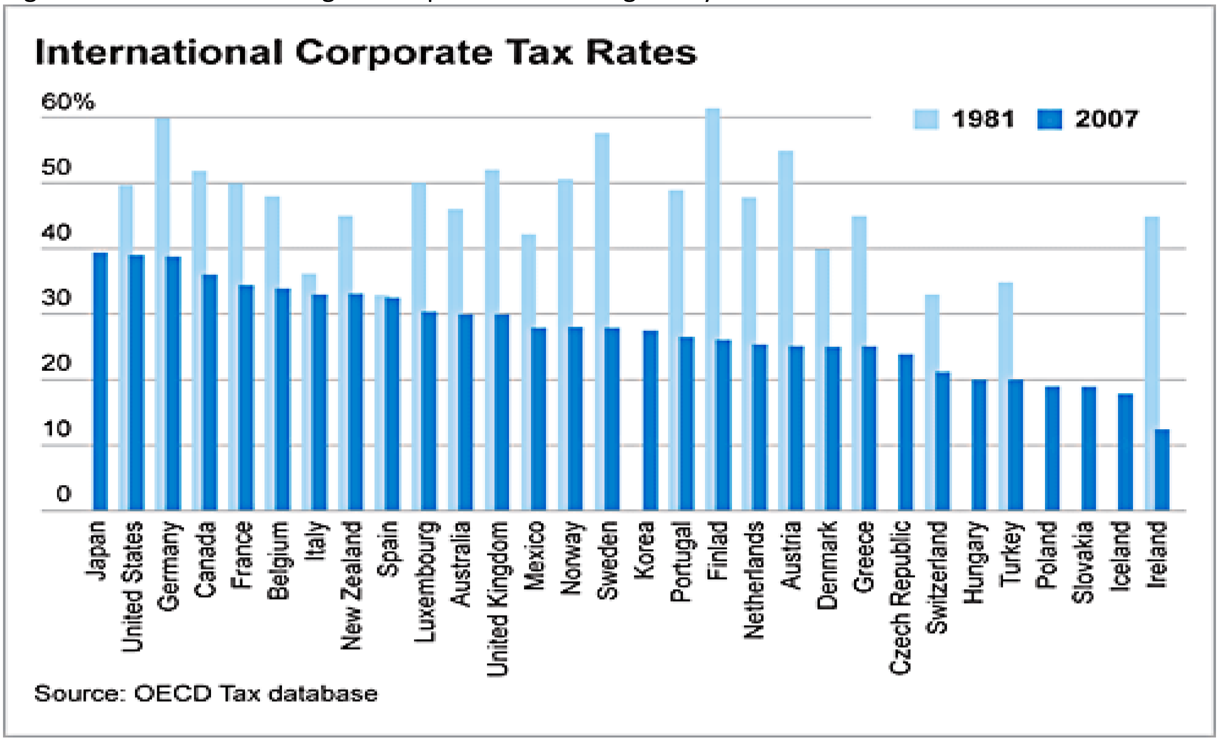
[88] BusinessDictionary.com, *corporation*, WebFinance Inc. (2015), last accessed 28.03.2015 <http://www.businessdictionary.com/definition/corporation.html>

[89] Pomerleau, Kyle, *Corporate Income Tax Rates around the World, 2014,* Tax Foundation (20 August 2014), last accessed 28.03.2015 <http://taxfoundation.org/article/corporate-income-tax-rates-around-world-2014>

[90] Dumaine, Brian, *The five countries with the highest corporate tax rates*, Fortune (21 November 2014), last accessed 28.03.2015 <http://fortune.com/2014/11/21/the-five-countries-with-the-highest-corporate-tax-rates/>

Hence, as just pointed out, the governments have much freedom in determining the corporate tax rates and adjusting them to their needs, beginning with rates as high as 55% to as low as 0%. The world average in terms of the corporate tax rate equals 22.6% and Europe is the continent to have the lowest average (18.6%), while Africa the highest one (29.1%). There has been observed a trend during the last decades, that the rate has been systematically lowered (as more and more economists point out their negative impact on the country's development) and generally more industrialized countries tend to have slightly higher rates than the others.

Figure 8: Trend for lowering the corporate tax rates globally



Source:europedebate.ie

The biggest decrease in absolute terms falls to Asia (over 10% in the average tax rate). As a result of this trend, there is a very limited number (namely 15) of countries imposing tax rate above 35%, especially as the reasonable tax planning strategies might help in the reduction of the tax burden, thus governments do not benefit from the potentially high tax revenue.[91] The rationale behind imposing the corporate tax by governments is related to the benefit principle. It means that companies, similarly to the natural person use public goods, which are financed by the latter ones in form of the income tax. It is reasonable to incorporate companies into the funding process as they also derive benefits from infrastructure, human capital educated in public institutions etc. Also as the corporations have the advantage of the aforementioned limited liability (which substantially decreases risk for the owners) this form of safety should be balanced by the tax payments, which some would call a compensating tax. Nevertheless, at this point some experts argue, that the owners of the company are already taxed as individuals, so the corporate tax might cause double-taxation problem.

The other rationale for introducing the corporate tax is also closely connected to the personal income tax. In the absence of the corporate tax, many people would be interested in establishing companies only to avoid tax payments (if such tax was not levied on enterprises).[92] Against the introduction of corporate tax speak the fact that entrepreneurs could make attempts to avoid paying their taxes by using appropriate tax planning and that it might deter the inflow of investments.

[91]Pomerleau, *loc. cit.*

[92]Nicodeme, Gaetan, *Corporate income tax and economic distortions*, Taxation Papers, European Commission (April 2009): 1-15

Capital is very mobile and therefore it is a relatively easy process to shift it across country borders. Corporate tax can be a huge contributor in such case and the consequences might be far-reaching. The more capital is leaving a given region, the less productive industries located there are becoming. This state of matters results in the situation, when workers gradually start getting lower wages due to their decreased productivity. Also as the enterprises try to avoid corporate tax payments, they spend much time and energy on implementing tax strategies allowing shifting their capital and earned incomes or on lobbying political elites to lower the rates.[93] The other huge disadvantage of corporate tax is its deterrent effect on inflowing investments. Although it is not the only one tax to exert such a negative impact, as the entirety of taxes in a given country influences the attractiveness of region, empirical researches show that high corporate tax rate has a large and significant adverse effect on the entrepreneurship. This especially holds for the investments in manufacturing sector, while in case of services it is, though still present, it is slightly less harmful.[94]

Corporate tax is a complex structure and can be differentiated on numerous levels. Firstly, the base of the corporate tax can be either broad or narrow. Taxes with broad base are imposed on most of the possible tax bases. On the contrary, taxes with narrow base are levied on fewer items. In theory, independently from the tax rate, the broad base will bring more revenues. However, there must be taken into consideration the fact that a significant trade off takes place. If the government decides to broaden the tax base, it has to lower the tax rate. Vice versa, when the base is narrowed, the rate must be heightened, simply because the government must balance its revenues with expenses incurred to finance public goods and services. Nevertheless, this latter form seems to be very harmful for the country's economic growth. There are few premises confirming this assumption. Regardless of the chosen option, whether the narrow tax base refers to the personal income or corporate tax, it entails very often the application of exemptions and deductions, which both introduce distortions and biases and cannot be fully justified by the measures to fight the poverty problems (the deductions might be ascribed to things such as medical insurance). The other failure of the narrow tax base dogma (especially in regard to corporate tax) is that the ingenious companies that normally would have to incur the significant tax burden (and therefore contribute to the state's revenues) are able to avoid tax payments by using appropriate tax strategies to decrease the taxable income. This concern is becoming very relevant as not only the globalization process is progressing, bringing with itself the growing ease of doing investments abroad, but also because capital is extremely mobile. Consequently, the narrow tax base is risky both economically and politically.[95] Additionally, it has been proven that both high tax rate and broad base negatively influence investments and entrepreneurial risk-taking.[96] On the contrary, the broad tax base functions in such a way, that all economic activities are treated in the same manner. This means that there is a possibility to avoid both discriminating and favoring specific groups of tax payers. It goes in line with the neutrality principle and ensures less discriminatory character of taxes (although sometimes states will deviate from the perceived fair broad base for instance to steer the direction of the country's development by favoring some sectors).[97] Generally, the low tax rate combined with the

[93] Desai, Mihir A., *A Better Way to Tax U.S. Businesses*, Harvard Business Review (July 2012), last accessed 28.03.2015 <https://hbr.org/2012/07/a-better-way-to-tax-us-businesses>

[94] Djankov, Simeon and Ganser, Tim and McLiesh, Caralee and Ramalho, Rita and Shleifer, Andrei, *The effect of corporate taxes on investment and entrepreneurship*, NBER Working Paper Series, Working Paper 13756 (January 2008): 1-29

[95] The Economist, *Inequality and the narrowing tax base Too reliant on the few*, The Economist Newspaper Limited (20 September 2014), last accessed 31.03.2015 <http://www.economist.com/news/leaders/21618784-taxes-are-best-raised-broad-base-many-countries-it-worryingly-narrow-too-reliant>

[96] Spry, John, *Aligning Taxes with Economic Growth*, Center of the American Experiment (18 September 2014): 1-17

[97] Institute on Taxation and Economic Policy, *Tax Policy Nuts and Bolts: Understanding the Tax Base and Tax Rate*, Policy Brief, Washington (August 2011): 1-2

broad base counteract all the distortions caused by the high rate and narrow base and drive investors as well as entrepreneurs to allocate capital and other resources in the most productive areas.[98]

Closely connected with the issue, whether the tax base is broad or narrow, is the question of tax selectiveness. Number of experts argue that an optimal tax system is characterized by the existence of well-designed and highly selective income taxes. It means that some kinds of income, costs or family situations are treated more leniently, while others less. The latter ones are therefore a subject to steep progressive tax rates. The idea of tax selectiveness aims at raising revenue from sources that are least damaged by the tax payments and to protect those sources which are potentially most sensitive to the tax burdens. Similarly to the effects exerted by the establishment of either broad or narrow tax base, selective income tax can influence the actions of economic entities and therefore the government is able (to some degree) to encourage or discourage specific activities. States rely on such approach when they deal with issues such as research, environmental protection or education.[99]

Tax holidays are another component of the corporate tax. Also known under terms tax abatement, tax subsidy or tax reduction, it is a form of deduction destined for private sectors. It also plays a role of an incentive for enterprises active in certain industries and/or located in given regions. During the appointed period of time corporate incomes are not taxable or taxed but within a lower rate. Tax holidays are easy to administer and by allowing the taxpayers a substantial reduction in contact frequency with civil servants they are potentially contributing to the decreased level of corruption.[100] Therefore they are often used in stimulating the inflow of foreign direct investments, particularly in the developing countries. As mentioned above, tax holidays either totally exempt or significantly decrease the tax rate, embracing specific forms of investments and time periods. Tax holidays are definitely classified as the tax incentives, and moreover they are assumed to be the most commonly used measure from the broad spectrum of available tax incentives. Tax holidays are constructed in such a way, that they lower the direct costs of foreign investments in a host country as well as they substantially reduce the compliance burden (those are processes and activities that a firm needs to undertake in order to adjust the organization to the existing local regulatory requirements), which is particularly troublesome and cost-generating for the new market entrants. Theoretically tax holidays, due to their tailor-made construction, are very suitable mechanisms for attracting investors, who are supposed to establish new enterprises within a given region and for whom the cost of entry becomes significantly decreased. As the company's initial, and often most costly, starting phase passes, only then new firm is obliged to pay taxes. Nevertheless, the assumptions of theory do not always correspond to the reality. Although the period length of the tax holidays validity is fixed in advance, it is a frequent practice, that it is prolonged. Additionally, such procedure has become a common thing. There is taken into consideration no distinction between the stages of development (especially regarding the market penetration) of particular companies and therefore all the enterprises might be easily granted this kind of incentive. Additionally, as the companies incur losses usually in their first periods after their establishment, they would not have to pay taxes anyway, as no income would be generated at this point of time. Notwithstanding, tax holidays are valid exactly at this point and hence, this state of affairs results in the decreased efficiency of such tax incentive measures. It seems therefore more logical, to grant tax holidays only then, when first income is earned by a firm. Another drawback of this tax tool, is that the period of exemptions is identical for all enterprises. Similarly to the lack of distinction between stages of development among firm, it reduces efficacy of such incentive and might cause intensified use of tax planning strategies.[101]

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[98] Spry, John, *Aligning Taxes with Economic Growth*, Center of the American Experiment (18 September 2014): 1-17

[99] Hines, James R. Jr., *Selective Income Taxation*, University of Michigan and NBER (February 2014): 1-24

[100] Rajan, Ramkishen S., *Measures to attract FDI*, Economic and Political Weekly (3 January 2004): 12-16

[101] Brauner, Yariv and Stewart, Miranda, *Tax, Law and Development*, Edward Elgar Publishing, Cheltenham (2013): 27-29

Tax allowance is another component of the corporate tax. It is a concession made by the governments, which allows reducing the taxable income. It means, that until achieving a specific level of income, a taxpayer is not obliged to pay income tax.

Another tax tool, although similar in name with the previously described one, should not be mistaken though. Investment tax allowances are the next form of tax incentives offered to the foreign enterprises by host countries. Companies are allowed to deduct part of their capital costs and thus decrease their taxable income.[102] Also known under the term investment expenditure allowance, this tax tool gives company the right to write off part of its investment expenditure, but only in the same year as it was undertaken. Hence it is said to constitute a direct up-front tax saving. A very similar mechanism is the investment tax credit. The difference appears only in a way that those two refer to the manner of how the final tax saving is made. By the investment tax allowance, as already pointed out, the deduction is made from the taxable income, while by the investment tax credit (as the name already indicates) there are given credits against tax liability. The advantage of this tax incentive is its specific focus. It targets exclusively new investments. Some experts are convinced, that because of the narrow base and the potential to significantly decrease the tax burden, it can contribute to inclining firms to undertaking long-term investments. Additionally, it does not completely eradicate the tax base. On the other hand, the disadvantage of the tax investment allowance is that it favors well-established companies over start-ups. The underlying reason is that in case of losses (what is characteristic for the new entrants on the market) a company cannot fully benefit from such allowance.[103] As described above, investment tax allowance is a capital expenditure-based incentive. As a rule it is granted only once. Additionally, the exemption rate is not fixed and varies with the type of products or activities. This kind of tax incentive applies mainly to sectors/areas such as manufacturing companies, high technology companies, small and medium enterprises (SMEs), tourist development or R&D expenditures.

2.2.7. Custom duties

Another component of tax systems that has an influence on the foreign investments flows are custom duties. Duties, called also tariffs, are a form of tax levied on the imported goods. They vary in value, depending on the products on which they are levied and on the countries where they are sold. Duties function in a way, that they increase the price of a given product, but only for the foreign buyers. Therefore they can significantly influence the company's competitiveness, when it tries to expand their sales reach and embrace other countries.[104] Tariffs are one of the tools used by governments practicing trade protectionism and thus hampering free trade. Such states claim that they want to protect infant industries, however tariffs are often existent in the already developed sectors. The main reasons why duties are levied on imported products seem to be (except for reducing competition for the infant sectors), the protection of employment within a country as well as consumers. Governments using tariffs may also impose them for strategic reasons. It means that they tend to protect those industries and companies which are important for the national security. Duties can also serve as a retaliation tool, when states consider the others unfair in terms of the undertaken international trade activities. If in the host countries the cost of the produced good is similar and there are imposed high tariffs, the buyers will incline towards the purchase of local goods, as simply the price is lower. Also in case when the production costs are higher, local goods are not doomed to failure either. Domestic manufactures are not forced to lower the prices, since the foreign goods are more expensive due to the imposed tariffs, which in some cases can be higher than 100% or reaching even more than 300% (for instance tobacco in the United States). The competition

[102] BusinessDictionary.com, *investment allowance*, WebFinance, Inc. (2015), last accessed 01.04.2015 <http://www.businessdictionary.com/definition/investment-allowance.html>

[103] Shome, Parthasrathi, *Tax Policy Handbook*, International Monetary Fund, Washington (1995): 167-168

is not as fierce as it would be under circumstances where foreign goods are not discriminated and therefore, consumers would not benefit from constantly lowered prices. Consequently, some of the less competitive firms manage to function, thus overall efficiency is decreased.

As pointed out, tariffs create market distortions. Therefore many countries, though not all of them, are resigning from using such tax tools, especially in face of the growing importance and reach of the free trade agreements and World Trade Organization.[105] Nevertheless, as already mentioned, duties may vary in regard to different countries and some of them still impose very high rates, while the others rather low.[106] As there are made more and more foreign investments into the export oriented sectors, this state of affairs enforces decline in the duties' use, especially the unilateral tariffs. The high level of foreign investments in relation to trade flows significantly contributes to this transformation, as it becomes the driver of countries' economic growth (and not export alone). The exemption from custom duties is particularly relevant for companies investing abroad, which establish there their facilities. Lower prices for the imported machinery or raw materials may be an important factor in the investor's decision making process regarding the choice of FDI location.

2.2.8. Local taxes

Similarly as in case of custom duties, exemptions may be applied to the local taxes. This kind of taxes is levied not by state, but by local authorities (county or municipality). Nevertheless, they are collected simultaneously with the state taxes. Those tax revenues are designated for expenses incurred at the community level and may vary between regions.[107] Usually they take form of property, sales, water, sewer and school taxes. Among those, property tax seems to be the biggest burden among all other local taxes for the companies. Property tax is levied on real estates and is calculated upon its value, exactly on both property and land. The rate is expressed by percentage but can be also given as a so called per mill (which is an equivalent to the 0,001 of a local currency unit), hence the second term in use for this kind of tax is the millage tax. Its calculation might be sometimes problematic and so cause excessive burdens for firms. For instance there are cases when the taxable company's property is so difficult to evaluate properly, that more tax is paid than it should be.

Generally, local taxes can have a huge impact on the enterprises, particularly in terms of their cash flows, effective tax rate or the risk profile. In case of corporate tax there can be implemented strategies by firm that allow avoiding tax payments (for instance shifting income to other jurisdictions). In case of local taxes the room for maneuver is much more limited. Therefore each exemption from the local taxes can be perceived as a huge incentive for an investor.

2.2.9. Write-offs

Fast write-offs constitute another important issue for investors. Depreciation is a cost expressed as a wear and tear of fixed assets (such assets must be in use for more than 12 months, nevertheless not all of them are eligible for the write-offs, for example land). Depreciation is a gradual process, consisting in charging the expense reflecting the wear of an asset corresponding to its lifespan. This charged costs allow making deductions from the income, what in turn diminishes the tax due. As already mentioned, not all assets can undergo the depreciation process. There are some conditions that must be met, for instance such asset must be owned by the enterprise, it must be used in an income-producing activity, its lifespan must be clearly indicated (and be at least 12 months as stated earlier) and its type cannot be excluded by tax regulations. Tax depreciation is a subject to strict rules referring to the asset type and not its actual usage and therefore wear and tear.

[105] Radcliffe, Brent, *The Basics Of Tariffs And Trade Barriers*, Investopedia, LLC. (2015), last accessed 02.04.2015 <http://www.investopedia.com/articles/economics/08/tariff-trade-barrier-basics.asp>
[106] http://www.export.gov/logistics/eg_main_018130.asp
[107] Investopedia, *Local Tax*, Investopedia, LLC. (2015), last accessed 02.04.2015 <http://www.investopedia.com/terms/l/localtax.asp>

Fast write-offs result in the substantial reduction of the tax due in the near future, because of the high costs ascribed to this time period.[108]

It can be said, that accelerated depreciation has two main advantages for the investors. Firstly, by reducing the tax liability, it diminishes firm's current cash to a lesser extent and secondly it acts as a driver for buying new assets. Because of those factors, fast write-offs might be treated as an equivalent to lower tax rate in general, however it allows savings to companies which extend their assets (this is the crucial difference between normal tax rate mechanism and depreciation). Hence fast depreciation boosts investments in capital (physical assets) and evidence shows that entrepreneurs are more eager to invest under conditions where there can be used accelerated depreciation instead of the conventional one.[109] Consequently, capital-intensive companies will benefit mostly from the possibility of fast write-offs.[110]

2.2.10. Effective tax rate

For investing companies it is important that tax system in a host country is friendly. For instance it might mean that the entirety of tax is characterized by low rates and hence that effective tax rate is low. Effective tax rate should not be mistaken with the statutory tax. Within a country there is imposed a multitude of different taxes by different authorities and accompanied by various kinds of exemptions and deductions. While calculating the tax liability by a company, the actual tax payment usually does not equal the actual tax rate. The difficulty in determining the liability ensues from the necessity of taking into consideration factors such as corporate financial policy, investment tax credits, depreciation or local taxes especially as they may vary between jurisdictions or even industry sectors and undertaken business activities.[111] Therefore, there exists a strong need for evaluating the effective tax rate, which can be expressed as a ratio of tax paid to pre-tax profits in an accounting period. Statutory tax rate are accrued to the taxable income, but then there must be considered different tax credits (in case of income earned abroad), deductions and tax preferences. Consequently, effective tax rate is equal to statutory tax rate diminished by the granted preferential tax measures. It reflects the actual cost of investment by determining the real tax burden a company must pay.

As already proven corporate taxes negatively influence the rate of return on investments. As the capital has become extremely mobile, investments are targeted at regions which will ensure the highest rate of returns, resulting into intensified tax competition among states. Governments are undertaking measures to reduce tax impediments. Although corporate tax is seen by many as the most detrimental tax burden to the foreign companies, taxes such as property or consumption tax also negatively influence investors' decisions about capital allocation (although to a lesser extent). As a result, multinational companies have become very vulnerable to the changes in the effective tax rates. The empirical research show that for every one percent of decrease in the effective corporate rate, there is recorded a growth equal to 3 percent in capital investment. The findings are even more astonishing for the foreign direct investments. The aforementioned reduction in the effective tax rate can bring as much as 5.6 percent increase in the FDI inflows.[112]

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[108] Bragg, Steven, *What is tax depreciation?*, Accounting Tools (31 May 2013), last accessed 02.04.2015 <http://www.accountingtools.com/questions-and-answers/what-is-tax-depreciation.html>

[109] Stockfisch, J.A., *Investment Incentive, Taxation, and Accelerated Depreciation*, Southern Economic Journal Vol. 24, No. 1 (July 1957): 28-40

[110] Rubin, Richard, *Faster Tax Write-Offs for Equipment Purchases Pass House*, Bloomberg (11 July 2014), last accessed 02.04.2015 <http://www.bloomberg.com/news/articles/2015-04-01/here-s-america-s-new-minimum-wage-map>

[111] Fullerton, Don, *Which effective tax rate?*, NBER Working Paper Series, Working Paper No. 1123 (May 1983): 1-26

[112] Dittmer, Philip, *U.S. Corporations Suffer High Effective Tax Rates by International Standards*, Tax Foundation Special Report, No. 195 (September 2011): 1-12

2.2.11. Tax havens and transfer pricing

As already mentioned numerous times in this paper, investors try to decrease their tax burden to the possible minimum. It has become easier over the last decades as capital is mobile and impediments for its cross border allocation have been gradually and constantly lifted. Therefore some countries have decided to become tax havens. The main advantage of such states is that there is no corporate tax. Referring to the statistical data, approximately 15% of all countries around the world are tax havens and they tend to be both small and wealthy. Nevertheless, the most important factor determining that a country can transform into a tax haven is the quality of its institutions. Only high-quality governance can ensure tailoring its tax policies to the maximal national advantage.[113]

Tax haven is a country or region characterized by no or very low rate of taxes and which is relatively stable politically and economically. Because of this, countries that are active in states with significant fiscal burdens, can benefit from such advantageous fiscal conditions (by shifting their profits there) even though they do not reside in a given tax haven.[114] Apart from the preferential tax treatment, tax havens provide secrecy (very valued by companies), meaning that they do not disclose information regarding firms' activities to the foreign tax authorities. Although enterprises claim not to act against the law (but rather to use the existing loopholes in the regulations), they do appreciate such veil of secrecy. This aspect is important to such a high degree, that tax havens are also interchangeably called the secrecy jurisdictions.[115] On the other hand, the aspect of secrecy may contribute to the corruption and market or investments distortions, because efficiency becomes less important than low tax liabilities and confidence. Those conditions might result in fraud, aggressive tax and financial regulations avoidance, embezzlement or money laundering. Host countries are deprived the tax revenues from companies (not rarely foreign enterprises) and thus the social welfare in a region is unfairly diminished. There are estimates that as much as $100 billion per year might be lost due to tax evasion and profit shifting to the tax havens. As pointed out, companies might be involved in either tax evasion which is illegal, or in tax reduction which is legal. There exists a thin line between those two activities and sometimes it is difficult to properly classify company's actions as legal or unlawful, especially as it undertakes numerous and various business activities. Illegal behavior is facilitated as tax havens are lacking transparency but provide aforementioned bank secrecy, share limited or no information and create no impediments to gain legal status allowing being a subject to local fiscal regulations. Those all measures are undertaken by tax havens mainly to attract capital.[116] Evidence shows that the highest probability of undertaking tax haven operations exists for firms that are internationally active, R&D intensive and that have high volumes of intra-firm trade. They shift income to the regions with lower tax rates by for instance establishing the affiliates there, which serve mainly the purpose of profits reallocation (via transfer pricing). Also companies present in the fast developing regions are frequently exploiting the possibilities offered by tax havens. Summarizing, as the flows of foreign direct investment, volume of world trade and intensity of R&D is growing, the demand for the tax haven operations will not decrease.[117] Nowadays companies are able to inexpensively shift their incomes to regions with low tax rates. It has implications for the investors' choice of place for the capital allocation. Investments might seem to be far less vulnerable to differentiated tax rates between countries. Nevertheless, it is more convenient for firms when the avoidance transactions do not have to cross international

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[113]Dharmapala, Dhammika and Hines, James R. Jr., *Which countries become tax havens?*, Journal of Public Economics 93 (2009): 1058–1068

[114] Investopedia, *Tax Haven*, Investopedia, LLC. (2015), last accessed 03.04.2015 <http://www.investopedia.com/terms/t/taxhaven.asp>

[115] Murphy, Richard, *World's Best Tax Havens*, Forbes (7 June 2010), last accessed 03.04.2015 <http://www.forbes.com/2010/07/06/tax-havens-delaware-bermuda-markets-singapore-belgium.html>

[116]Gravelle, Jane G., *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service (15 January 2015): 1-34

[117] Desai, Mihir A. and Foley, Fritz C. and Hines, James R. Jr., *The demand for tax haven operations*, Journal of Public Economics 90 (2006): 513– 531

boundaries.[118]There are few major ways of exploiting the potential of tax havens by corporations, nevertheless the most important one which is analyzed in this paper is the transfer pricing method. Transfer pricing allows shifting firm's profits between jurisdictions characterized by different tax rates via selling products or services within the company's affiliates. Under the tax regulations in force, such intra-firm sales and purchases should be priced as if they were traded with unrelated market entities. Companies involved in the transfer pricing operations set lower prices when they sell products (in regions with high tax rates) and heighten them while purchasing (in low tax jurisdictions). That way income is relocated. For the tax authorities there exists methods to check whether prices are set at the appropriate level of products and services (for instance cost plus a markup). Nevertheless, in case of intellectual properties and other intangible assets, as they barely ever or not at all have equivalents in the market, such methods unfortunately fail. This constitutes a serious problem for governments as more and more enterprises tend to exploit this loophole in regulations. Statistics show that corporate tax evasion (individuals are not taken into consideration here) causes revenues loss ranging from $10 billion to as much as $90 billion, or even more. To the detriment of tax authorities this shady business practices are steadily increasing.[119]

2.2.12. Export processing zones

Export processing zones are the other important factor in terms of fiscal policies aiming at the attraction of foreign direct investments (for both goods and services). The number of such zones is steadily growing and are mostly proliferated in regions such as Asia, Latin America, Africa and developing countries. Export processing zones are the result of governmental attempts to make the investment environment more friendly and tailored to the investors' needs. They constitute a well-designed set of financial incentives, optimal business administration and trade liberalization located in a given, geographically limited, region. Although some may argue that despite being beneficial to few, they cause general distortions in an economy, it cannot being denied that they successfully attract foreign direct investments, thus bringing advantages such as decrease in unemployment rate. Hence the potential loss of tax revenues seem to be not only offset, but even outweighed by benefits such as jobs creation or provision of foreign exchange earnings. Moreover, export processing zones seem to be a cradle of reforms, especially in countries undergoing trade liberalization. As addition to trade and investment incentives there are provided preferential tax treatments. Those are inter alia exemptions from import duties (for instance on raw materials, as well as other inputs and capital goods necessary for the production process), exemptions of customs fees and sales tax on exported products and services (and even on goods and services purchased in the host country that are further used in the production), tax holidays, rebates, reduced corporate tax rates, indirect subsidies (for example special grants for education and training) and direct subsidies (those embrace for instance providing electricity below market rates) and no tax on reinvested profits. Some exemptions maybe be valid for as long as 15 years and can embrace all kinds of taxes.[120] Obviously those preferential treatments of foreign companies vary across countries, nevertheless they are designed to somehow match incentives offered by other regions around the world.

There are also arguments against the very preferential tax treatment in the export processing zones. Instead of maximal lowering tax burdens, there should be imposed moderate corporate tax rates. That way there would be no need for implementing permanent tax holidays or granting exemptions from other numerous taxes. The reasoning behind this is that the actual impact of tax incentives must be considered in combination with the home tax policies (for instance when it grants

[118]Mintz, Jack and Smart, Michael, *Income shifting, investment, and tax competition: theory and evidence from provincial taxation in Canada*, Journal of Public Economics 88 (2004): 1149– 1168

[119]Gravelle, Jane G., *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service (15 January 2015): 1-34

[120]Engman, Michael and Onodera, Osamu and Pinali, Enrico, *Export Processing Zones: Past and Future Role in Trade and Development*, OECD Trade Policy Papers, No. 53 (2007): 10-45

tax credits) and with the possibilities that companies might shift their incomes via transfer pricing practices.[121]

2.2.13. Harmonization of tax systems

The harmonization of tax systems is another important factor influencing the foreign investments flow when considering taxes' role in this process. In general, harmonization describes the evening out of the given country's tax bases or tax rates so as they match the arrangements existent in the other countries or regions. For instance a group of regions will agree on a minimum tax rate for a given tax (income taxes, VAT etc.) that should not be transgressed by any of such group's members. There has been going on a fierce debate among economists whether tax harmonization is a better solution than the tax competition. On the one hand tax competition leads to heightened government's efficiency, on the other hand it might induce inequality and deteriorate the market performance.[122] This market failure would result from a fact, that if the tax rates that are imposed are not equal or the scope of tax bases differ, the free movement of goods and services is hindered.[123] In this respect, tax harmonization would seem as a good solution contributing to the improvement of commodities flows between regions. Nevertheless, the cross-national cooperation regarding the tax regulations is characterized by the need of unanimity, what directly implies that all the parties involved must find the proposed solution (tax rates or bases) appealing or at least be convinced that the gains from introducing new regulations would outweigh the losses (for instance decreased tax revenues due to the lower income tax rate). Given that conditions the full harmonization of whole tax systems is hardly achievable. However, it is more likely to take place in some categories of taxes. Consequently, if any taxes undergo the process of harmonization, those are above all indirect taxes (e.g. VAT). Much less cooperation can be seen in the area of direct taxes on capital and labor.[124] Although this view is commonly shared among economists, there are some voices against such solution. It is justified by the assumption, that if there are countries with efficient tax systems competing against regions with inefficient tax systems, that latter group will be exposed to losses caused by competition over capital income taxes. Therefore, those losses should be compensated by incomes gained from the direct taxes. In this scenario, the harmonization of direct taxes does indeed seem to be less appropriate with regard to the efficiency aspect.[125]

2.2.14. Bilateral tax agreements

Bilateral tax agreement (also called bilateral tax treaty) is an agreement regarding the avoidance of double taxation between two sovereign states (in cases when a tax payer is assumed to be a resident of two or more tax jurisdictions at the same time). The negotiations of the bilateral tax agreements must be considered in a light of not only tax regulations but also of aspects such as monetary, fiscal or even social. If the countries involved in the negotiation process are relatively similar in regard to their stage of economic development, the achievement of treaty is facilitated to a large extent. This holds mostly for the developed countries. This state of affairs results from the fact that the reciprocal flows of capital and thus the potential gains from investments and losses of tax revenues do not significantly differ in magnitude for both parties. Nevertheless, this statement does

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[121] Madani, Dorsati, *A Review of the Role and Impact of Export Processing Zones*, The World Bank (August 1999): 26-28

[122] Bénassy-Quéré, Agnès and Trannoy, Alain and Wolff, Guntram B., *Tax harmonization in Europe: Moving forward*, French Council of Economic Analysis (17 July 2014): 1-12

[123] Chetcuti, Jean-Philippe, The Process of Corporate Tax Harmonization in the EC, Lex E-Scripta (2001), last accessed 04.04.2015 <http://www.inter-lawyer.com/lex-e-scripta/articles/eu-tax-harmonization-2.htm >

[124] Bénassy-Quéré, Agnès and Trannoy, Alain and Wolff, Guntram B., *Tax harmonization in Europe: Moving forward*, French Council of Economic Analysis (17 July 2014): 1-12

[125] Mendoza, Enrique G. and Tesar, Linda L., *Why hasn't tax competition triggered a race to the bottom? Some quantitative lessons from the EU*, Journal of Monetary Economics 52 (2005): 163–204

not apply for the countries which enter the negotiation process and are characterized by large differences in their economic development. The relatively equal benefits in the first case take form of high profits for the developed country and immeasurable sacrifices for the developing one. Theoretically the developing countries are rather reluctant to sign such treaty that can result in the substantial reduction of tax revenue from the locally produced income.[126] Nevertheless it can be observed that it is not rare that they do sign double tax agreements in a hope of attracting foreign direct investments. They seem to sacrifice the potential revenues from the corporate tax as this loss should be compensated by the numerous (not only financial) profits delivered by the increased inflows of FDI. In practice developing countries gain fewer benefits than their developed counterparts. Nevertheless, in case that a treaty is signed with the major capital exporting nations, they are able to profit (to some extent) by the reception of the higher overall FDI stock and more FDI inflows (regarding both their frequency and bigger size). Hence the sacrifice in terms of giving in the authority to corporate tax income is likely to be compensated enough by the bigger foreign direct investments. However, when investigating this issue in more detail, it turns out that for the middle-income developing countries the double tax treaties are effective, while for the low-income ones they are not.[127]

Generally, as already mentioned before, tax treaties have the ability to attract foreign investments. As the multinational company is obliged to pay tax on income earned abroad firstly to the host (local) tax authorities and secondly to the authorities of the home country, an investor will consider such conditions as obstacles and significant financial burden, which can even make investments uneconomical. Tax treaties are designed to lift such barriers for the entrepreneurs. However, the investors benefiting from the avoidance of double taxation might simultaneously suffer from the impediments resulting from the limited opportunities to apply tax planning strategies (such as transfer pricing). OECD explicitly points out, that one of the tasks ascribed to the formulation of tax treaties is the prevention of tax avoidance and evasion. Though, the more savvy parties can sometimes profit from the complex web of treaties among countries.[128] So despite the fact that entering tax treaties is to rationalize the tax burden and hence efficient allocation of capital among countries and an intended byproduct is the reduction of the tax avoidance, multinational companies (MNC) derive even bigger advantages such as complete reduction of the corporate tax payments. It ensues from the fact that MNC establish the so called shell companies in tax jurisdictions with beneficial tax agreements and as a result they might be not an object to taxation in none of the regions, what could be named as double non taxation. This process of setting up shell companies is known under term treaty shopping.[129]

There are several mechanisms which find application while entering a tax treaty. The most common ones are deductions, exemptions, credits, allocation of expenses and tax sparing. Deductions are understood as an allowance for not paying taxes to the authorities in a country of residence if they are paid to the foreign authorities (calculated upon the foreign source income). The other mechanism, exemptions, consists in releasing the taxpayer from the duty to pay taxes on the foreign source income, the only one tax revenue for the authorities is the one earned on the domestic source income. Granting credits by the governments to the company active abroad is another mechanism of the tax treaties. Credits reflect the amount of the tax by which the enterprise is allowed to decrease its tax payment to the domestic authorities, based on the amount of tax paid to the foreign country's government. Simply put, when a firm pays tax in a host country, it gets from the home country credits equal to this amount and when it has to pay taxes in the home country it

[126] United Nations, *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*, Department of Economic and Social Affairs, ST/ESA/PAD/SER.E/37, New York (2003): 5
[127]Neumayer, Eric, *Do double taxation treaties increase foreign direct investment to developing countries?*, Journal of Development Studies, 43 (8) (2007): 1501-1519
[128] United Nations, *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*, Department of Economic and Social Affairs, ST/ESA/PAD/SER.E/37, New York (2003): 5
[129]Lejour, Arjan, *The foreign investment effects of tax treaties*, Oxford University Centre for Business Taxation, Working Paper Series, WP 14/03 (February 2014): 2-21

can subtract the amount represented by credits. This mechanism does not aim at decreasing the taxable income, but tax duty in itself. This system seems to be very beneficial to the companies, however one must remember there are some exceptions to the rule. For instance, credits cannot be granted when the tax rate in a foreign country is higher than the domestic one. The number of credits is restricted to the sum of the domestic tax payable on the foreign-source income. Allocation of expenses is the next solution finding application in the bilateral tax agreements. It allows expenses incurred by taxpayers between their foreign and domestic source income and influences specifically the amount of gross income. Tax sparing, the last considered method, consists in the granting of the so called tax sparing credit by the residence country. The difference between tax sparing credits and the ones mentioned as the third mechanism lies in the fact, that they are given for the taxes which were payable under normal conditions in the host country, but actually not paid (for instance due to tax holidays). It has to be noted, that according to the OECD and UN only exemptions and credits mechanisms are recognized as the legitimate solutions applicable in the tax treaties.[130]

2.3. State of the art

The state of the art regarding the influence of the taxation systems on the FDIs is very rich and simultaneously outstandingly heterogonous - beginning with the models implying that taxes have only a minor impact on attracting foreign direct investments, up to the ones stating that it can be a decisive factor, especially when other circumstances in the analyzed host countries (for instance their macroeconomic indicators) are similar.

There is a firm consensus among both scholars and practicing businessmen that taxes have an impact on the attraction of the foreign direct investments. However, the bone of contention is the degree, to which taxes will exert such an influence and which particular components of tax systems play role here. Going through the whole spectrum of opinions, there are representatives of the view, that tax systems play only a negligible role in investors' considerations regarding the choice of location for their future FDIs, yet there are many supporters of the view, that this influence is significant. The first group constitute a minority and is represented inter alia by Hartman[131] and Beyer[132]. It is important to note here, that their publications are relatively old (especially Hartman's article) as they date back to 1989 and 2002 respectively. Therefore their opinions on the matter might have been partly shaped by lack of either full data set or knowledge about the latest developments in that field or even by obsolete research methods that were in use at that time. Nevertheless, their contributions should not be omitted, as extreme opinions might trigger a justified questioning of the commonly accepted dogma, which could turn out to be false in the long run. Hartman refers in his research to the mature multinational companies. He states, that the tax incentives that the host country is creating for the attraction of the foreign investment is irrelevant and therefore of no use, since the investing company will consider its home tax as the main cost, especially under circumstances when there is established a territorial approach to taxation.[133] Beyer also indicates the negligible impact of tax incentives on the attraction of FDI, however he bases his considerations on different premises than Hartman does. Beyer conducts a research that focuses on countries in transition and claims that introduction of the tax incentives in those regions has no direct impact on the level of the inflowing FDI. He justifies this state of affairs by the fact that the most common means applied by host governments are tax holidays (timely limited exemption from the tax collection) which are of no use to investors who expect profits after a certain time period, or tax exemptions embracing investments of a specific volume, thus presenting no value to the small

[130] Iqbal, Zafar, *How Tax Treaties Allow Benefits from Double Taxation*, Azimuddin Law Associates, HG.org - HGExperts.com (2015), last accessed 17.04.2015 <http://www.hg.org/article.asp?id=30908>
[131] Hartman, David G., *Tax policy and foreign direct investment*, Working Paper No. 689, NBER Working Paper Series (June 1981): 1-28
[132] Beyer, J., *"Please invest in our country" – how successful were the tax incentives for foreign investment in transition countries?*, Communist and Post-Communist Studies, Vol. 35 (2002): 191-211
[133] Hartman, *loc. cit*.

investors. In the empirical research he proves his assumptions to be true, concludes however, that taxes might have an indirect influence on FDI through privatization processes and overall tax level.[134]

Opposed to those views, there is a significant group of researchers favoring the view that taxes are of a great importance when attracting FDI and especially the corporate tax. Benassy-Quere et al. argues that FDI are sensitive not only to the market potential, but also to the corporate tax rate. Nevertheless, she points out that as a high rate of the aforementioned tax strongly discourage the FDI inflow, the relatively low rate does not trigger any additional FDI. She bases her considerations on the premises that high rates of corporate tax significantly diminish the after-tax profits, thus decreasing the propensity of investors to allocate funds abroad. The conducted empirical research to prove this thesis, while also controlling for factors such as provision of public goods and transfer pricing, only confirms the author's assumption.[135] Similar opinion on the corporate tax is shared by Asano, who states that the high corporate tax rate will deter investors. However, he stands up for the view that the low rate in the host country will attract more investors (as opposed to the Benassy-Quere findings), particularly under ambiguity (not to confuse with risk). In his empirical studies he proves, that as the investing firm lacks confidence in the market potential and the host country's GDP level due to ambiguity, the reduction of the optimal corporate tax rate would act as a trade-off for those poor conditions and hence result in encouraging FDI inflow.[136] Still concerning the area of tax rates influencing the level of inflowing FDI, Hong and Smart describe in their article the relation between corporate tax and mobile investments. They contend, that although the theory supports the idea that since the mobile forms of capital can be allocated anywhere, the governments will be more willing to lower the tax rate to a greater extent than it would be optimal, only to attract investor to the region, there is little empirical evidence confirming this presumption. They explain, that this state of affairs results from the fact that multinational corporations will implement into their strategies the elements of tax planning and therefore move their profits to tax havens. In practice it means that investors should become less susceptible to high rates of corporate tax, what simultaneously means, that the host country would not be deprived of profits derived from its domestic companies. It is suggested therefore, that as opposed to the commonly shared view, corporate tax rate will be not lowered to attract FDI. It does not mean, however, that tax system does not influence the inflow of foreign capital. It does, but in a form of tax havens, with which rise, more investments in the neighboring non-haven regions will be made. This suggests that the companies' strategic instruments such as tax planning and transfer pricing (which allows the shift of income to another place) constitute the important factor in the decision-making process of an investor regarding the FDI destination.[137]Zambujal-Oliveira shares similar opinion to Hong and Smart and emphasizes the importance of transfer pricing while planning the destination for the future FDI. The ability of a company to shift its profits to the regions with lower corporate tax rate seems to be crucial, especially under circumstances of information uncertainty regarding the economic environment of a host country.[138] Another aspect of the impact that taxes exert on the inflowing FDI is addressed by Blonigen and Davies. They describe the influence of bilateral tax treaties on the attraction of FDI. Blonigen and Davies, being convinced that in general investors are responsive to specific tax policies of a receiving country, they (similarly to Hong and Smart) contradict one of the commonly shared opinions about bilateral tax treaties, that are although seemingly logic and intuitively correct, turn out not to be empirically supported. They predict and subsequently prove in their research, that with the increase of the bilateral tax treaties, the amount of the incoming FDI decreases. The researchers explain, that although the intentions of entering such treaty by the party

[134] Beyer, *loc. cit.*

[135]Bénassy-Quéré, Agnès and Fontagné, Lionel and Lahrèche-Révil, Amina, *How Does FDI React to Corporate Taxation?*, International Tax and Public Finance, Springer, vol. 12(5) (September 2005): 583-603

[136] Asano, Takao, *Optimal tax policy and foreign direct investment under ambiguity*, Journal of Macroeconomics 32 (2010): 185–200

[137] Hong, Qing and Smart, Michael, *In praise of tax havens: International tax planning and foreign direct investment*, European Economic Review 54 (2010): 82–95

[138]Zambujal-Oliveira, J., *Tax competition for foreign direct investment under information uncertainty*, Economic Modelling 29 (2012): 2269–2273

are good and such agreement should serve above all the double taxation relief, it might have other, less clearly predictable consequences. And so, such treaty enforces the information exchange between parties, thus hampering the investors' ability to engage in transfer pricing and tax-saving strategies of another kind (which, as earlier proved by Hong and Smart, might be crucial in the decision-making process for an investor).[139]

Haufler and Wooton consider on the other hand, whether a host country size affects the tax competition that will be implemented by its government to attract the foreign capital. They conclude, that factors such as tax and tariff competition will contribute to the success of a big country rather than of a small one. It is determined by the facts that the size of a country is not considered in absolute terms (but relatively to the size of the other remaining regions) and that generally companies will incline towards investing in potentially larger markets. Therefore the level of tariffs in the next biggest country, will determine the threshold that cannot be extended, if a government is to attract the investment. In case of a small country its government will set up a low tax rate, what will result in a comparatively high utility level per capita in the Nash equilibrium (if no actor changes his strategy, the all parties involved will get the highest pay-offs that the current situation allows).[140]

Raff and Srinivasan deal with the issue of signaling, which is identified in this case with tax incentives aiming at attracting FDI. They argue that the company tending to invest abroad but lacking full information about the environment in a host country, will be encouraged by tax incentives, which should be interpreted as heralds for the favorable business conditions in general. Tax incentives are considered more effective than tariffs walls. Although governments are sacrificing part of its potential tax revenues, they will still be ready to lower taxes, since foreign investments tend to bring other benefits such us technology spillovers or employment of domestic labor force. In the conclusion of their research, the authors state that the bigger the country risk and its openness, the more tax incentives will be implemented.[141] The very similar view is represented by Tung and Cho, who investigate the impact of special tax incentive zones on attraction of FDI to China. They prove that incentives in a form of concessionary tax rates, do indeed attract more investors, as the after-tax return is not substantially diminished. They also prove, that choice of particular tax incentives entails specific forms of FDI. Although that other factors, which are hard to control for during the research (such as other governmental policies) might have contributed to the heightened amount of inflowing FDI, it is indisputable, that proper tax systems played a significant positive role in the process.[142]

Desai et al. refers in his research to the multitude of taxes in a host country that will affect investors' decision. Therefore he departs from the mainstream, which focuses mostly of the implications of the corporate tax for the FDI, and takes into consideration non-income taxes. In his opinion those indirect taxes are of a great importance, since corporate tax is a subject to the regulations concerning double taxation. Since there are granted foreign tax credits to the companies by their home governments, corporate tax appears to be a relatively small financial burden to the investor. On the other hand, a company in a receiving country is not relieved in a similar manner from paying indirect taxes and thus they might constitute a significant cost that will be carefully considered by the investor before he decides to enter new country. The empirical research conducted by the author proves that the extent to which direct and indirect taxes (in the absence of tax credits) influence the inflow of FDI is more or less equal. There is one important difference however. The direct tax will cause the decrease in the capital/labor ratios, while indirect taxes also

[139]Bloningen, Bruce A. and Davies, Ronald B., *Do Bilateral Tax Treaties Promote Foreign Direct Investment?*, Working Paper 8834, NBER Working Paper Series (2002): 2-21
[140]Haufler, Andreas and Wooton, Ian, *Country size and tax competition for foreign direct investment*, Journal of Public Economics 71 (1999): 121–139
[141] Horst, Raff and Srinivasan, Krishna, *Tax incentives for import-substituting foreign investment: Does signaling play a role?*, Journal of Public Economics 67 (1998): 167–193
[142] Tung, Samuel and Cho, Stella, *The Impact of Tax Incentives on Foreign Direct Investment in China*, Journal of International Accounting, Auditing & Taxation, 9(2) (2000):105–135

but to a significantly lesser extent.[143] Those findings are confirmed by Becker et al., who concludes that there is a correlation between heightening the corporate tax rate and an increase in the labor intensity against capital. Thus, Becker is proving that implemented tax policies, will not only influence the quantity, but also a quality of inflowing investments.[144] This statement remains in line with the research outcomes provided by already mentioned Tung and Cho. Gondor and Nistor on the other hand, just as Desai et al., put emphasis on the whole fiscal policy of the host country, contradicting the common opinion, that corporate tax is the one of a decisive nature for the investors' decision about capital allocation. They claim that tax competition should be based on regulating not only corporate tax, but ensuring the proper business environment, which anyway is shaped to a great extent by the fiscal policy. They conclude, that merely lowering corporate tax is not sufficient to attract investors. There must be created conditions of predictability, transparency, lack of tax fraud etc.[145]

From the described state of the art, it clearly ensues, that the opinions regarding the importance of tax systems for the attraction of FDI is strongly diversified. Nevertheless, apart from the underrepresented group (in terms of its size), almost all the researchers agree on the fact that taxes (in various form) do matter. It remains an open question which opinions should be treated more seriously than others, as the topic of relation between fiscal policies and FDI is being all the time actively investigated and completed by new findings.

2.4. Analytical framework

As pointed out in the previous section, the literature on the topic regarding the influence of the tax systems on attracting FDI is exceptionally heterogeneous, varying sometimes even in the very fundamental assumptions. For the needs of this paper, there will be used a framework constructed upon the content of the scientific article written by Jacques Morisset and Neda Pirnia.[146] In their review, the authors gather the contributions from the numerous researchers and create a compendium, composed of at that time available scientific findings regarding functions of different tax-related factors in the process of FDI attraction to the foreign countries.

Morisset and Pirnia state that governments involve themselves in a fierce competition to induce foreign companies to invest in their regions. The host countries will implement a whole variety of mechanisms serving the attraction of FDI, as they realize how beneficial they might be to their economic development and general welfare. As the taxes influence the value of return on investment, fiscal system of a host country will not remain unnoticed when considering the investment destination. However, the favorable tax system will not constitute a sufficient substitute for remaining bad conditions such as unstable political environment or poorly endowed infrastructure. Therefore the authors contend that the tax systems will be recognized as a decisive factor in the investor's decision making process regarding the FDI location only if all other factors (for instance market size, macroeconomic indicators) remain more or less equal for the potentially considered destinations. Taking these circumstance into account, Morisset and Pirnia list (in their opinion) relevant tax instruments that matter for the foreign investors. First of all, they mention the corporate tax, which is seemingly of the superior meaning to investors as it directly refers to their income. Governments that are involved in a tax competition have few options how to strategize. On the one hand they might decide to establish a low rate of corporate tax on a broad base, what can be

[143] Desai, Mihir A. and Foley, C. Fritz and Hines Jr., James R., *Foreign direct investment in a world of multiple taxes*, Journal of Public Economics 88 (2004): 2727– 2744
[144] Becker, Johannes and Fuest, Clemens and Riedel, Nadine, *Corporate tax effects on the quality and quantity of FDI*, European Economic Review 56 (2012): 1495–1511
[145]Göndör, Mihaela and Nistor, Paula, *Fiscal Policy and Foreign Direct Investment: Evidence from some Emerging EU Economies*, Procedia - Social and Behavioral Sciences 58 (2012): 1256 – 1266
[146]Morisset, Jacques and Pirnia Neda, *How Tax Policy and Incentives Affect Foreign Direct Investment, A Review,* Policy Research Working Paper 2509, World Bank eLibrary (December 2000): 1-30, last accessed 21.02.2015 <http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-2509>

interpreted as a part of signaling strategy (communicating a readiness of a country's government not to interfere into investment structure, but letting the market determine it), on the other hand they might implement the selective approach (e.g. tax rate reduction only in specific sectors) following the so called discretionary policies. The host countries can also reach for alternatives such as tax holidays (exemption from taxes for a certain period of time) or tax allowances (level of income upon which tax payment is due). Another policy might consist in granting companies investment tax allowances (lowering tax rate only under condition of capital investment), which causes lesser loss of tax profits from the company than tax abatement. The less common means is the so called stability premium. Its mechanism is based on the premise, that an investing company can buy a right guarantying that the rate of corporate tax will be sustained for the purchaser, even if the country's fiscal policy will change in the future. Except for regulating the corporate tax, governments possess a broad spectrum of other fiscal tools. Those are for instance exemptions from custom duties and other local indirect taxes (taxes that do not directly refer to the company's earned profit). Regulations allowing fast write-offs for investment expenditures (the gradual reduction of an asset's value translates into diminishing of the taxable income) are another kind of mechanisms making the host country more appealing to companies. The government of a host country might also undertake more radical step such as changing the whole fiscal system instead of its particular components. In this case it will tend to decrease the effective tax rate, which reflects how much percentage of an overall investment a company will have to pay due to the entirety of the fiscal regulations in force. Even more extreme solution is to transform the host country into a tax haven. Regions possessing this title decide to either substantially decrease the income tax rates or to completely eliminate direct taxes, what is particularly appealing to the investors with mobile capital (which by means of transfer pricing are able to shift their profits to such locations). If such favorable conditions are only limited to the export-oriented activities, they are called Export Processing Zones and are characterized also by other favorable conditions like disproportionally long tax holidays. The governments trying to lure investors can also decide to carry out the process of tax systems harmonization to match international regulations. Although it has the aim of ensuring the stable and transparent environment, which would facilitate the conduct and adaptation of foreign companies, it also produces potentially negative side effects. Too much of a standardization can hinder the investors from undertaking tax planning measures or from employing the mechanism of transfer pricing. This might act as a deterrence especially to large multinational companies. Therefore, the optimal policy is to undertake the harmonization only of the very fundamental tax regulations, to provide sufficient degree of clarity but not to scare away bigger investors. It cannot be omitted, that not only host countries will have an influence on the investors' decisions. Tax systems in the home countries play here a significant role. The existence (or its lack) of the bilateral tax treaties might determine, whether a company will be financially capable of investing abroad. For instance the institution of granting tax credits in home country granted for taxes paid abroad might solve the problem of double taxation, which otherwise could severely damage earned profits. If the country is entirely exempted from the taxes earned abroad (using the credits mechanism), it will tend to invest into regions with much higher tax rates as compared to investors who have to pay either some part of taxes or the whole sum, as the double taxation is not regulated.

Morisset and Pirnia also point out in their review, that specific forms of tax incentives will result not only in a quantity of inflowing FDI, but also in their qualitative features (here are to distinguish for instance export-oriented companies or firms active in multiple markets). And so, according to their review, export-oriented enterprises are the ones mostly vulnerable to the changes in the tax rates. Also characterized by high degree of mobility, those firms often compare different investment locations in view of their tax systems and are able to benefit from differentials among various regions. In favor of start-ups act incentives that decrease costs incurred by the foundation of a company. On the contrary, companies that are already established and are in the midst of expanding themselves, tax mechanisms related to the profit are of greater importance. Companies active in the manufacturing industry are interested in the possibility of fast write-offs (depreciation), since they are using many fixed assets. In regard to the size of an enterprise, it turns out that smaller firms are more vulnerable to tax incentives that big ones in general. The reason probably lies in the financial capacities. Large companies can afford hiring specialists that will create complex strategies for tax avoidance and will supervise the functioning of such mechanisms (e.g. transfer pricing), while small investors are incapable of undertaking such ventures, and are therefore thrown back merely on the existing tax incentives from which they can benefit. Bigger firms also profit from special tax treatments, as the benefits from the investment in a host country might compensate for the lost tax revenues. In the review, there has been also made an annotation, that companies active in numerous industries show more vulnerability to the tax rates of host countries. Because of their multiple operations and use of the transfer pricing (and other tax avoidance strategies) they are searching for the locations with the lowest rates (preferably tax havens) and shift profits there (because it is complex to prove where they were earned).[147]

The analytical framework for the analysis of the influence of tax systems on the FDI will be wholly based on the remarks included in the Morisset and Pirnia's review. Each of the chosen regions that will come under scrutiny, will be analyzed with regard to the relative attractiveness of the following components of its tax system: corporate tax (including low rate on a broad base or selective approach, tax holidays, tax allowances or investment tax allowances), exemptions from custom duties and other local indirect taxes, fast write-offs for investment expenditures and , possibly change of the whole fiscal system (decreasing the effective tax rate), decision to become a tax haven, Export Processing Zones, harmonization of tax systems and existing bilateral tax treaties. As the next step they will be compared between regions to find out the relative superiority of one over another places. There will be also made an attempt to investigate, whether host countries respond to the tax avoidance strategies of the companies and how effective such counteracting is. The exact structure of the analytical framework is provided below in a form of table.

Table 1: Analytical framework part 1

Is the given component of a tax system existent in a region? If so, what are its characteristics?
• Corporate tax → *low rate on a broad base* → *tax holidays* → *tax allowances* → *investment tax allowances*
• Exemptions from: → *local taxes* → *custom and excise duties*
• Write-offs for investment expenditures
• Change of the whole fiscal system (decreasing the effective tax rate)
• Becoming a tax haven
• Export Processing Zones
• Harmonization of tax systems
• Bilateral tax treaties

Table 2: Analytical framework part 2

Do the host countries respond to the tax avoidance strategies of the companies?
• What are the undertaken measures?
• How effective are they?

Apart from constructing criteria for the analysis, few other details need to be specified (e.g. choice of the host regions and time frame). As the authors note that tax systems are the decisive factor mostly for the FDI location choice when other circumstances are more or less similar (in practice it is impossible that remaining conditions are identical), the regions that will be taken under scrutiny are Hong Kong, Taiwan, Singapore and South Korea. This decision is based on the premise

[147] Ibid.

that all those 4 regions belong to the East Asia region and are commonly called Asian Tigers, representing similar development potential. All those regions have undergone rapid industrialization from 1960 onwards and transformed into highly developed economies, currently ranking among top richest nations worldwide.[148] Additionally the size of markets is acceptably similar (especially when compared to other regions in the area such as People's Republic of China or Japan), moreover 2 out 4 have the status of city-states. Considering those circumstances, the choice of the aforementioned regions for the purposes of this research seems to be justified. Regarding the time frame, the analyzed period will embrace the recent years, meaning not addressing events that had taken place before 2000. Tax systems are characterized by rapid and frequent changes and consequently the regulations are being constantly developed and adjusted to the current situations. Focusing on period longer than 15 years might cause unnecessary confusion, since older practices and polices might no more find application and therefore be simply irrelevant. For the purposes of this paper there has been used the mix of descriptive, comparative and explanatory research methods. It means, that firstly there are described the characteristics of the analyzed objects (tax systems and their influences on the inflowing FDI) and simultaneously made comparisons between analyzed entities and subsequently. Based on the accumulated information and revealed differences, there will be made attempts to explain the reasons of the current state and the possible consequences for the future.

3. Analytical part

3.1. Hong Kong

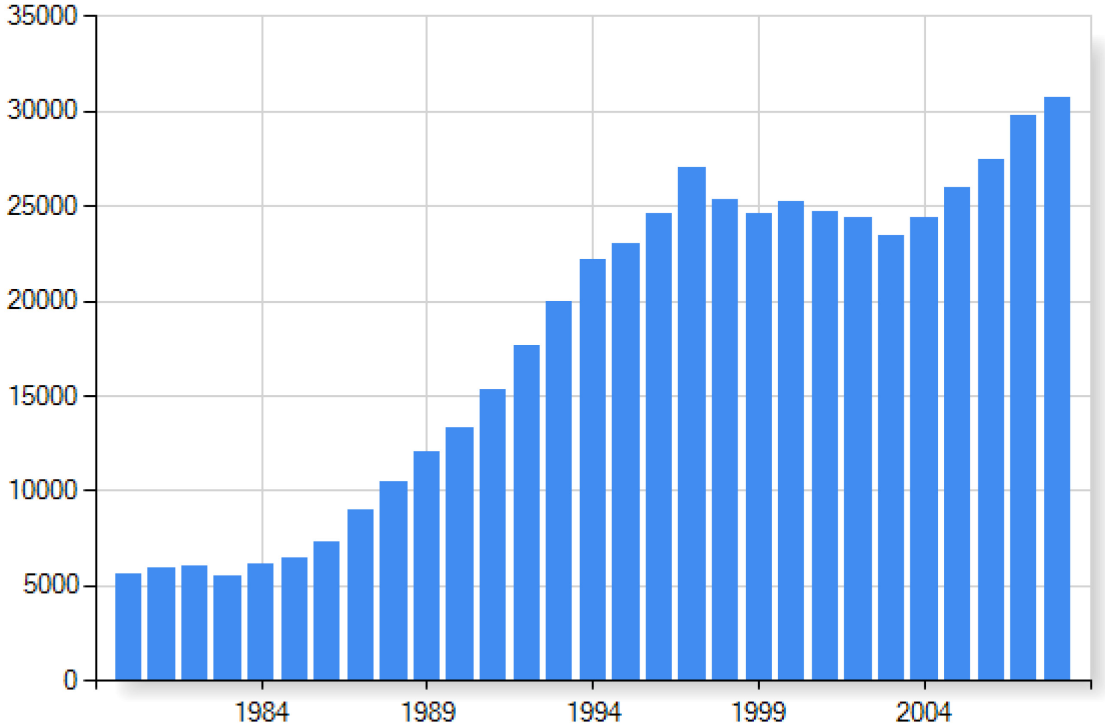
3.1.1. Region's profile

Hong Kong is a Special Administrative Region of the People's Republic of China. The city is located on the southern coast of China, exactly at the Pearl River Estuary to the South China Sea and so it has been a natural port for the Guangdong province. The city's geographical location has played a crucial role in shaping its economic development, given the fact that Hong Kong was (and still is) considered to be one of the most important Chinese ports, thus being a strategic point for both regional and global trade. This fact contributed to a large extent to the city's quick transformation from the initially sparsely populated region into one of the top international financial centers worldwide. Today Hong Kong is called an Asian Tiger due to its high degree of economic development, which beginnings can be dated back to 1960s, when there started a rapid industrialization process. After 1949 (the establishment of the People's Republic of China), when China was trying to isolate itself from the rest of the world and was plagued with numerous disasters (famine, civil wars, unrests etc.), a high number of refugees and entrepreneurs was supplying the city with human capital, being beneficial to the development of labor-intensive production (destined above all for export). Small and medium-sized enterprises (SME) accounted at that time for 91% of all manufacturing firms, getting close to 100% after 2000. Compared to other East Asian economic power states, Hong Kong's quick economic development was not based on the state-led industrialization (as in case of the rest of Asian Tigers) nor on domination of foreign firms (as in Singapore) nor on large companies' close relations with government (e.g. South Korea). Hong Kong showed preferences rather towards low taxation, no government debt and to free trade. After the city's return under Chinese rules in 1997, Hong Kong managed to preserve its economic regime, as it proved to be profitable for the mainland. "One country-two systems" policy was introduced and thus Hong Kong could both monetarily and economically function as a separate entity, however restricted in terms of the people's movement.[149] It is remarkable that throughout the industrialization process

[148]Barro, Robert J., *The East Asian Tigers Have Plenty To Roar About*, Business Week (27 April 1998): 24
[149] Schenk, Catherine R., *Economic History of Hong Kong*, EH.Net Encyclopedia (16 March 2008), last accessed 26.04.2015 <http://eh.net/encyclopedia/economic-history-of-hong-kong/>

the role of state remained negligible. There have taken place numerous market self-adjustments, which were turning out to be very efficient. Because of the very limited capacity of the internal market, the export-oriented activities (already at the outset of the development) proved to be extremely reasonable, giving the region growth opportunities.[150] As a result, it had one of the highest growth rates globally. While in 1961 the income per capita equaled $410 (corresponding to 13.8% of the United States income per capita at the same time), in 1996 it leveled already US$24,490 (85.1%), rapidly narrowing the income level gap with the developed countries.[151]

Figure 9: GDP in Hong Kong between 1980-2008



Source: statinfo.biz

As there has occurred the energy crises in 1970s, Hong Kong experiencing difficulties due to its hitherto vast and buoyant manufacturing sector (which utilized much fuel), faced the situation when it had to transform its industry structure to prevent its collapse. Following western counterparts, it shifted focus towards profitable finance, property and tourism sectors. This change has brought many benefits, but also some issues have caused troubles to the region. Despite the fact, that economic fluctuations can be ascribed to the business cycle (which is an ordinary thing in any economies), the ones occurring in Hong Kong are more frequent and have greater intensity compared to other places in the world. This might negatively impact the economy, by hurting industries which cannot successfully develop due to changing conditions and risks of recession. This statement is particularly valid for the financial and property sectors, on which Hong Kong relies nowadays to a great extent.[152]

Hong Kong, characterized nowadays by the free market economy, relies mainly on international trade and finance, while manufacturing has largely migrated to the mainland. The value

[150] Chen, Edward K.Y., *Foreign Trade and Economic Growth in Hong Kong: Experience and Prospects*, Trade and Structural Change in Pacific Asia, National Bureau of Economic Research, Inc. (1987): 333

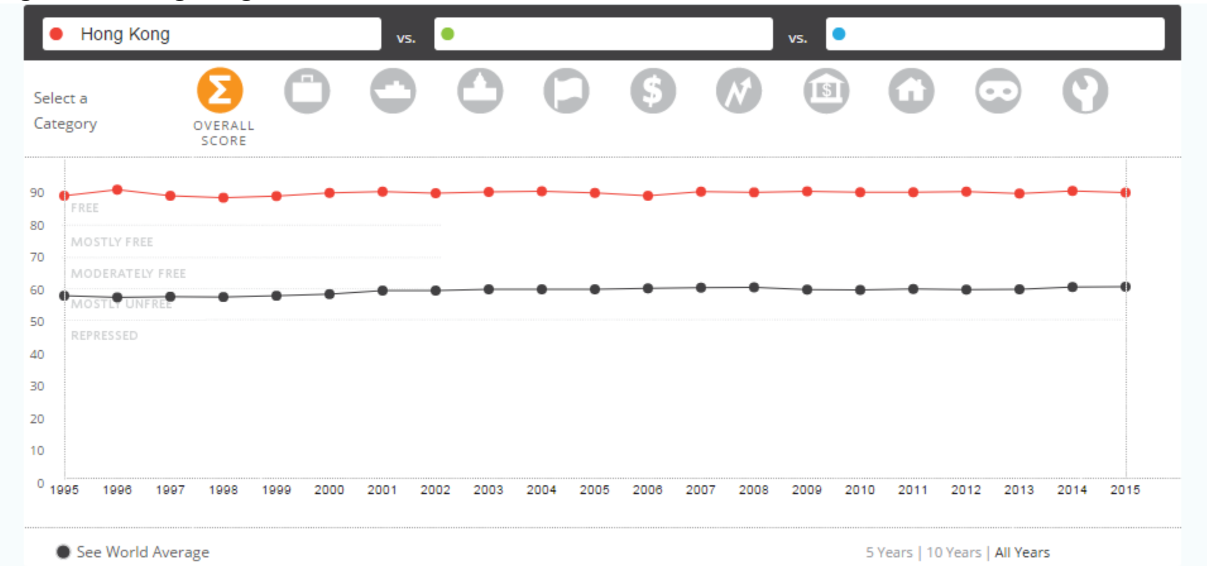
[151] Sung, Yun-Wing and Wong, Kar-yiu, *Growth of Hong Kong Before and After Its Reversion to China: The China Factor*, Pacific Economic Review, Vol. 5, No. 2 (June 2000): 1-26

[152] Cheung, Alex, *Hong Kong's Economic Development*, Savantas Policy Institute (13 August 2013), last accessed 26.04.2015 <http://www.savantas.org/?p=1169>

of commodities being exported is approximately four times of the city's GDP. Therefore its economy is very vulnerable to the global economic recessions or crises. After the slowdown in 2008, due to the links with China (embracing above all trade, tourism and finances), Hong Kong was able to recover from the crises relatively fast, but because of its heavy reliance on foreign trade and investments it remains exposed to the global financial market volatility.[153]

Hong Kong's market-oriented policies rank the region on the first place in the Economic Freedom Index worldwide, with the total score of 89.6/100. Being a global free port and perceived as a financial hub, the city's growth is boosted by the free flow of goods, services, and capital. Its well-thought-out regulations, tax system characterized by low rates and well developed capital markets manage to attract many international companies.[154] In 2014 there have been 1389 regional headquarters representing parent companies located outside Hong Kong.[155] Additionally the rule of law is respected and judiciary is not influenced by the government. Moreover, there are no risks regarding the property rights. The transparency of regulations acts to the favor of the business formation. The labor market is flexible and wages are determined mainly by the market forces. Regardless the city's uniqueness in terms of economic freedom and institutions, lately there have been taking place some circumstances undermining the almost intact reputation of Hong Kong. Above all, the bureaucracy has slightly expanded resulting in the heightened corruption (although still at the very low rate) and some of the recent political events have lowered the public trust into administration. On the other hand, to the benefit of Hong Kong, is the fact that the 2014 mainland's attempts to gain more control over the region resulted in the strengthened pro-democracy attitudes.[156]

Figure 10: Hong Kong's score in the 2015 Index of World Economic Freedom



Source: heritage.org

Hong Kong is one of the most open economies for trade and investments. Well-functioning financial system provides numerous incentives for companies in form of innovative financial tools, backed up by thriving banking sector.[157] As a result companies planning to allocate their capital

[153] Forbes, *Hong Kong*, Forbes.com LLC (2015), last accessed 26.04.2015 <http://www.forbes.com/places/hong-kong/>

[154] 2015 Index of Economic Freedom, *Hong Kong*, The Heritage Foundation (2015), last accessed 26.04.2015 <http://www.heritage.org/index/country/hongkong>

[155] Census and Statistics Department, *Companies in Hong Kong Representing Parent Companies Located outside HK*, Business Expectation Statistics Section (23 October 2014), last accessed 26.04.2015 <http://www.censtatd.gov.hk/hkstat/sub/sp360.jsp?tableID=133&ID=0&productType=8>

[156] 2015 Index of Economic Freedom, *loc. cit.*

[157] Ibid.

abroad barely ever can resist the attractiveness of Hong Kong, hence there are recorded high flows of foreign direct investments. In 2013 FDI inflows equaled US$77 billion, being the highest score right after only after the US (US$188 billion), Chinese mainland (US$124 billion) and Russia (US$79 billion), what is impressive considering the size of Hong Kong compared to the three remaining countries listed. The region's total stock of inward direct investment reached approximately US$1,344 billion in the same year. Most of the investments were coming from the Chinese mainland (when not considering the capital coming from tax havens), providing approximately one third of all inflows, followed by the United States and Singapore. Inflowing investments target mostly service industries (investment and holding), real estates, business services, banking, import / export, wholesale and retail trades.[158] It is important to note here, that Hong Kong has taken an active role of an intermediary in the process of funneling capital and technology into Chinese mainland from the rest of the world. Reversely, it also assists in the introduction of Chinese companies, goods and services abroad. Hence it can be compared to a gate for going in and out regarding the Chinese economy. Approximately 80% of all firms investing in Hong Kong admits, that they use the region as such a gateway to the mainland.[159]

3.1.2. Attractiveness of the Hong Kong's tax system for the FDIs inflow

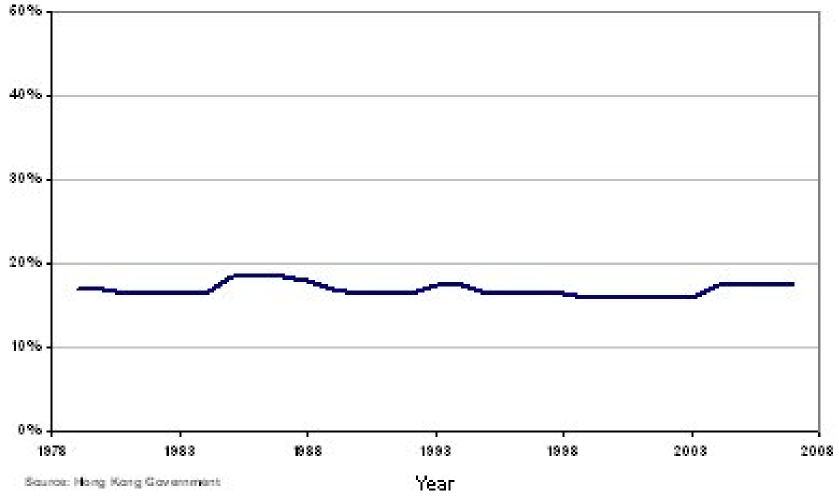
Hong Kong is considered to be the freest economy in the world. Because it is a Special Administrative Region, its fiscal system and public finance remain independent from the mainland (thus all the revenues collected through taxes go to the Hong Kong's budget). The study called 2015 Paying Taxes conducted by the PricewaterhouseCoopers indicates Hong Kong as the fourth most tax-friendly economy worldwide, right after Qatar, United Arab Emirates and Saudi Arabia, while taking into consideration factors such as total tax rate, time to comply and number of payments. In SAR there are imposed on taxpayers only three direct taxes, supplemented by numerous subsidies and deductions. Before 1940, Hong Kong did not levy any income taxes. Only during the wartime and under colonial government one income tax was imposed, but merely at the 10% rate. Nowadays it also remain very low. Some argue that this is a result of a business community's strong opposition against the heightening of the rate. It might be surprising then, that the current taxation system in this city-state remains practically the same as 75 years ago. Therefore, although one could accuse it of being obsolete, paradoxically it is one of the most advanced and up to date tax systems globally. Few decades of stable fiscal policies have been the reason why both private entities as well as enterprises feel secure about the fact that most of the money they earn, can be kept by them instead of reinforcing public finance. The taxation system is constructed in such a way that it puts a tax burden rather on those who are capable of paying it. The government does not feel much pressure to collect funds from taxes as it is generously financed through sales from the land bank (and therefore via the so called property sales stamp duty) and through other non-fiscal sources of income.[160]

[158] Ma, Wenda, *Economic and Trade Information on Hong Kong*, Hong Kong Trade Development Council (27 March 2015), last accessed 26.04.2015 <http://hong-kong-economy-research.hktdc.com/business-news/article/Market-Environment/Economic-and-Trade-Information-on-Hong-Kong/etihk/en/1/1X000000/1X09OVUL.htm>

[159] Pang, Melissa Kaye, *Hong Kong as a Base for Doing Business in Mainland China*, American Bar Association (June 2013), last accessed 26.04.2015 <http://www.americanbar.org/publications/blt/2013/06/01_pang.html>

[160] Lynam, Robin, *Hong Kong's simple, low taxes: don't we all want it?*, The Globe and Mail (25 July 2013), last accessed 09.07.2015 <http://www.theglobeandmail.com/report-on-business/economy/canada-competes/hong-kongs-simple-low-taxes-dont-we-all-want-it/article13393877/>

Figure 11: Hong Kong's corporate tax rate between 1978-2008



Source: archive.freedomandprosperity.org

Corporate tax

Profit tax is imposed under the Inland Revenue Ordinance on the "assessable profits". Generally, there are no signs that the corporate taxes are to rise much (if at all) in the near future. This situation is not only due to the Hong Kong's strategy to finance it public expenses from other sources than taxes and to create a competitive business environment but also because of the guarantee of low rates included in the Article 108 of the SAR's basic law.[161] The standard income tax rate is 15%, while the maximum rate equals 16.5%.[162] A taxpayer of the corporate tax is a person or company who conducts any type of business activities or trade in Hong Kong. Such taxpayer pays tax only on profits from those activities (excluding capital gains) that are sourced in SAR, meaning that arise or are derived from there. Simply speaking, if the business activities earning profits were conducted in Hong Kong, they would be taxed there too. In case they were gained abroad (the so called offshore profits) they would be not a subject to taxation. This is an example of a territorial concept. Therefore, also dividends derived from foreign companies are not the subject to profit tax.

Dividends from firms located in Hong Kong are not taxed either. After incorporation (a process consisting in forming a new legal entity) Hong Kong's tax authorities keep track of such companies. They are normally issued with tax return. In case of its absence (tax return) they have to report the earned profits anyway for the time period called the year of assessment. It normally lasts from 1st April until 31st March of the next year. For the foreign companies there is an obligation to fill in the tax return only with respect to their branches or subsidiaries operating and making profits in Hong Kong. Tax regulations specifically determine how to calculate taxable profit and which items are excluded from such computations. Fortunately for companies, capital gains, offshore profits, bank deposit interests and dividends are non-taxable. This presents a huge incentive for foreign investors. Despite the fact that the government does not dedicate any targeted tax incentives to the overseas companies, it provides a range of investment friendly tax policies in terms of corporate tax. For instance there can be applied preferential profits tax treatment consisting in imposing only 50% of the used tax rate or granting exemptions from profits gained from operating ships in Hong Kong. There are also exemptions targeting applicable debt instruments, reinsurance businesses or offshore funds' profits gained by non-residents. For the future there is planned another exemption embracing private equity funds.[163]

[161] Ibid.

[162] 2015 Index of Economic Freedom, *Hong Kong*, The Heritage Foundation (2015), last accessed 26.04.2015 <http://www.heritage.org/index/country/hongkong>

[163] Deloitte, *Taxation and Investment in Hong Kong 2015*, Deloitte Touche Tohmatsu Limited (2015), p. 2-3

Although the corporate tax rate is low and there are granted numerous exemptions, the tax base remains narrow. There has been debated lately the possible broadening of this base by the introduction of a Goods and Services Tax (GST). This step seems to be necessary to ensure the steady inflow of financial resources to the public budget and moreover complies with the current trend to broaden the base rather than heightening the existing rates. Additionally, in Hong Kong there are some other profit tax related exemptions. They embrace among others interests on loans made available to borrowers from foreign jurisdictions, income from the international operations of shipping companies (unless they operate in Hong Kong waters), rental income from foreign real estates, interests from Government bonds, exchange fund debt instruments, dividend income earned by parent company settled in Hong Kong from its foreign branches as well as profitable disposal remitted to the parent company. Capital gains from medium debt instruments are taxed only to the extent of 50% of the basic rate and life insurance enterprises pay only 5% of the premiums' value created in Hong Kong. Airline companies, irrespectively of the management and control center, pay proportion of income arising within Hong Kong to their total worldwide income.[164]

Regarding tax holidays and tax allowances there exist none as such. Nevertheless, there are special tax deductions for capital expenditures when acquiring some fixed assets or intellectual property rights (even 100% in case of certain patent rights or know-how used in activities generating taxable income).[165] There are also available special deductions when spending on R&D or on technical education as well as when purchasing already mentioned patent rights, copy-rights, registered trademarks or by capital expenditures on production machinery, IT soft- and hardware and environmentally friendly vehicles (for the last category the extend has been heightened in 2010 from 72% up to 100% percent of the capital expenditure).[166] Generally, the Hong Kong's authorities derive little income from direct taxation. This contributes to flourishing of SMEs and gives incentives to would-be entrepreneurs.

Exemptions

To the most notable local taxes belong property tax and the so called stamp duty. In Hong Kong there are no environmental taxes. The first one applies to the both owners and tenants of the real estates located in Hong Kong. It complies with the territorial principle (an owner can be a non-resident or citizen of a foreign country, not necessarily from Hong Kong) and is levied on buildings, parts of buildings, wharves, piers and other structures. The tax rate is 15% and is calculated from the annual rental income. Some types of properties are exempted from this tax and those are properties of foreign governments as well as of some charitable bodies and business entities (the latter ones in case when the property tax is higher than profits tax). Corporations acquiring properties for its own occupation (not for rental) are also exempted from the property tax. Additionally, Hong Kong corporate entities can deduct interests on a loan to finance the purchase.[167]

The second meaningful local tax is the Special Stamp Duty (SSD), which is levied on residential properties. It is either a fixed fee or calculated on the value of given transaction. It should be payed in case of leases, assignments and conveyances of immovable property and transferring securities or bearer instruments. There are, however, also exemptions in this case and they embrace instruments transferring "non-residential property", immovable properties being a gift to a charitable institution or public trust, the transfer of such properties to either diplomatic or consular bodies or between associated corporate bodies (when one company owns at least 90% of shares of another company). Additionally mortgages are excluded from the scope of stamp duty. In case of remaining

[164]OcraWorldwide, *corporate taxation*, OCRA Worldwide (1995-2015), last accessed 10.07.2015 <http://www.ocra.com/solutions/taxation-hongkong.asp>

[165] PricewaterhouseCoopers, *2014/15 Hong Kong Tax Facts and Figures*, PricewaterhouseCoopers Limited, 2014

[166] Deloitte, *loc. cit.*

[167]Lowtax, *Hong Kong: Domestic Corporate Taxation Property Tax*, Wolters Kluwer TAA Ltd (2015), last accessed 10.07.2015 <http://www.lowtax.net/information/hong-kong/hong-kong-property-tax.html>

kinds of transactions the following are exempted: loan capital transactions, bills of exchange, promissory notes, certificates of deposit, exchange fund debt instruments and Hong Kong multilateral agency debt instruments.[168] This broad spectrum of exemptions present huge incentive to foreign investors which can expect very low tax payments.

Hong Kong is perceived as the globally most open place towards international trade and investment. This state of affairs is due to the particularly easy customs procedures and excise duties payed only on four commodities. Those are hard alcohol, tobacco, hydrocarbon oil and methyl alcohol. Wine and beer have been made lately duty free, thus significantly boosting their turnover. As a consequence, not only is Hong Kong characterized by the 0% average tariff rate[169], but also there are no quotas nor dumping laws. Therefore, one could say that it is of no importance, that there are no exemptions from the custom and excise duties, as they are imposed on particularly narrow range of products and additionally it is a free port, meaning there is no duty on imports and exports. It is particularly important for exporting and importing companies.

Write-offs for investment expenditures

20% initial capital allowance is available for construction of industrial buildings and structures, while 4% of the annual allowance. 60% is prescribed for the machinery and plants in the same year the expenditure has been made and 10%, 20% or 30% in the following years depending on the sort of purchase.[170] In case of spending on either renovation or refurbishment there are foreseen equal deductions over five consecutive years. Plants or machinery destined for manufacturing as well as IT software and hardware can be written off in the full amount in the year of their acquisition. Additionally, tax depreciation does not depend on the assets' value but on the cost incurred while purchasing.[171] Capital intensive enterprises may derive advantage from such fast write-offs, which decrease the taxable income, thus allowing some savings during either their establishment or expansion.

Change of the whole fiscal system (decreasing the effective tax rate)

As already mentioned before, tax system in Hong Kong has remained relatively unchanged for few decades. Even if considering the period from the 1997 when it was handed over to the People's Republic of China and in the time of progressing globalization and fast changes, much has remained the same. If some changes occurred, they rather did not act to the economy's detriment. Tax rates did not rise significantly and tax treaty network has expanded. The main changes that have taken place throughout the last years embrace offshore funds legislation, exemption from profits tax of interest income earned on deposits, taxation of certain royalty payments (if intellectual property is used outside Hong Kong), introduction of restrictions on deductions for interest expense and abolition of estate duty. Hong Kong did not tend to use its tax system with the particular aim to attract FDI (except for abolishing the estate duty which targeted foreign investments), but rather took the view that keeping a transparent and simple taxation system will contribute to the general improvement of its economy's condition.[172] The effective tax rate is 13.7% which is much lower than in many countries, where the average oscillates around 20-22%.[173] This low rate can be also attributed to the lack of VAT, capital gains tax and tax on dividends.

[168]Lynam, *loc. cit.*
[169] 2015 Index of Economic Freedom, *loc. cit.*
[170]GovHK, *Profits Tax*, Inland Revenue Department, The Government of the Hong Kong Special Administrative Region (3 April 2014), last accessed 10.07.2015 <http://www.ird.gov.hk/eng/tax/bus_pft.htm#a06>
[171] Deloitte, *op. cit.*, p. 9-10
[172] KPMG, *Hong Kong Taxation Post Handover | A retrospective of the decade*, KPMG (June 2007), p. 2-7
[173] PricewaterhouseCoopers, *Global Effective Tax Rates*, PricewaterhouseCoopers (14 April 2011), p. 2-13

Becoming a tax haven

In 2015 Hong Kong has appeared on the European Union's first list of tax havens. This Special Administrative Region has scored high in the Financial Secrecy Index (3rd place), which is constructed upon characteristics such as secrecy and share of the global market for offshore services. The latter ones account for 4% overall. It is assumed that nowadays Hong Kong is the top growing tax haven (or as some also call it secrecy jurisdiction). Hong Kong is perceived as laissez-faire and anti-tax place, offering numerous offshore services such as tax exemptions, transfer pricing facilities, escape routes from Chinese exchange controls and much of a highly valued secrecy. Hong Kong does not fully participate in Automatic Information Exchange nor it restrain itself from promoting tax evasion through tax credit systems. It does not utilize appropriate tools for effective analysis of the tax related information, nor does it require firm's accounts to be available on public record as well as there is no maintenance of companies' ownership details in official records.[174] Additionally, the very low corporate tax rates and numerous exemptions together with the territorial principle of taxation present a great incentive to the foreign companies, which aim at the maximal reduction of the tax due. Therefore Hong Kong, which has recently received an official title of tax haven, is heavily occupied by companies using both tax strategies and the mechanism of transfer pricing allowing shifting their profits.[175]

Export Processing Zones

There are no export processing zones in Hong Kong as such.

Harmonization of tax systems

Hong Kong is an example of a region following tax competition strategy. It has extremely low tax rates and a very narrow tax base. The harmonization of tax systems calls for unification of the range of taxes and their rates (so as to deprive governments the potential benefits from lowering taxes) and therefore to create business environment based on equal tax conditions. Hong Kong does not apply those rules and additionally is an example of tax haven. Therefore it cannot be stated that its tax system is characterized by harmonization with the international standards.

Bilateral tax treaties

Companies making business in Hong Kong do not face many problems with the double taxation. Because of the territorial rule that it applies, enterprises that do not earn profits in Hong Kong are not obliged to pay taxes on such earnings. Worth mentioning are also numerous arrangements for the double taxation relief of shipping and airline income. Hence, companies are overall not exposed to the burden of double taxation. The main mechanisms allowing the avoidance of double taxation consist in granting credits against tax imposed on a resident in respect of income earned in Hong Kong and granting either deduction allowance or credits for tax paid in any territory outside Hong Kong.[176] Additionally the authorities have been steadily increasing the scope of the tax treaty network.[177] Hong Kong has signed bilateral tax treaties with the following countries

[174] Financial Secrecy Index, *Narrative Report on Hong Kong*, Tax Justice Network (7 November 2013), p.1-12

[175]Pahlman, Kari and Kondos, John and Lee, Irene and Bae, Sunkyung and Chan, Jeff, *Hong Kong: Hong Kong's transfer pricing environment rapidly maturing*, International Tax Review (14 March 2014), last accessed 15.07.2015 <http://www.internationaltaxreview.com/Article/3319592/Hong-Kong-Hong-Kongs-transfer-pricing-environment-rapidly-maturing.html>

[176]Yau, Pansy, *Avoidance of Double Taxation between Hong Kong and the Chinese Mainland*, 18 March 2015, Hong Kong Trade Development Council Research, last accessed 16.07.2015 <http://china-trade-research.hktdc.com/business-news/article/Guide-to-Doing-Business-in-China/Avoidance-of-Double-Taxation-between-Hong-Kong-and-the-Chinese-Mainland/bgcn/en/1/1X000000/1X002LKP.htm>

[177] Deloitte, *op. cit.*, p. 9-10

(alphabetically): Austria, Belgium, Brunei, Canada, the Czech Republic, France, Guernsey, Hungary, Indonesia, Ireland, Italy, Japan, Jersey, Kuwait, Liechtenstein, Luxembourg, Malaysia, Malta, Mexico, the Netherlands, New Zealand, People's Republic of China, Portugal, Qatar, Spain, Switzerland, Thailand, the United Kingdom and Vietnam. Those double tax agreements are derived from the OECD model treaty. Apart from giving credits against profits tax regarding the same profits, those treaties play important role in improving the exchange of information.[178] It contributes to gaining good reputation, basing on transparency.

Tax anti-avoidance strategies

There is a number of measures that Hong Kong's government has implemented in order to prevent situations when companies try to avoid tax payments as well as to counteract abusive tax schemes. Because of the numerous transnational transactions taking place in this Special Administrative Region, followed by fast growing scope of the treaty network, transfer pricing practices have become a problematic issue for the tax authorities. As an answer to this phenomenon, the Inland Revenue Department has issued in May 2009 the Departmental Interpretation and Practice Notes No. 45 (DIPN 45) regarding the relief from the double taxation due to transfer pricing or profit reallocation adjustments and in December of the same year, the DIPN 46 on Transfer Pricing Guidelines – Methodologies and Related Issues. The main goal accompanying the issuance of those two documents was to equip the taxpayers with comprehensive information on how to proceed when dealing with transfer pricing mechanism, so as to do it properly and not against the existing regulations. Three years later, there has been also issued DIPN 48 targeting the advance pricing arrangements. With its aid, the Inland Revenue Department put into practice the APA programme. Until recently, the only statutory provision was the Section 20(2) of the Inland Revenue Ordinance. It founded application in cases when an entity with a resident status was carrying out transactions with a so called 'closely connected' person without such status (simply speaking a resident with a non-resident). The Section 20(2) was designed so as to eliminate the possibility that the transactions between such residents and non-residents were not conducted in an unlawful way, but rather in compliance with the regulations embracing good tax practices (meaning they were carried out as if the involved parties were not related in any way). Nevertheless, the Section 20(2) used to be commonly perceived as limited when it came to its implementation and practical application. Therefore the tax authorities have been favoring other anti-avoidance measures such as disallowing expenses incurred by the Hong Kong resident (IRO Sections 16 and 17), embracing non-resident taxpayers by IRO Section 14 (meaning that both sides of the transactions are taxed) or strictly controlling and questioning suspected arrangements in accordance to IRO Section 61A guidelines (which enable appropriate legal authorities to counteract the mispriced transactions). Above all, the Inland Revenue Department strives to identify and investigate the transactions arousing suspicions. To facilitate this process, there has been introduced an obligation for the companies to annually provide the filled profits tax return specified by Section 86. Within the scope of such reports, the taxpayers must disclose what follows: transactions for/with non-resident persons, payments to non-residents for use of intellectual properties, payments to non-residents for services rendered in Hong Kong as well as transactions with closely connected non-resident persons. There has been also introduced a thorough guidance called the Departmental Interpretation and Practice Notes, which includes instructions and clarifications regarding a broad spectrum of tax issues (they are however not legally binding). On the other hand, both DIPN 45 and DIPN 46 were the items comprising explicitly stated Inland Revenue Department's views on dealing with transfer pricing-related matters. As already mentioned, DIPN 45 serves as a basic reference in cases of transfer pricing adjustments in double taxation arrangement context. Thus its scope embraces only entities from Hong Kong conducting transactions with parties from jurisdictions that has signed Double Taxation Agreements. Its main assumption is that if the given entity has transfer pricing adjustment in one of the treaty countries that has caused double taxation, such entity might be allowed to conduct a corresponding

[178] Deloitte, *op. cit.*, p. 9-10

adjustment in Hong Kong (if reasonably justified). DIPN 46 is a legal framework indicating procedures with transfer pricing, applicable methodologies and required documentation. It also provides some guidelines against tax avoidance schemes, for instance explanations on relevant provisions, articles in Double Tax Agreements allowing transfer pricing adjustments, necessary definitions (e.g. of an associated enterprise etc.) or Model Tax Convention.

In Hong Kong the burden of proof is the taxpayer's responsibility. The companies may be asked to show their accounts and to justify the legitimacy and aptness of the transfer pricing use. Thus taxpayers should keep the corresponding records of transactions with parties involved in transfer pricing mechanism for 7 years after the execution of such transactions. There is however no particular penalty regime directed at the transfer pricing 'offence' specifically. Punishments can be imposed based on the general penalty provisions. In Hong Kong they can be as high as 300% of the underpaid tax. Although the area of transfer pricing is relatively new to the Inland Revenue Department and there is no separate unit within its structures dealing only with this issue, the introduction of APA (advance pricing arrangements) programme, under DIPN 48 (which clarifies guidelines regarding acceptability of transfer prices practices) has been contributing to the building expertise on this topic.[179]

In Hong Kong there are no thin capitalization rules, nor CFC (controlled foreign companies) legislation. The anti-avoidance rules may be found therefore only in IRO and find use in cases when companies behavior aims solely on producing tax benefit or other abusive efforts. Nevertheless the included regulations there are very general, thus their practical application is somehow limited.

3.1.3. Summary

Hong Kong's economy is perceived as the freest worldwide. The very modern tax system significantly contributes to this perception. The corporate tax rate is among the lowest ones in the region. Capital gains, offshore profits, bank deposit interests and dividends are non-taxable. There is offered a wide range of preferential tax treatments such as lowered tax rates, tax exemptions, deductions for capital allowances and alike. Surprisingly there are no tax holidays. The biggest share of the tax incentives is targeting financial sector, R&D, know-how acquisition and related areas as well as environmental friendly technologies, vehicles etc. Those incentives turn out to be highly effective in attracting foreign capital to those areas. Additionally, in Hong Kong there are only few local taxes, such as stump duty or property tax, and they are generously endowed on exemptions, thus not significantly adding to the company's overall tax burden. Same goes for the excise and custom duties. Hong Kong is known as one of the world's most known free ports. Thus duties are imposed on only four types of commodities and customs procedures are design so as not to cause confusion, being clear and easily understandable.

The Hong Kong's legislation foresees the possibility of accelerated depreciation, even in the full amount in one year. This preferential tax measure is directed at companies active in manufacturing sectors, tending to expand or upgrade itself. Due to possible savings, boosting competitiveness in this industry is more easily attainable. Nevertheless there are no export processing zones.

Hong Kong's tax system has remained pretty much unchanged for the last couple of decades. The citizens' and companies' reluctance towards heightening tax rates or overwhelmingly complicating the existing tax regulations prevailed over any government's plans to introduce such novelties. Due to this fact as well because of the introduction of more and more tax exemptions, the effective tax rate has been shaped on the level of 13.7%, being extremely attractive to investors. This low rate is also one of the reasons why Hong Kong has been placed on the tax havens' list. SAR is characterized by the very high degree of secrecy it offers to companies operating within its borders. It does not take part in the Automatic Information Exchange and it possesses transfer pricing facilities enabling shifting firms' profits with the aim of tax evasion. Therefore one cannot say that it strives towards full harmonization of its tax system with the international standards. However, it derives

[179] PricewaterhouseCoopers, *International Transfer Pricing 2013/14*, PricewaterhouseCoopers (2015): 458-463

benefits from the best practices available such as tending to levy taxes on a broad base with low rates and shifting focus from direct to indirect taxation.

Hong Kong has somehow enabled the avoidance of the double taxation through signing numerous bilateral treaties with other jurisdictions and by using the credits systems. To the less legitimate way of avoiding excessive taxation belongs the already mentioned transfer pricing mechanism. Although the Singaporean authorities have introduced very extensive legislation regulating this issue (accompanied with the relative severe punishments for not abiding by the rules), the Hong Kong's hitherto reputation of tax haven successfully attracts investors allocating or shifting their capital there.

Generally, although some incentives for investors (such as exemptions) do exist in Hong Kong, its authorities do not perceive tax system as a specific tool to attract foreign capital. It is convinced that it offers such an investment friendly environment embracing well-developed infrastructure, skilled manpower, a strategic position and generally favorable tax system that it does not have to use the latter one as a specific incentive. The taxation policy and light legislation are only one of the components aiming at attracting investors. Therefore no extra tax incentives need to be offered.

3.2. Taiwan

3.2.1. Region's profile

Taiwan is located southeast of China and north of the Philippines and the number of population inhibiting this region is close to 23 million. Although it has its own government, constitution and democratic system backed up by well-functioning economy, it is struggling with an independency problem. The mainland China continuously comes up with claims that the island is not a separate sovereign entity, but on the contrary a part of the mainland. Nevertheless, despite all those territorial disputes, Taiwan manages to sustain high level of economic growth and is ranked among the most developed regions worldwide. Moreover, it seems that the processes of industrialization rather than geopolitics gain more and more importance in shaping the relationship between mainland China and Taiwan.[180]

Taiwan is an unprecedented example of an economic miracle. Both rapid industrialization and high economic growth rates occurring already in 1950s resulted in a very successful state's development. The beginnings of the aforementioned miracle can be indirectly ascribed already to the land reforms in 1940s, which aimed at increasing the overall agricultural output, and combined with hardworking population inhibiting Taiwan, it allowed shifting the government's focus on improving the infrastructure and education system. Those undertaken state's measures and policies targeting fast economic development resulted in relatively high growth rates (between 1952 and 1982 8.7% on average).[181] The overarching process named economic miracle might be split in four distinct, though overlapping phases. The first one, stage of import substitution, was characterized by the supplies of American foreign aid funds and creating strict but efficient fiscal policies, the already mentioned land reform and development of both physical infrastructure and human capital. The second phase, called export-driven industrial development, consisted of Taiwan's attempts to overcome the problems ensuing from ending supplies of foreign aid. There have been implemented policies aiming at the development of export driven economy. By 1970s there occurred a strong need for expanding the large-scale industrial sector. The third stage of the development of computer-centered high-tech industries entailed the expansion of consumer electronics industry and other technology sectors (followed by rises in wages), which were caused by the technology transfers from the United States.

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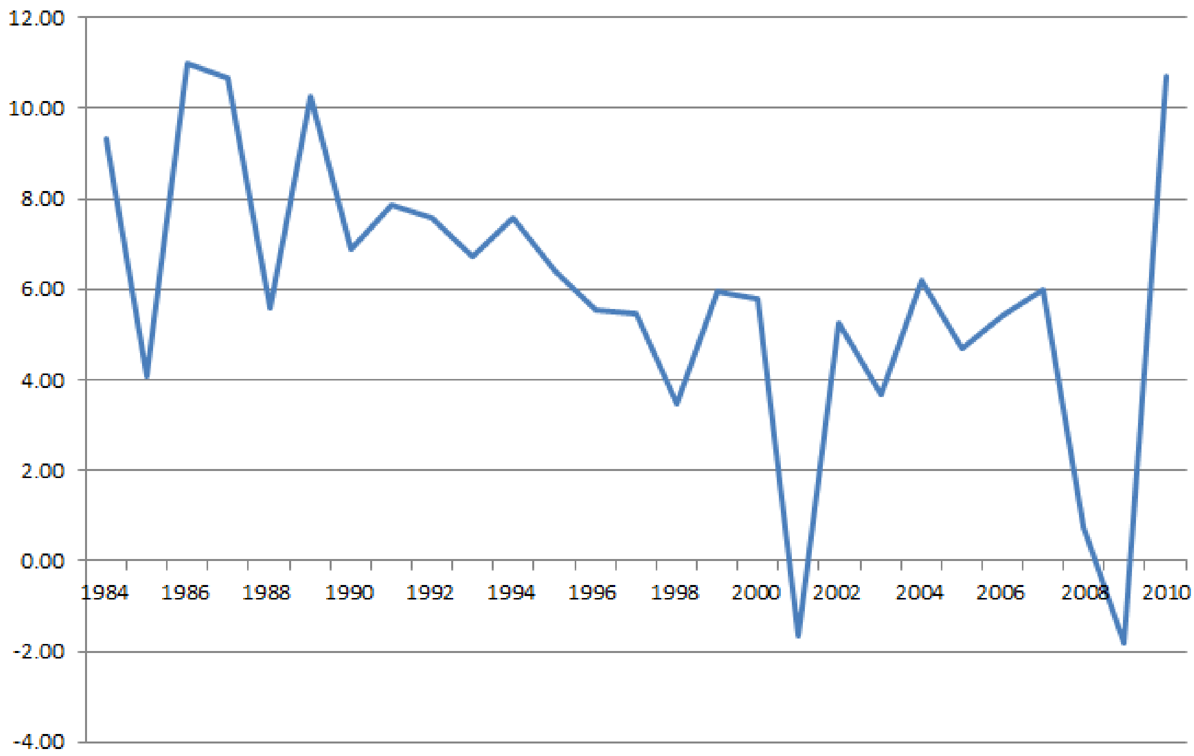
[180] Zhou, Ping, *Geopolitical Situation of Taiwan*, about education (2015), last accessed 27.04.2015 <http://geography.about.com/od/politicalgeography/a/Geopolitical-Situation-Of-Taiwan.htm>

[181] Al Fathi, Saadallah, *Taiwan Miracle is a good example economic progress for others*, Gulf News (9 September 2012), last accessed 27.04.2015 <http://gulfnews.com/business/analysis/taiwan-miracle-is-a-good-example-economic-progress-for-others-1.1071868>

There have been also taking place the gradual opening of Taiwan towards the rest of the world, what initiated the fourth stage of economic relations with and transfer of technology to mainland China.[182] Nowadays, Taiwan is perceived as a dynamic capitalist economy, where the governmental guidance with regard to the international trade and investment policies is systematically lifted. The economy is based upon exports, where the dominant role is played by electronics, machinery and petrochemicals.
As many benefits this state of affairs brings to Taiwan, it also bears some risks. Depending on exports to a great extent makes the region extremely vulnerable to the global demand. Also the fertility rate, which is among the lowest worldwide, entails well justified concerns about the human capital shortages and consequently falling domestic demand, what only heightens the degree of export dependency and risks bounded to it.[183] However, the statistics speak for themselves. Taiwan's success is reflected by the average growth rate of 4.5% (since 1992) thus raising income levels (per capita) from $9,116 (in 1992) to $19,762 (in 2012). The region is ranked as the 28th wealthiest country globally and within Asia as the 6th one.

Figure 12: Taiwan's economic growth rates between 1984-2010



Source: stat.gov.tw

As already mentioned, foreign trade has contributed much to this success. From 1992, when its total trade equaled approximately $180 billion (82% of GDP), it managed to increase this amount up to $650 billion (140% of GDP), what ranks Taiwan on the 19th place among the globally largest traders. It is noteworthy, that only 1% of the region's exports is constituted by agriculture goods (because of the very limited areas of the arable land), while the remaining 99% accounts for goods manufactured in the industrial sector. Those are above all parts and components (intermediate goods), which can be subsequently embedded into final products (which find their sales markets mainly in Japan, the United States and European Union). Nevertheless, China remains the Taiwan's most important trading partner, with exports reaching levels of $80.7 billion in 2012.

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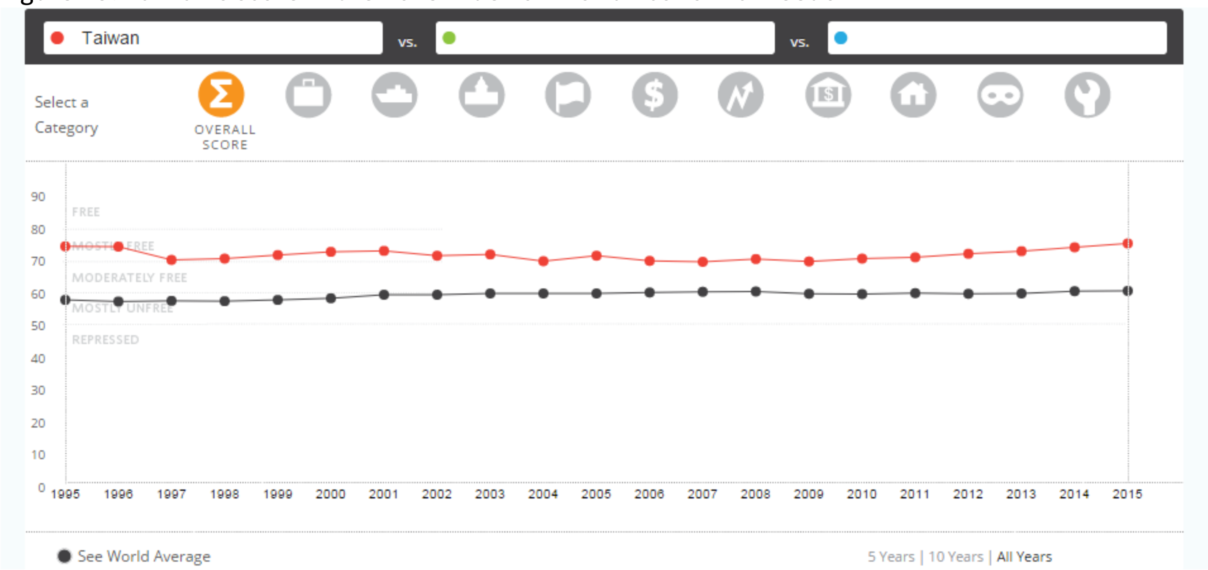
[182] Douglas, Fuller B. and Rubinstein, Murray A., *Technology Transfer Between the US, China and Taiwan: Moving Knowledge*, Routledge, New York (2013): 25-46
[183] Index Mundi, *Taiwan Economy Profile 2014* (23 August 2014), last accessed 27.04.2015 <http://www.indexmundi.com/taiwan/economy_profile.html>

As the international trade was propelling Taiwan's growth, so did the investments. Again the biggest receiver of the FDI coming from Taiwan is China (80% of total FDI outflows), thus integrating the mainland into the supply chains of Taiwanese businesses.[184] But not only outflowing investments were contributing to Taiwan's success, but also the inflowing foreign capital. For a long time the attraction of FDI has been considered as a part of the region's overall growth strategy. The free flow of capital was not always a case though, as there have been imposed numerous restrictions on incoming foreign direct investments. It was a result of the government's long-term objectives to lure export-oriented investments. As a main advantage, the state was promoting its highly competitive human capital. As the structural changes were gradually taking place, the focus shifted towards investments into technology-intensive areas, whereas the government hoped for technological spillovers as the byproducts of such foreign capital allocation. In order to achieve that, Taiwan has lifted the hitherto valid list of permitted investments (however they should not exert a negative impact on the region's security and environment). There are shared common expectations that the FDI inflows to Taiwan will be on a steady rise. For example, only in 2011 Taiwan signed bilateral investment agreements with 30 countries. Nevertheless, when compared to the other states in the East Asian region, Taiwan can be classified at most as a moderate recipient of inflowing FDI, which are targeted mainly at manufacturing, finance and insurance services. And though, as already mentioned, the interest in allocating foreign capital in Taiwan is on the rise (particularly after its recovery from the last financial crisis), the average size of investments is decreasing.[185]

According to the 2015 Index of Economic Freedom Taiwan is ranked on the 14th place, scoring 75.1/100 and as 5th one in the Asia-Pacific. The recently stable monetary and legal systems are substantially contributing to this state of affairs as well as openness towards global trade. The entrepreneurship and thus private sector are well established throughout the region creating numerous opportunities for collaboration with foreign partners. The establishment of a company is facilitated as there is no requirement for the minimum capital. Property rights seem to be well protected and judiciaries effective in contract enforcements. The financial system functions well and provides investors with a whole range of financial instruments. To the Taiwan's detriment act however high corruption (perceived) and inflexible labor market.[186]

Figure 13: Taiwan's score in the 2015 Index of World Economic Freedom



Source: heritage.org

[184] Meltzer, Joshua, *Taiwan's Economic Opportunities and Challenges and the Importance of the Trans-Pacific Partnership*, East Asia Policy Paper Series, No. 2 (January 2014): 1-14
[185] Chen, Victor Zitian and Kao, Ming-Sung and Kuo, Anthony, *Inward FDI in Taiwan and its policy context*, Vale Columbia Center on Sustainable International Investment (22 March 2012): 1-7
[186] 2015 Index of Economic Freedom, *Taiwan*, The Heritage Foundation (2015), last accessed 27.04.2015 <http://www.heritage.org/index/country/taiwan>

3.2.2. Attractiveness of the Taiwan's tax system for the FDIs inflow

Taiwan is ranked among the 15 top freest economies worldwide. Besides well-functioning and modern market, it has a developed taxation system. The region's authorities are constantly making efforts to improve it and adapt to the high standards of a quickly changing business environment and new challenges brought by increased transnational capital flows. Taiwan's taxation system is characterized by the principle of "the Rule of Law" (which aims at the protection of citizens' rights) and thus by the "Doctrine of Taxation by Law". It means that only laws can regulate the aspects of tax collection. The Tax Collection Act serves as the guideline specifying all the procedures and the Administrative Procedure Law ensures their transparency and clarity. National Tax Administrations and Tax Collection Units in municipals or counties are the responsible bodies for the tax collection, depending on whether they are national or local respectively. The foremost institution regulating all the tax related issues is the Ministry of Finance. Within its competence there are decisions such as where the tax revenue will be spent or on what the tax will be imposed. The aforementioned Ministry of Finance, facing more and more changes in the business environment, has undertaken recently many tax reforms, not to fall behind other neighboring and highly competitive states such as Hong Kong or Singapore. The most notable changes embraced among others the introduction of imputation system in 1998, imposing the Tonnage Tax for Shipping Industry in 2011 as well as the implementation of the Transfer Pricing Assessment Rules in 2005, the Alternative Minimum Tax in 2006, the Anti-thin Capitalization Rule in 2011, the Specifically Selected Goods and Services Tax Act in 2011. Because Taiwan has joined the World Trade Organization in 2002 it has also adapted its custom duties regulations to the ones from the WTO, so as to comply with its high standards. Generally speaking, the taxation system in Taiwan is strongly characterized by numerous reforms striving at its overall improvement. There is a tendency to lower the tax rates and to heighten exemption amounts (what is important in terms of attracting FDI). The system in itself seems to be sound and friendly and therefore trustworthy in the public eyes.[187] However, the multitude of regulations makes the legislation intricate.

Corporate tax

According to the Taiwanese laws, all the profit-seeking enterprises operating in Taiwan should be taxed on a basis of their net income (revenue minus deductible costs and expenses as well as losses). Additionally, domestic entities (companies incorporated under Taiwanese Company Law) are taxed on a worldwide basis. If a non-resident has either the fixed place of business or an agent, it falls within similar regulations as a resident. On the other hand, non-residents, in case they have no such fixed place of business nor agent, are taxed on income sourced in Taiwan under the withholding tax regime (on dividends, interest and royalties and which can be reduced if there are signed relevant tax treaties with other countries). Corporate tax is paid in two equal installments. The semi-annual tax payment needs to be done at latest 9 months after the prior fiscal year's end (which is on the 31st December each year), while the second installment is due together with the tax return at latest 5 months after the current fiscal year's end.

The corporate income tax rate in Taiwan has been lowered in 2010 to the level of 17%, from the previously established 25%. This step was undertaken with the pure intention to increase the state's competitiveness in the region with regards to the foreign direct investment flows. Importantly, the income below NT$120,000 is taxed at the rate of 0%, and 17% rate applies only for income exceeding this amount.[188] Additionally, in Taiwan there is no capital gains tax, and therefore losses and gains from this category fall into the firm's taxable income. Although the corporate tax

[187] Invest in Taiwan, *Introduction of Taiwan Tax System*, Department of Investment Services, Ministry of Economic Affairs, R.O.C., last accessed 20.07.2015 <http://investintaiwan.nat.gov.tw/eng/show.jsp?ID=7>
[188] Sackin, Richard, *Taiwan Tax Guide 2013*, PKF International Tax Committee (May 2013): 1-8

rate has been significantly lowered, some argue, that without broadening the tax base, the financial authorities might struggle with the curbed tax revenues, as the base remains still relatively narrow.[189]

There is a 10% profit retention tax which is imposed on the corporate earnings that remain undisturbed by the end of the fiscal year. Also part of the income is calculated on a separate basis of a withholding tax (tax imposed on interest and dividends from securities possessed by a non-resident). This includes earnings among others on short-term bills, certificates from both financial asset and real estate securitization or prizes won from the governmental lotteries. It means, that such income is not included in the final tax assessment, but in a separate form. Also worth mentioning is the tonnage tax system. It can be chosen by any companies operating in Taiwan and dealing with the maritime transportation activities. If this alterative is selected, then an enterprise pays a lump sum tax, which corresponds to the fleet's net tonnage. Once chosen, the system cannot be changed to the regular tax system for 10 consecutive years. Its drawback is, that normally applicable tax incentives cannot be exploited under this regime. Another peculiarity of the Taiwanese tax system is its imputation tax system. It serves the elimination of the double taxation on corporate earnings. Within this system's frames, the already paid 17% corporate tax and 10% profit retention tax can be transferred to the resident individual shareholders in a form of tax credits with the aim of offsetting (to the limited extent) against their individual income tax. Under Taiwanese regulations there also exists the so called income basic tax. It is compulsory for all the Taiwan resident companies and those treated alike, to compute it when they earn some tax-exempted income. Its rate equals 12% is due in case when the income basic tax (IBT) exceeds the corporate income tax (CIT) amount. The sum that needs to be additionally paid is the 12% of the difference between IBT and CIT.[190]

When arriving at the taxable income, numerous tax holidays and exemptions are applicable. In Taiwan there is available a tax holiday up to 5 years. It applies to the sectors and industries perceived as emerging and/or strategic. It can be granted only if it qualifies the company for the investment tax credit and if it is not claimed though. Additionally, the tax holiday is targeted at the transport infrastructure investments as well as at the scientific, technical and investment enterprises, which tend to expand themselves and are located outside the Science-based Park.[191] Also other expenses can be deducted from the income. And so, expenses that are bounded to earning activities of an enterprise are deductible to the extent that they are either ordinary or necessary (within operating the business). Moreover, foreign companies, instead of asking for certain deductions, may calculate their taxable income based on their net income. Also if engaged in specific industries such as international transport, construction contracting, technical services and equipment leasing, those companies are eligible for applying to the Tax Authorities to consider certain part of its gross business income as taxable (10% for international transport activities and 15% for all other businesses). To other incentives belongs the possibility of granting credits up to 15% of the R&D expenditures against the company's income tax. Also biotech and new pharmaceutical enterprises may claim deduction from the income tax due in cases of carrying out R&D on both new drugs and high-risk medical devices and also for the personnel training. Moreover, the Offshore Banking Act 1983 specifies that banks undertaking offshore banking business are exempted from income tax, business tax, stamp duties, and withholding tax on interest.[192] Companies are entitled to tax credits (5% to 20%) of the expenditures on the "automated production equipment or technology, resource recycling, pollution control equipment or technology, equipment and technology used in energy saving, new and clean energy, and recycling of industrial wastewater, equipment and technology for reducing greenhouse gas emission and improving energy utilization efficiency, hardware, software,

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[189] Chen, Ting-An, *Introduction to Taiwan's Taxation System: Major Problems and Reform*, Chunghua Association of Public Finance, Taiwan (19 January 2008): 2-18

[190] Fan, Rosamund, *Taiwan Corporate - Taxes on corporate income,* PricewaterhouseCoopers (4 June 2015), last accessed 20.07.2015 <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Taiwan-Corporate-Taxes-on-corporate-income>

[191] PKF, *Doing business in Taiwan*, PKF Taiwan: 1-30

[192] Sackin, *loc. cit*.

and technology used in internet, broadcasting capacity, enterprise resource planning, communication and telecommunication products, electronics, video conference equipment and digital content production that would promote the efficiency of corporate digital information”.[193] There are also tax incentives targeting establishing logistic and distribution centers in Taiwan, where the gained income is tax exempted. Particularly it embraces managerial service or R&D income, royalty income and investment income. Additionally, in case of logistic and distribution centers, income earned on warehousing, simple processing of goods and their delivery (but only to domestic consumers) is tax exempted too.[194] Taiwanese authorities also foresee deferred tax on investment in technology as an incentive for FDI and tax exemptions embracing capital gains from land sales and derived from securities and dividends from other domestic companies.

Exemptions

To the local taxes belong among others stamp tax, land value tax, land value increment tax, house tax, deed tax, amusement tax and vehicle license tax. The stamp tax is levied on documents such as business transaction documents, property titles or permits (only if signed in Taiwan). Its rates run into levels ranged from 0.1% up to 0.4% of the document’s value or by the contract for sale of moveable property it is NT$12. There are granted numerous exemptions embracing among others any documents used by offshore banking branches or executed abroad, receipts confirming deliveries of goods and chosen other transactions. The full list of exemptions includes over 15 categories of documents’ types. The land value tax is imposed on all kinds of land located in Taiwan that possess any value. Such lands can be destined for the industrial, residential or public use and are taxed with flat rates of 0.1%, 0.2% and 0.6% respectively. In case the land finds another use than the aforementioned one, it can be taxed from 1% up to 5.5%, depending on the purpose. Statutes for Reduction and Exemption of Tax on Lands grants numerous exemptions, particularly when the land is used as private experimental facilities in farming, forestry, mining or for industrial use as well as for the infrastructure purposes such as expanding railways etc. Closely connected with this tax is the land value increment tax, levied on the increase in the land’s estimated value since the previous sale or transfer. The rate falls in the range between 20% and 40% on a progressive scale, with some exceptions when the rate equals only 10%. Inherited lands are exempted from this tax. The house tax is imposed on buildings and construction situated in territory of Taiwan, however does not embrace most of the taxpayers being non-profit organizations, churches and alike. Additionally there are granted some deductions, even as high as 50%. The deed tax is due when there takes place the transfer of real estate. The respective tax rates range from 2% to 6%. Also in this case there exist some exemptions and moreover, this tax is not levied when the Land Value Increment Tax has been already imposed. The amusement tax refers to the payment made upon sold tickets or fees charged by amusement places such as cinemas, dancing halls and alike. The tax rate is relatively high, ranging from 10% up to even 100%. There are, nevertheless, exemptions available. The last of the municipal taxes is the vehicle license tax and it is compulsory for all owners of any form of transportation form, regardless of its purpose. No exemptions, nor deductions are available in this case.[195]

From the perspective of custom and excise duties, there are no incentives targeting FDI. Not only, there are almost no exemptions, but also custom rules turn out to be particularly complex and therefore time-consuming. Generally, the value of customs duties on imported goods is calculated upon their value, including transport and insurance costs or alternatively on their quantity with prescribed rates depending on the goods’ category. Although there are no harbor duties, the Trade Promotion Service Fee must be paid at 0.04% of a customs value.[196] Numerous commodities can be imported only under special permit (e.g. medicines or plant products) and there are additionally imposed excise duties on products such as alcohol, cigarettes, fuel or automobiles (their rates vary

[193] Fan, Rosamund, *Corporate Taxation System in Taiwan*, PricewaterhouseCoopers (2015): 1-6
[194] Fan, *Corporate Taxation System in Taiwan*, *loc. cit.*
[195] PKF, *loc. cit.*
[196] PKF, *loc. cit.*

accordingly). The exemptions are granted only for raw materials and export goods. Based on the customs value there is levied a 5% VAT on the import's total value.[197]

Write-offs for investment expenditures

Currently there are allowed in Taiwan several depreciation methods. Those are among others straight-line method, fixed-percentage method, sum-of-years-digits method, production method and working-hour method. Before deciding for the most suitable method, a company is obliged to report it to the respective authorities. In case it fails to do so, it is assumed to adapt the straight-line method. In Taiwan there exists a possibility of an accelerated depreciation. It applies particularly for the equipment and facilities used solely for the purposes of R&D, experimentation and quality control as well as for the equipment, machinery and facilities used for either energy conservation or clean energy production. The accelerated depreciation period lasts two years in such cases. Additionally, if the property's value does not exceed NT$80,000 or its useful life is less than 2 years, can be depreciated in the full amount in the same year as it was purchased. Regarding passenger cars, there has been established a maximal depreciation limit equaling NT$2.5 million.[198]

Change of the whole fiscal system (decreasing the effective tax rate)

According to the survey conducted by PricewaterhouseCoppers in 2009, the effective tax rate in Taiwan in the same year equaled 13.6%. Between years 2006-2008 it was slightly higher, formed at the level of 14.4%. Regardless of the time of observations made, in both periods, the rate was much lower than the OECD average, oscillating around 22.6%. Moreover, after decreasing the corporate tax rate in 2010 from 25% to 17%, the aforementioned effective tax rate must be even lower than in 2010. Based on this numbers, Taiwan can be perceived as a competitive region in terms of its taxation system and attractiveness for foreign direct investment. As already pointed out in the beginning of this section, there have taken place numerous structural changes aiming at improving the overall fiscal system through modernizing it so as to keep up with the newest trends of lowering the rates and broadening the base. Although there have been imposed some new taxes such as tax on retained profits or the tax imputation system, there are accompanied by exemptions and deductions lowering the overall fiscal burden. Except for the relatively strict custom duties regulations and the vehicle license tax, exemptions and deductions lowering the payment due are (in all other described here cases) very generous.[199]

Becoming a tax haven

Taiwan is not considered to be a tax haven. Similarly, it cannot be found in the Financial Secrecy Index issued by the Tax Justice Network.

Export Processing Zones

In Taiwan there are ten Export Processing Zones. They are located in north in the Taichung area as well as in the south in both Kaohsiung and Pingtung areas. The first one was opened already in 1966 and until 2015 it has attracted as many as 621 companies, accounting for the investment of $17.850 million. In order to attract even more foreign capital, the authorities have enacted over this period the "Statute for Investment by Foreign Nationals", the "Statute for Investment by Overseas

[197] KPMG, *Taiwan*, KPMG (2015), last accessed 20.07.2015 < http://www.kpmg.com/cn/en/aspac-trade-and-customs/pages/trade-customs-taiwan.aspx>
[198] JLL, *Tax Depreciation*, Jones Lang LaSalle (2015), last accessed 21.07.2015 <http://www.joneslanglasallesites.com/investmentguide/country/taiwan/taxdepreciation>
[199] PricewaterhouseCoopers, *Global Effective Tax Rates*, PricewaterhouseCoopers (14 April 2011): 1-11

Chinese" and the "Investment Encouragement Act".[200] It has contributed to the significant shift from the labor-intensive traditional industries to technology- and capital-intensive high-tech industries.
In terms of taxes there are numerous incentives aiming at boosting the attractiveness of the region. Machinery, raw materials, fuels, materials, semi-finished products and musters imported by zone businesses as well as some of the finished products are exempted from import, commodity and business taxes. No corporate tax is levied upon zone businesses for exported goods, labor, machinery, raw materials, materials, fuels and semi-finished products sold to companies located in EPZs and to enterprises from the science-based industrial parks. Additionally only 10% corporate tax is levied on the transshipment operators. House tax is reduced to 1.5% for the production plants and no contract taxes are due for the newly constructed factories within EPZs and buildings purchased from the administrative authorities. Machinery and equipment utilized more than 5 years are not the subject to custom duties when moved beyond the EPZ. The corporate income tax remains at the 17% rate.[201]

Harmonization of tax system

The current taxation system in Taiwan is rather complex and lacks clarity. Although it has implemented the imputation tax system (to avoid double taxation problems), what is a step towards simplification, it still remains somehow problematic. The main obstacles ensue from the complicated way of determining the tax-exempted income and investment tax credits (outlined in the Statute for Upgrading Industries) as well as from the introduction of the minimum tax system which effectively hinders the process of filing corporate tax returns. Those factors cause both time and financial costs to the taxpayers and decrease efficiency of the overall fiscal system. Nowadays countries tend to simplify the tax related regulations and procedures and to ensure transparency. Taiwan struggles with it as it introduces numerous laws in many dimensions including exemptions, deductions, brand new taxes and alike. Moreover Taiwan's audit standards do not comply with those applicable in the majority of countries. Despite the (reportedly) rule in force claiming the substance over legal formality, in reality the rule of document over substance is prevailing, as so much accounting evidence and thus accounting items adjustment is required. Taiwan lacks both flexibility and creativity when it comes to the taxation system. It could follow examples of similar nations (in size and economic models) in order to learn how to make its fiscal system more attractive towards foreign investors. Putting emphasis on the system's simplification and removal of the main impediments as well as harmonization of the system's standards to the international ones could potentially bring many benefits to the Taiwanese authorities. There are already first sign of such behavior, for example lowering the corporate tax rate, what goes in line with the current global tendencies.[202]

Bilateral tax treaties

Taiwan has entered into several tax treaties aiming at the avoidance of the double taxation, prevention of fiscal evasion and enhancing the overall investment environment. The double taxation agreements are based on the OECD and UN models. Besides putting emphasis only on the economic factors, Taiwan also considers factors such as political and fiscal status as well as trade of the parties involved. Until 2013 it has signed treaties with 25 jurisdictions embracing (alphabetically) Australia, Belgium, Denmark, France, Gambia, Germany, Hungary, India, Indonesia, Israel, Macedonia, Malaysia, Netherlands, New Zealand, Paraguay, Senegal, Singapore, Slovak Republic, South Africa,

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[200] Invest in Taiwan, *Export Processing Zones*, Ministry of Economic Affairs, R.O.C. (June 2015), last accessed <http://investintaiwan.nat.gov.tw/eng/show.jsp?ID=249&MID=2>
[201] Invest in Taiwan, *loc. cit.*
[202] Lin, Yishian, *Taiwan's Tax System, Past and Future*, PricewaterhouseCoopers (2015), last accessed 21.07.2015 <http://www.pwc.tw/en/challenges/taxation/indissue0264.jhtml >

Swaziland, Sweden, Switzerland, Thailand, United Kingdom and Vietnam.[203] Additionally it has signed several international transportation income tax agreements with Canada, the European Union, Germany, Israel, Japan, Korea, Luxembourg, Macau, Netherlands, Norway, Sweden, Thailand and the United States.

Before 2010, Taiwan has been using the Guidelines for the Application of Double Taxation Agreements as its main basis for concluding the bilateral double tax avoidance agreements activities. In 2010 it has issued the new guideline called Assessment Rules Governing Applicability of Double Taxation Agreements. The main change it brought within was the more rigorous criteria referring to the verification of the potential tax treaty beneficiaries. Additionally there has been enacted the Tax Ruling Tai-Tsai-Shuei No. 09604506050 (already in 2007) stating how the appropriate assessment of income attribution and tax payment of the parties involved in the double taxation avoidance agreement should look like.[204] Despite relatively many treaties signed by Taiwan, empirical studies point out that it did not enter into agreements with countries that provide the largest volume of FDI into it and thus that bilateral tax treaties are there not among the main tools promoting the FDI activities.[205]

Tax anti-avoidance strategies

Already in 2005 the Taiwanese financial authorities have tightened the regulations regarding the transfer pricing issues. As a consequence, laws regulating transfer pricing have become more precise and have been enforced much more intensively. The main guideline is the legislation called Regulations Governing Assessment of Non-arm's Length Transfer Pricing of Profit Seeking Enterprises. Under the laws in force, companies must submit reports (or similar documents) in accordance to the arm's length principle and are subject to one of two kind of audits: the general tax audit or the special transfer pricing audit. The companies undergoing such controls are obliged to disclose all information (such as legal structure, data about parties involved, proof of signing APAs with tax authorities and others alike) regarding the transactions taken under scrutiny.[206] The firms' reports must include the industry and economic analysis, the functional and risk analysis as well as the description of chosen pricing methods considered as the most appropriate in the given case. The last aspect is related to the rule of using the most suitable pricing method chosen from the permitted ones such as comparable uncontrolled price method (CUP), resale price method (RPM), cost plus method (CP), comparable profits method (CPM), profit split method (PSM) and other methods approved by the Ministry of Finance, which is the responsible governmental body for regulating the transfer pricing issue. In case a company fails to prove the legitimacy of executed transactions, there can be imposed a penalty which can be as high as 200% of the underpaid tax. Punished companies have no other way of defense than defending the income adjustment it has reportedly done right. The burden of proof lies always on the taxpayer. Because audits seems not only to have the role of ensuring the proper execution of transaction and thus improving the existing taxation system but also started to act as a new tax revenue source, the relevant authorities (besides intensifying controls as already mentioned) began questioning the aggregate testing approach, what means that each transaction is checked separately.

In Taiwan there exist also the Advance Pricing Agreements (APA) regime. In its scope it determines documents needed for an application for APA, notification pointing out significant changes in both conditions and agreement termination, audit periods, signing procedures, submission of yearly APA

[203] KPMG, *Taiwan Tax Profile*, KPMG Asia Pacific Tax Centre (January 2013): 1-14

[204] Go, Steven, *Introduction to Taiwan tax rules*, Taiwan Pocket Tax Book 2011, PricewaterhouseCoopers (May 2011): 1-64

[205] Wu, Wen-Chieh Jack, *Bilateral Tax Treaty and Taiwan's FDI Activity*, Department of Public Finance, National Chengchi University, Taipei, Taiwan (October 2013): 1-28

[206] KPMG, *Global Transfer Pricing Review Taiwan*, KPMG International Cooperative (April 2013): 2-6

reports and how to deal with changes affecting prices or profits.[207] Companies are allowed to undertake negotiations with the respective tax authorities regarding some of the criteria. The application of APA might be valid for the time period of 3 to 5 years (with the possibility of one extension under specific circumstances).

Another popular form of tax anti-avoidance measures is the thin capitalization. In Taiwan, it will be denied if the company's debts are held by the related entities and simultaneously the debt-to-equity ratio is higher than 1:3. Another generally applicable measure is the rule of substance-over-form. Nevertheless, as already pointed out in the "Harmonization of tax system" section it is rarely the case, as the authorities constantly require more and more accounting evidence for all the operations. To other measures belongs the anti-treaty shopping.[208] Additionally, recently (beginning in 2013) the Ministry of Finance has shifted its focus towards the transfer pricing transactions involving both intangibles and technical service fee.

3.2.3. Summary

The taxation system in Taiwan is characterized by being both taxpayer-friendly and simultaneously somehow complex. There have been constantly taken place changes in the legislation by introducing new regulations or undertaking reforms etc. The corporate tax has been steadily lowered reaching 17% in 2010, thus being among the lowest ones in the region. Importantly the income not exceeding NT$120.000 is taxed at 0% rate, what is very beneficial to the small enterprises. Additionally there is no capital gains tax. However, there has been introduced the 10% profit retention tax and income basic tax, which cause much confusion when calculating the tax due and does not allow tax savings. On the other hand, there are available numerous tax exemptions and tax holidays (but only up to five years). With the help of such measures, Taiwanese authorities aim at targeting among others R&D, automated production equipment and technologies, equipment and technologies used in energy saving as well as new and clean energy sector, communication and telecommunication as well as electronics. Also numerous exemptions appear within local taxes. Additionally, the rates of those are not excessively high, thus not imposing much burden on the taxpayers. On the other hand, Taiwanese authorities did not consider custom and excise duties as potential investment incentives. The regulations are particularly complex, burdensome and almost no exemptions are available.

Regarding write-offs, there exists a possibility of an accelerated depreciation. It is however limited to a narrow scope of items such as equipment and facilities used only for R&D, experimentation and quality control and energy conservation or clean energy production and they are simultaneously loaded with numerous rigorous laws. To the investors' detriment act the fact that the period of accelerated depreciation is 2 years instead of 1 year occurring in other countries using this preferential treatment. On the other hand, considering the effective tax rate, Taiwan enjoys good reputation having only 13.6%. This rate is far below the world average and thus is very attractive for investors. It is the result of numerous tax reforms introduced to make the fiscal system more business friendly. Gradual introduction of more and more incentives managed to significantly reduce the noticeable tax burden. Despite this, Taiwan is not considered to be a tax haven.

The meaningful advantage of Taiwan is the fact that there are located several export processing zones on its territory. Because entrepreneurs can enjoy there exemptions from import, commodity and business taxes on chosen items as well as a broad range of other preferential tax treatments, there has taken place a significant shift from the labor-intensive traditional industries to the technology- and capital-intensive high-tech industries. Nevertheless, despite all those advantages, including the presence of export processing zones, the Taiwan's tax system remains complex and investors might potentially not catch up with the constantly introduced changes. Particularly onerous is the fact that the rule claiming the substance over legal formality does not hold

[207] Raby, Nick, *International Transfer Pricing 2013/14*, PricewaterhouseCoopers (2013): 767-773
[208] KPMG, *Taiwan Tax Profile*, *loc. cit.*

in practice and extensive accounting documentation is required. If Taiwan followed an example of other similar tax jurisdictions, it could gain much flexibility and ingenuity regarding the taxation solutions. However Taiwanese authorities seem to be resistant towards such manner of improving their current fiscal situation. Therefore, the full harmonization of the Taiwanese tax system with the international standards, although not impossible, remains kind of a remote mirage.

Taiwan has taken care of a double taxation aspect and entered into several tax treaties with other tax jurisdictions. The choice of countries however seems to be somehow accidental. Empirical studies have shown that Taiwan did not choose place from where it was receiving most of the foreign capital, but rather the authorities were taking into consideration the political aspects. On the other hand, the transfer pricing regulations are very accurate and extensive. The broad spectrum of measures embracing also thin capitalization, APAs and alike as well as high penalties for failing to prove the legitimacy of transactions, ensure the right and legally correct course of executing transactions and leaves no possibilities for tax evasion.

Generally, although Taiwan seems to go in the right direction in terms of attracting foreign capital, it lacks some of the very essential attributes. The most meaningful drawbacks are the lacking clarity of regulations and small flexibility. It generously grants tax exemptions, tax holidays and possesses export processing zones, but also imposes taxes rarely present anywhere else (such as profit retention tax) and thus discourage potential investors.

3.3. Singapore

3.3.1. Region's profile

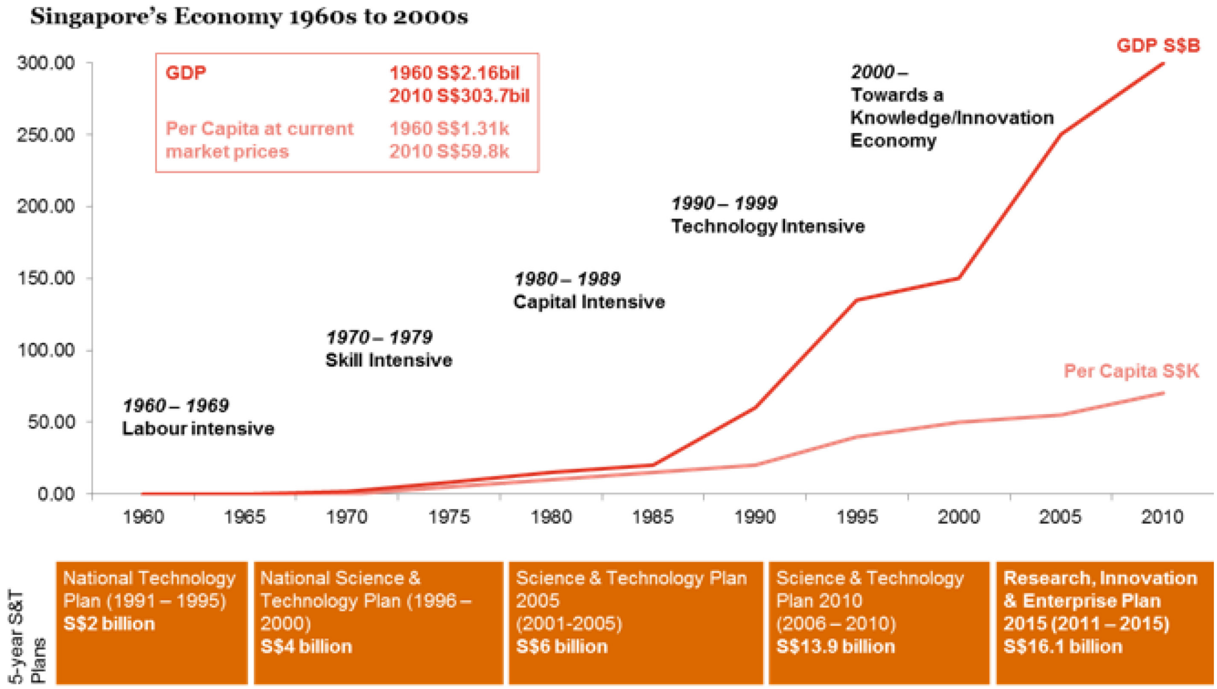
Singapore is a city-state in South-East Asia and it is located at the end of the Malayan Peninsula. Despite the fact that its total area is slightly more than 700 km² and the region is poor in arable land and natural resources, the city-state is one among the most developed nations worldwide. Still around 50 years ago, Singapore was perceived as a relatively backward country. Its GDP per capita was not even reaching US $320. Nowadays it amounts US $60,000, putting it on the 6th place globally, when considering GDP per capita. It owes its economic success to the fortunate combination of its location, relatively recent historical events and reasonable decisions of its policy makers. Given the extremely harsh geographic conditions (in terms of arable land etc., not to mistake with its location), its success is truly remarkable.[209]

Singapore has a coastline measuring 190 kilometers, being a natural reason for setting up ports there. Particularly favorable circumstances in form of the proximity of numerous important shipping routes in the Southeast Asian region contributed to the fact that trade and commerce have become crucial factors shaping the Singapore's economic development. Singapore spent more than 100 years under British control. Only in the light of the Japanese aggression during the WWII and British impotence to help Singaporean people, there have been evoked anti-colonial sentiments resulting in its independence in 1963. After becoming a part of Malaysia, it was quickly expelled to gain formal independence just two years after achieving liberty from the British ruling. Initially struggling with high unemployment rates and poverty, the government saw the chance in embracing globalization, as the force propelling the economic growth. It was a more feasible option, as country did not have any traditions with industrialization, but rather with trade and services. In order to attract foreign investors, Singapore had to undertake a set of measures making the region investment-friendly, meaning above all free from corruption, safe and fiscally attractive. On the one hand it entailed introducing sort of draconian laws (including for example death penalty for corruption), thus imposing much control over society. On the other hand, such measures in combination with business-friendly laws found much appeal among foreign investors. Singapore went up in foreign companies' estimation by becoming predictable and stable (as compared to the neighboring countries). Adding to this its favorable location which made it possible to establish ports,

[209] Zhou, Ping, *Singapore's Economic Development*, about education (2015), last accessed 29.04.2015 <http://geography.about.com/od/economic-geography/a/Singapore-Economic-Development.htm>

it appeared as a perfect destination for the development of a manufacturing sector. In less than a decade Singapore managed to attract foreign investors so as they constituted around 25% of its all manufacturing companies, followed by the double-digit GDP growth. Those circumstances resulted in the government's decisions to put an emphasis on improving human capital. The main method was to educate people by multinational companies operating in this city-state, what turned out to be extremely successful. And so, while in 1970s Singapore was still exporting goods such as textiles, garments and basic electronics, 20 years later it was already specializing in wafer fabrication, logistics, biotech research, pharmaceuticals, integrated circuit design and aerospace engineering.[210] It can be observed, that Singapore transformed from the labor-intensive into the high value-added products. Trade kept on playing an important role for the overall country's performance and also the meaning of services, particularly in financial sector, has significantly grown. This state of affairs was the result of the country's outward-oriented development strategy.[211]

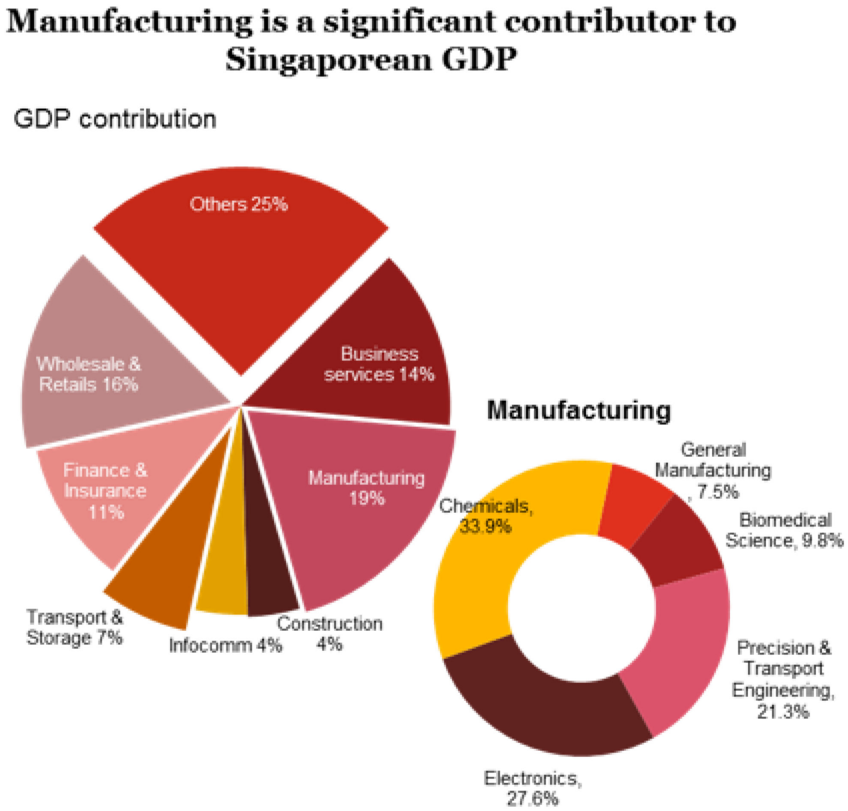
Figure 14: Transition of Singapore's economy between 1960s and 2000s



Source: digitalinnovation.pwc.com.au

[210] Ibid.
[211] Monetary Authority of Singapore, *The Singapore Economy*, Monetary Authority of Singapore (2015), last accessed 29.04.2015 <http://www.sgs.gov.sg/The-SGS-Market/The-Singapore-Economy.aspx>

Figure 15: Industry sectors in Singapore in 2013



Source: digitalinnovation.pwc.com.au

Nowadays, Singapore is an ultra-industrialized region, being the busiest entrepôt globally and also a well-known tourist destination (particularly in terms of medical and culinary tourism). Both banking and biotech sectors are thriving. As a consequence, there are registered over 3,000 foreign companies (constituting almost 70% of the manufacturing output).[212] During the first decade of the XXI century, the country's GDP almost doubled, equaling S$304 billion in 2010. Singapore sees its chance for further development in attracting long-term investments. Therefore it strives for imposing regulations aiming at sustaining favorable and simultaneously macroeconomic conditions, acting against the potential cyclical changes. One of the most important tools in this process are sound fiscal policies and focusing on exchange rate rather than on prices itself, to ensure price stability. Additionally, the city-state is continuously adapting to the new challenges and global trends that emerge. Lately it has been focusing on developing the infrastructure needed for the creation of the world-class financial center it aims to be. Liberating domestic banking and insurance sectors and allowing more foreign presence as well as developing debt market were few among the numerous undertaken measures. All those factors, as well as the aforementioned strategic location, stable political and macroeconomic environments, outstanding infrastructure and telecommunications are the reason of the high standing of Singapore in the international community in terms of economic development.[213] It is sometimes called the "the Switzerland of Asia". Moreover, because of the government's continuous commitment and attempts to sustain the friendly business environment, Singapore managed to rank first in the World's Bank ranking regarding the Ease of Doing Business (for 11 consecutive years).

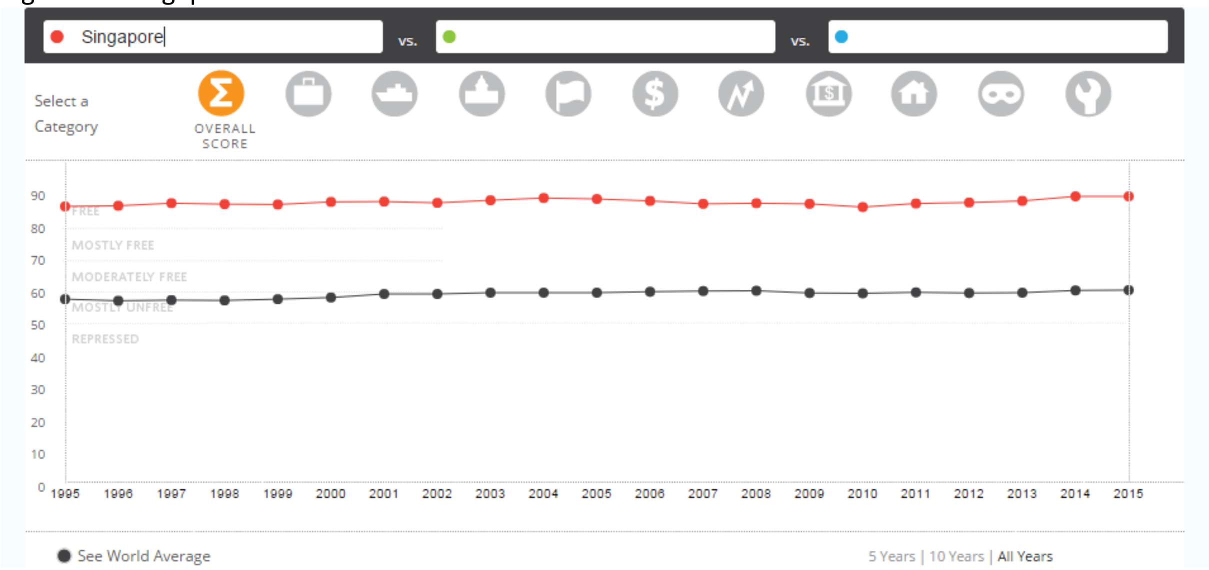
The city-state is widely perceived as an entrepreneurial hub. Lately, it has been heavily investing into areas such as research and entrepreneurship (over S$16.1 billion between years 2011 and 2015) resulting in institutions such as NUS Entrepreneurship Center, which cooperates closely

[212] Zhou, *loc. cit.*
[213] Monetary Authority of Singapore, *loc. cit.*

with a number of top universities and also in new universities itself. The byproduct of such actions was the creation of a very dynamic entrepreneurial class within its society.[214]

According to the 2015 Index, the economic freedom of Singapore is ranked as the second highest worldwide (89.4/100), right after Hong Kong, and it seems to be constantly improving in areas such as management of government spending as well as monetary and labor freedom. Though, there has occurred a slight deterioration in terms of corruption. As already mentioned, Singapore is committing itself to introducing new reforms corresponding to the fast pace of changes brought by globalization and technological advancements, attempting to become the world-class financial center and also to expand the scope of its international trade. Additionally it gradually reduces the government's involvement in key sectors, to ensure the progressing economic freedom. Nevertheless, despite the fact that Singapore is said to be democratic, on the contrary to the economic freedom, the freedom of assembly and speech remain restricted. However, as the country is one among the most prosperous ones in the world, this system seems to function well. The strict rules ensure minimal corruption. Consequently contracts and intellectual property are secure, expropriation does not occur and judiciary system is effective and regulatory framework is highly efficient. For instance, for starting a new business an entrepreneur needs only 3 days and will find the procedures very clear. Additionally, there is no minimum wage level, thus making it more profitable to hire new workers. Foreign investors find the region very attractive and they will tend to set up businesses there, although investments in some sectors remain restricted.[215]

Figure 16: Singapore's score in the 2015 Index of World Economic Freedom



Source:heritage.org

The main challenges for the Singapore's government is the rising competition coming from the other states in region (especially from emerging markets), its ageing society and its vulnerability to the volatile demands for goods and services in uncertain times, as it is strongly export-oriented. Despite the relatively high inflation for the past few years (4-5%), the prices do not fluctuate drastically, nor does the unemployment increase. As a conclusion for the economic situation in Singapore is can be stated, that although its economic model characterized by sacrificing personal

[214] Tim, Ho Chi and Sussman, Sam, *What Makes An Asian Tiger? Singapore's Unlikely Economic Success Lies In Its History*, Forbes Asia (7 October 2014), last accessed 29.04.2015 <http://www.forbes.com/sites/forbesasia/2014/07/10/what-makes-an-asian-tiger-singapores-unlikely-economic-success-lies-in-its-history/ >

[215] 2015 Index of Economic Freedom, *Singapore*, The Heritage Foundation (2015), last accessed 29.04.2015 <http://www.heritage.org/index/country/singapore>

freedoms for the sake of creating friendly business environments is controversial and probably could not be implemented in any of the Western states, it is highly effective and brings desired benefits.[216]

3.3.2. Attractiveness of the Singapore's tax system for the FDIs inflow

Among 186 countries embraced by the 2015 Index of Economic Freedom, Singapore is ranked as the second freest economy worldwide (with the score 89.4/100), placed right after Hong Kong. Singapore manages to sustain its position in the ranking, but also to improve some of the components making up the high score such as monetary freedom or management in governmental spending. This city state is also perceived as the financial and investment hub.[217] The taxation system definitively favors entrepreneurship and contributes to the increased flows of foreign capital. It is characterized by one of the lowest corporate tax rates globally and by numerous incentives (such as tax exemptions and alike) that boost enterprises' growth and development. Already under the British colonial government the Singaporean authorities realized how important role taxes can have in steering the direction of the region's economic development. Interestingly, because of the implementation of the Model Colonial Territories Income Tax Ordinance at that time, Singapore's tax system has common historical roots with Malaysia, Australia, New Zealand and South Africa. As Singapore was undergoing the process of rapid industrialization in 1960s, it has generously supported particular economic sectors (e.g. labor-intensive) by numerous tax incentives (derived from the Economic Expansion Incentives Act) embracing for instance 90% tax exemption on the export income. Similar patterns occurred throughout 1970s, 1980s, 1990s and after 2000, when Singapore, depending on the sectors or business activities that it was considering as crucial for the further development, was stimulating by the careful selection of appropriate fiscal tools. In the beginning, the dominating strategies were to grant exemptions and deductions as well as phasing out some sorts of taxes, while in the later phases there appeared a tendency to lower tax rates and to shift the focus towards indirect taxation so as to comply with global trends in shaping the tax systems.[218] Nowadays, the Singaporean tax system is characterized by business friendly and clear tax regulations. The main sorts of taxes imposed are the personal income tax, corporate tax, goods and services tax, property tax, tax on rental income, stamp duty, customs & excise duties, motor vehicle taxes and betting taxes. The responsible authority for managing and collecting taxes is the Inland Revenue Authority of Singapore (IRAS).

Corporate tax

Singapore has the third lowest corporate tax rate in the world. Since few years it has been constantly lowered to achieve the level of 17% (flat rate) in 2010. Importantly, already in 2003, there has been implemented the single-tier corporate income tax system, which took place of the previously used imputation system. As a consequence there is no double-taxation for stakeholders, because all dividends paid by a firm to shareholders are tax exempted. There is no capital gains tax. Additionally, for the purposes of determining the taxable income there must be made a clear distinction between income and capital profits, as the latter ones are not taxed.[219]

The taxation of income follows the guidelines included in the Income Tax Act and the Economic Expansion Incentives Act. The tax year, also called year of assessment upon which the taxable income is calculated, is equal to the calendar year (beginning in the 1st of January and ending on the 31st of December). Singapore applies the territorial tax system and therefore foreign companies are taxed on a remittance basis, while resident companies pay taxes on the income

[216] Zhou, Ping, *loc. cit.*
[217] 2015 Index of Economic Freedom, *Singapore*, The Heritage Foundation (2015), last accessed 23.07.2015 <http://www.heritage.org/index/country/singapore>
[218]Hawksford, *Singapore Tax System & Tax Rates*, Hawksford Singapore Pte Ltd (2015), last accessed 23.07.2015 <http://www.guidemesingapore.com/taxation/topics/singapore-tax-rates>
[219] KPMG, *Asia Pacific Taxation Singapore*, KPMG International Cooperative (2012): 4-53

earned in Singapore.[220] It means that any profits sourced in Singapore are a subject to corporate taxation. Under the existing laws, the company does not necessarily have to be incorporated in Taiwan to fall within the Singaporean tax legislation. It is enough that an enterprise has its place of control or management in Singapore.
In order to make its market more competitive, Singapore has put emphasis on the indirect taxation rather than on direct one. Keeping broad base of the Goods and Services Tax (7%), allows constantly decreasing the direct taxes' rates. There are also numerous local income taxes, which are attributable to the concept of broad base and low rate. This approach has not only the benefit of lowering the companies' tax burden but also decreases the tax revenue volatility.[221]

In Singapore there are available numerous tax holidays and exemptions, particularly for businesses which decide to incorporate there. There has been implemented an incentive in 2005, called Start-up Tax Exemption (SUTE) scheme, claiming the right for the new businesses, which additionally have no more than 20 individual shareholders and have been incorporated in Singapore, to be fully exempted on the first SGD100.000 income for the first three consecutive years. In 2008, there has been added a possibility of a further 50% exemption on the next SGD200.000. Even if a start-up does not fulfill all the necessary criteria for the full exemption, it can be granted the partial one under specific circumstances. Another meaningful incentive is the corporate income tax (CIT) rebate from year 2013 on. It consists in granting the 30% corporate income tax rebate, being a subject to SGD30.000 annual cap, to all companies for the year of assessment in 2013, 2014 and 2015. Moreover, in Singapore there has been enacted another exemption scheme under the name foreign sourced income exemption scheme (FSIE). It applies for the foreign sourced dividends, foreign branch profits and foreign-sourced service income, but under condition that the corporate tax rate abroad, from where the income comes is no lower than 15% and profits has been already taxed there.[222] There exists a long list of specific tax exemptions which target chosen sectors. The main beneficiaries are the financial services industry, banks, fund management industry, global trading companies, shipping and maritime industries, tourism industry, event organizers, e-Commerce industry, some approved ventures, insurance companies, processing services' companies, legal firms as well as R&D, innovation and product development activities. Chosen industries can enjoy tax holidays as long as 10-15 years, tax exemptions and other similar.[223] Foreign as well as domestic investors can also count on generous investment allowances. The following expenses are qualifying for the relief: factory building in Singapore, acquisition of know-how and patent rights, new or second-hand productive equipment. The granted investment allowance cannot exceed 100% of the fixed capital expenditure. In case the allowance is not used it can be carried forward indefinitely. Nevertheless, the assets enjoying such allowance cannot be sold, leased nor disposed off within the qualifying period. For 2 years after the end of such period there is still required the Minister's agreement to do so, otherwise the allowance can be recovered.[224]

Exemptions

There are only few local taxes in Singapore. To the most important ones belong stamp duty, property tax, motor vehicle taxes, betting tax and the foreign worker levy. Stamp duty is a tax levied on legal documents relating to stock and shares (on no other financial instruments since 1998) as well as on the immovable properties, such as lease agreements and alike. The rate varies from 0.2%

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[220]Hawksford, *loc. cit.*
[221] Ibid.
[222] Singapore Company Incorporation, *Singapore Corporate Tax Guide 2014*, Singapore Company Registration & Work Visa Specialists (2015), last accessed 23.07.2015 <http://www.singaporecompanyincorporation.sg/how-to/taxation/singapore-corporate-tax-guide/>
[223]Hawksford, *Industry Specific Tax Incentives in Singapore*, Hawksford Singapore Pte Ltd (2015), last accessed 23.07.2015 <http://www.guidemesingapore.com/taxation/corporate-tax/industry-specific-tax-incentives>
[224] ACCA, *Selected tax incentives in Singapore*, ACCA (24 April 2015), last accessed 23.07.2015 <http://www.accaglobal.com/lk/en/student/exam-support-resources/professional-exams-study-resources/p6/technical-articles/selected-tax-incentives-in-singapore-.html>

up to 16% depending on the transactions' value. If a document has been signed but the stump duty not paid, the taxpayer can expect a penalty as high as 400% of the stump duty's initial value. To facilitate the paying process there is available an IRAS' e-Stamping system.[225] There has been introduced a relief for companies that plan to either restructure or merge (to boost their competitiveness). There is also imposed no stump duty on the transfer of assets between associated enterprises. However, certain conditions must be met to be granted the relief. Property tax is another local tax burden. Imposed on flats, houses, offices, factories, shops and lands must be paid regardless of the fact, whether such property is occupied or not. Calculated upon the property's gross net value, the taxpayer faces the progressive rate, shaped at levels of 0%, 4%, 6%, 8%, 10%, 12%, 14% and 16%. There is available an exemption for the land under development.[226] Motor vehicle tax serves the goal of decreasing the road congestion and is imposed on car owners and consists of registration fees, road tax and alike. The exemptions may be applied for light goods vehicles, heavy goods vehicles and mobile cranes. Betting tax refers to the duties imposed on the casinos' gross gaming revenue, private lotteries, betting and sweepstakes. The tax rates oscillate between 25% and 30% and no exemptions are available. The foreign worker levy is kind of a specific, compulsory fee that a taxpayer needs to pay when hiring foreign workers in Singapore. Its amount depends on the workers' class. In the course of time inheritance tax and payroll tax have been abolished.

Singapore is considered as a free port. It means that it has only very few custom and excise duties on chosen commodities. Those are petroleum products, motor vehicles (not the same as motor vehicle tax), tobacco products and intoxicating liquors. The rates are arranged either specifically or ad valorem. In case of export, no excise duties are imposed. There are rather no exemptions from those duties, however the very narrow base of items on which they are levied, remains attractive for companies.[227]

Write-offs for investment expenditures

In Singapore tax depreciation (also known under term capital allowances) can be applied only in regard with plants and machinery destined for trade, business or profession. Normally the depreciation period can last either 5, 6, 8, 10, 12 or 16 years. Nevertheless there is a possibility of an accelerated depreciation lasting only 3 years and additionally write offs in one year for computers and automation equipment, robots, some kinds of power generators, pollution control and energy efficient equipment, chosen diesel driven goods, websites as well as small assets of a value lower than SGD1.000. Additionally, there can be written down 100% of expenditures on R&D activities (under approved cost-sharing agreements). Within capital allowances there has been created incentives particularly targeting acquisition of property rights, industrial buildings and land intensification.

Change of the whole fiscal system (decreasing the effective tax rate)

In 2009 the effective tax rate in Singapore equaled 13.8%. This score is among the lowest ones among the countries embraced in the study conducted by the PricewaterhouseCoopers in 2011. The company's overall tax burden is made up by the relatively low corporate tax rate and additionally low rates of other local taxes and available exemptions. The main goal of the Singaporean fiscal policy, besides revenue rising, is the promotion of economic goals. Taxes have been used to affect the entrepreneurial behavior of the companies operating in its market. The tax rates have been constantly lowered so as to be competitive when comparing with its neighbors. It can be best

[225] Singapore Company Incorporation, *An Overview of the Singapore Tax System*, Singapore Company Registration & Work Visa Specialists (2015), last accessed 25.07.2015 <http://www.singaporecompanyincorporation.sg/how-to/taxation/singapore-taxation-overview/>
[226] KPMG, Asia Pacific Taxation Singapore, *loc. cit.*
[227] Ibid.

presented by the visible trend when before 2000 the corporate tax rate equaled 26% and then underwent gradual changes throughout the next decade (25.5% in 2001, 24.5% in 2002, 22% between 2003 and 2004, 20% between 2005 and 2007 and 18% between 2008 and 2009) to stabilize at 17% in 2010. Also there have been introduced changes within the legislation, either abolishing some of the local taxes (e.g. inheritance tax) or granting exemptions and deductions aiming at boosting specific sectors. Additionally there have been never imposed some of the popular taxes such as tax on capital gains and alike. To sustain the tax revenue inflowing to the national budget, Singapore has introduced the Goods & Services Tax (GST) in 1994 that is perceived as neutral for companies, as its burden might be easily transferred onto final consumers. Additionally, it strengthens the resilience of the region's fiscal position.

Becoming a tax haven

In case of Singapore, its straight classification as a tax haven is somehow complicated. There are premises speaking for the fact that it really is a tax jurisdiction allowing tax evasion, while others (particularly Singaporean authorities) argue that those are only pretenses of being a tax haven, while in fact it is a so called value-adding hub. The Singapore's authorities were claiming from the very beginning (when they were accused of allowing the tax evasion practices) that all the tax incentives that have been used, were legal and in the spirit of a fair tax competition. They were introduced so as to support its economic growth.

Singapore is characterized by the world's highest concentration of millionaires, being the 5th largest recipient of FDI worldwide and by having extremely low tax rates, especially when comparing with the tax rates (above all the corporate tax) of its neighbors (25% in China or 30% in the Philippines). In the financial secrecy index Singapore is ranked on the 5th place, being close to the already analyzed Hong Kong. Therefore, besides low tax rates, Singapore is perceived as a place providing very much valued privacy and confidentiality for its customers. For instance, the disclosure of bank information may be punished by either a fine of $250.000 or even by an imprisonment up to 3 years. Until 2009, Singapore was included in the OECD official anti-tax avoidance grey list, when it was finally put on the white list. Singapore had to sign numerous bilateral information-sharing agreements, proving its willingness to cooperate in terms of fighting off the tax evasion practices. Nevertheless, there is a threshold that Singapore does not want to cross. Although it agreed on disclosing more information as well as to demand from banks and other financial institutions revealing the transactions which might be somehow connoted with the tax evasion, it announced that such reports will be available only upon specific requests of respective tax authorities and not available to everyone. Thus a slight relaxation of the secrecy laws should not significantly affect the hitherto flows of foreign capital.

All in all, Singapore wants to avoid the damaging opinion of being a tax haven. Instead, it promotes itself as an investment-friendly region with the high degree of transparency (despite some limitations on information disclosure as already mentioned). To prove its collaborative intentions, Singapore has signed numerous double taxation treaties and beginning in 2008 it has been signing information exchange agreements with other tax authorities (e.g. Japan or Great Britain). Despite the fact, that it is not a member state of OECD, it has clearly supported the Base Erosion and Profit Shifting Report from 2013 as well as entered negotiations regarding an Inter-Governmental Agreement with the United States on the Foreign Account Tax Compliance Act (FATCA).[228]

Export Processing Zones

In Singapore there are located no export processing zones. Nevertheless, the Suzhou Industrial Park, located in Suzhou, Jiangsu, was developed under the cooperation of Singaporean and

[228]Khadem, Nassim, *Singapore's government says it's not a tax haven, it's a value-adding hub*, The Sydney Morning Herald (30 April 2015), last accessed 25.07.2015 <http://www.smh.com.au/business/singapores-government-says-its-not-a-tax-haven-its-a-valueadding-hub-20150430-1mwvdu.html>

Chinese authorities. Because of its location beyond Singapore, this export processing zone will be not discussed in this paper.

Harmonization of tax systems

Similarly to Hong Kong, Singapore is imposing very competitive direct tax rates on a relatively narrow scope of items. Its numerous tax exemptions and other incentives effectively distinguish Singapore from the regional landscape characterized by less favorable fiscal systems. Also for a long time it has been suspected of being a tax haven, thus not complying with the international standards of full information disclosure and strict ban of allowing the tax evasion strategies. Nevertheless, it has signed lately numerous agreements with other countries about information exchange and further cooperation towards the abatement of illegal tax practices. It has also entered into some Free Trade Agreements (FTAs) aiming at the removal of transnational barriers and standardization of laws, what potentially facilitates mutual cooperation and execution of transaction. Therefore, on the one hand it can be stated that Singapore somehow strives towards the aforementioned harmonization (resulting in more transparency and ease of doing business by foreign companies), on the other hand its competitive rates and tax incentives definitely speak against such harmonization. Thus it cannot be unambiguously stated, towards which trend Singapore inclines more (tax harmonization or competition).

Bilateral tax treaties

Singapore has done much to attract foreign investors by ensuring that the problem of double taxation will not occur. First of all it has signed numerous treaties for the purpose of the double tax avoidance (over 50 bilateral comprehensive tax treaties). It has created a very encompassing tax treaty network, by signing double tax agreements with the following countries: Albania, Georgia, Malaysia, Russia, Australia, Germany, Malta, Saudi Arabia, Austria, Hungary, Mauritius, Slovak Republic, Bahrain, India, Mexico, Slovenia, Bangladesh, Indonesia, Mongolia, South Africa, Belgium, Ireland, Myanmar, Spain, Brunei, Isle of Man, Netherlands, Sri Lanka, Bulgaria, Israel, New Zealand, Sweden, Canada, Italy, Norway, Switzerland, China, Japan, Oman, Taiwan, Cyprus, Jersey, Pakistan, Thailand, Czech Republic, Kazakhstan, Panama, Turkey, Denmark, South Korea, Papua New Guinea, Ukraine, Egypt, Kuwait, Philippines, United Arab Emirates, Estonia, Latvia, Poland, United Kingdom, Fiji, Libya, Portugal, Uzbekistan, Finland, Lithuania, Qatar, Vietnam, France, Luxembourg and Romania. The signed agreements are created upon the OECD model and there has been followed the credit method. Additionally, there exists a tax sparing provision, meaning that even if a foreign investor is granted tax holidays or exemptions in Singapore while paying taxes, it might be relieved from paying taxes in its home country to a certain extent. Secondly, except for bilateral tax treaties, Singapore also grants unilateral credit. It is a favorable solution for the companies of which home countries do not have bilateral treaties with Singapore. The extent of credit is limited to the payable tax, also in case when the foreign tax due is higher. Detailed documentation is required for such operations. The unilateral credit is also valid for foreign source income remitted to Singapore.[229]

Tax anti-avoidance strategies

Singapore in its endeavors not to be perceived as a tax haven, but rather as an extremely investor's friendly region, has introduced legislation regulating the tax anti-avoidance activities. Although there is no controlled foreign companies (CFC) rules, nor thin capitalization, there are other laws in force helping to control the transfer pricing and other similar practices. The main guidelines are included in the transfer pricing guidelines circular from 2006. It has been issued by the Singaporean tax authority and is similar in its form to the legislation propagated by the OECD. The underlying rule is the arm's-length principle which finds much support in the domestic tax laws. The

[229] Deloitte, *Taxation and Investment in Singapore 2012*, Deloitte Touche Tohmatsu Limited, 2012, p.1-22

Inland Revenue Authority of Singapore requires from the taxpayers that they conduct a thorough analysis of their transactions and based on that they determine the right arm's-length price. There must be a possibility of proving that such efforts have been undertaken. Additionally, the analysis should be conducted on a transaction-by-transaction basis, so each one should be done separately. If comprehensive documentation is not available upon the authorities' request, a company lacking such evidence may face the accurate control procedures undertaken by the respective tax services and might be challenged in terms of their transactions' appropriateness. However, there is left some freedom to the taxpayers. Firstly, no priority methodology is imposed on the companies, meaning that they can choose the most suitable one (and which is supposed to produce the most reliable results). The available methods embrace the comparable uncontrolled price (CUP) method, resale price method, cost plus method, profit split method and transactional net margin method. Secondly, there are no fixed deadlines for firms that need to be met when producing the necessary reports. Consequently, there are no specific penalties for failing to provide such documentation. The core issue is to be prepared for the tax audits. If, as already mentioned, such adequate proof of proper execution and valuation of transaction is lacking, the necessary tax adjustment will be made by the IRAS. Regarding transfer pricing, there exists additionally the possibility of benefiting from the unilateral and bilateral APAs. They can last from 3 up to 5 years. They issued guidelines on APAs refer particularly to the related party loans and services. In case of not sticking to the existing rules, there can be imposed a penalty no exceeding SGD 1.000. If a taxpayer fails to pay the fine there is a threat of imprisonment up to 6 months.

Regarding other general anti-avoidance rules, IRAS is entitled to make adjustments in order to counteract any potential and illegal tax advantages. Also, in frames of the anti-treaty shopping, IRAS is enabled to counteract any behavior aiming at taking the advantage of beneficial withholding tax rates under tax treaty provisions. On the other hand, the specific anti-avoidance rules refer to the particular situations like the sale of assets between related parties, whereas those assets are evaluated below the market value.[230]

3.3.3. Summary

Singapore has an extremely friendly tax system from the investors' perspective. In the region it stands out in terms of the relatively low corporate tax rate as well as numerous tax incentives. In line with the newest trends in shaping modern tax systems, it inclines towards broad base and low rates, what is not only welcomed by the taxpayers, but also ensures fiscal stability. In Singapore there are available tax holidays and exemptions, which are granted to companies aiming at investing in specific sectors, particularly in manufacturing and services, maritime sector, trade, financial services and R&D. Investors enjoy preferential tax rates or tax holidays reaching even 15 years. The other meaningful incentive targeting start-ups is the so called Start-up Tax Exemption (SUTE) scheme, granting either full of 50% tax exemptions for the first three years of business activity. Investment allowances are another measure frequently appearing in the tax legislation. They are destined mostly for the factory building or acquisition of know-how and patent rights. Apparently, these components favor either setting up new businesses or upgrading the existing ones, thus increasing their competitiveness.

Singapore is perceived as a free port. Custom and excise duties are imposed on a particularly narrow base and regulations seem to be clear and simple. Additionally, there are no duties imposed on export, thus particularly boosting such activities. Moreover, there are only few local taxes in Singapore. Perhaps there are not too many exemptions available, but those taxes do not significantly contribute to the overall company's tax burden as the rates are rather low. The authorities take care of improving the paying process by introducing online procedures saving both time and costs.

Regarding the possibility of fast write-offs, Singaporean authorities in fact do foresee the accelerated depreciation, however only very few items qualify for it. Beneficial treatment is targeted

[230] Ibid.

mainly at R&D. Other expenses underlie the traditional methods and time periods of depreciation. Investors might not feel encouraged enough to make huge capital investments.

When looking at the taxation system as a whole, Singapore makes visible efforts to decrease the effective tax burden. Not only has the corporate tax rate been constantly lowered over the last years, but also the tax burden has been shifted from the direct onto the indirect taxes, thus relieving companies. In this manner, it can effectively attract foreign investors which are prone to the potential tax savings. Additionally there is a contentious issue of being perceived as a tax haven. On the one hand, investors see their chance to avoid excessive tax payments due to the competitive rates and feel safe because of the highly respected aspect of privacy and reluctance towards information revealing unless necessary. On the other hand, Singapore might face international despise if not counteracting the harmful tax avoidance practices. Singapore in order to recover from the damaging opinion of enabling money laundry, has entered many bilateral information-sharing agreements and supported the Base Erosion and Profit Shifting Report. It also increased the scope and intensity of the information exchange with other jurisdictions' tax authorities.

In Singapore there are no export processing zones, despite the fact that it has cooperated with China to established one (but on the Chinese territory).

Singapore does not strive for the full harmonization of its tax system with the other countries' systems. It has imposed truly competitive tax rates followed by preferential treatments for companies active in specific sectors. Additionally it does not comply with the rule of full information disclosure, although some steps towards cooperation in this field have been undertaken. Among others, for this reason, Singaporean authorities have entered over 50 tax treaties with other jurisdictions as well as has introduced numerous regulations regarding the tax evasion practices. Although the rules are not extremely strict and the available penalties moderate when comparing to other countries, they regulate the issue of transfer pricing and other abusive practices relatively effectively.

Generally it can be said that the tax system in Singapore can be perceived as very attractive for foreign investors. The government consciously uses different kinds of fiscal tools to steer the inflows of foreign capital and relies on taxes as on one of the main incentives from the broad spectrum of available tools.

3.4. South Korea

3.4.1. Region's profile

South Korea is another state commonly known as an Asian Tiger. Similarly to the previously described Singapore, Hong Kong and Taiwan, it has undergone a rapid industrialization in the last decades and nowadays is one of the most developed countries worldwide, being at the tops of the global rankings regarding the size of GDP and economic development. For five decades it has been growing 7% on average yearly and being a member of organizations such as the Organization for Economic Cooperation and Development or G-20.[231]

The country is located in East Asia on the southern part of the Korean Peninsula. In the north it is neighboring with the Democratic People's Republic of Korea and from the other sides it is surrounded by the Sea of Japan, East China Sea and Yellow Sea.[232] South Korea's land area is 97350 sq. km, what amounts for almost half of the peninsula that it occupies.[233] Although the majority of the region has the mountainous landscape and the rest consists of coastline characterized by bays

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[231] Noland, Marcus, *Six Markets to Watch: South Korea*, January/February 2014 Issue, Foreign Affairs, Council on Foreign Relations (January/February 2014), last accessed 07.07.2015 <https://www.foreignaffairs.com/articles/south-korea/2013-12-06/six-markets-watch-south-korea>

[232] Yu, Woo-ik, *South Korea*, Encyclopædia Britannica, Inc. (2015), last accessed 07.07.2015 <http://www.britannica.com/place/South-Korea>

[233] Trading Economics, *Land area (sq. km) in South Korea*, Trading Economics (2015), last accessed 07.07.2015 <http://www.tradingeconomics.com/south-korea/land-area-sq-km-wb-data.html>

and rocky shores, still in the early 1960s most of the South Koreans was engaging into farming activities, with over two thirds of population inhabiting rural areas (however only around one fifth of the land was arable). South Korea's GDP per capita was close to those in undeveloped regions throughout African and Asian continents, being less affluent than Bolivia or even Mozambique.[234] Throughout the next half century it managed to completely change this structure and transform from the rural into an urban, highly industrialized state.

Although the first traces of the Korean nation can be dated back to as far as 3rd millennium BC, the state in its current form was established only in 1948 when there has taken place a partition into South and North along the 38th parallel. While the Democratic People's Republic of Korea decided to follow the communist path characterized by state control (manifested among others by command economy and spending heavily on military), the South decided to direct its steps towards capitalism and economic reforms.

Already in the mid-1940s, South Korea had some of the important attributes necessary for building a strong state. Those were among others educated citizens, established property rights, undergone land reform that contributed to higher productivity. Unfortunately, the Korean War that started in 1950 and lasted for 3 years, destroyed country's accomplishments and left it struggling until 1960s. Therefore, in 1952 there has been established the U.S. assistance, which goal was to enable the country's recovery. It consisted mainly in providing food and other needed goods (almost 70% of total imports) and lasted until 1962. A year before the American aid supplies have been suspended, Park Chung-hee seized the power and put emphasis on the economic development. He initiated a bulk of policy reforms that aimed chiefly at boosting domestic savings (by rising interest rates) and opening the economy to the international trade. Simultaneously, the U.S. side has established a massive advisory presence in South Korea in order to provide its government with advice regarding the development of the country. Nevertheless, Koreans did not strictly follow the advices they were given, but rather made their own decisions which were in line with their ideas of an economic development path.[235] And so, for instance, against the U.S. strong recommendations to focus on small- and medium-sized companies, South Korean government was concentrating on the creation of large conglomerates, known under term chaebol (which on the one hand resulted in establishing international brands such as Samsung, but on the other hand has been contributing to the increased political corruption, monopoly power and economic inequality).[236] Park also promoted a system based on close state-business connections, such as directed credit or restricted imports (favoring raw materials and technology, while discouraging consumer goods).[237] So although striving to the capitalistic model of economy, the initial changes introduced within South Korea were rather of an authoritarian nature, characterized by massive state interventions.

Also in 1961 there has been established the Economic Planning Board, which targeted rapid industrialization mainly through exports, manifested in four Five-Year Economic Development Plans. Besides this fact, Park was putting emphasis on the importance of private entrepreneurship, by giving a range of incentives such as low-interest bank loans, import privileges or tax benefits. Export was particularly favored as already mentioned, by granting direct subsidies and removing all fiscal burdens and restrictions on import of goods destined for production of export commodities. Nevertheless, textile and machinery industries did not grow due to lack of raw materials. South Korea's exports have become competitive on the international arena and thus started to attract foreign investors, boosting further the foreign exchange. The first two five-year plans turned out to be particularly successful. During the third one, the authorities decided to expand heavy and

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234 Noland, *loc. cit.*

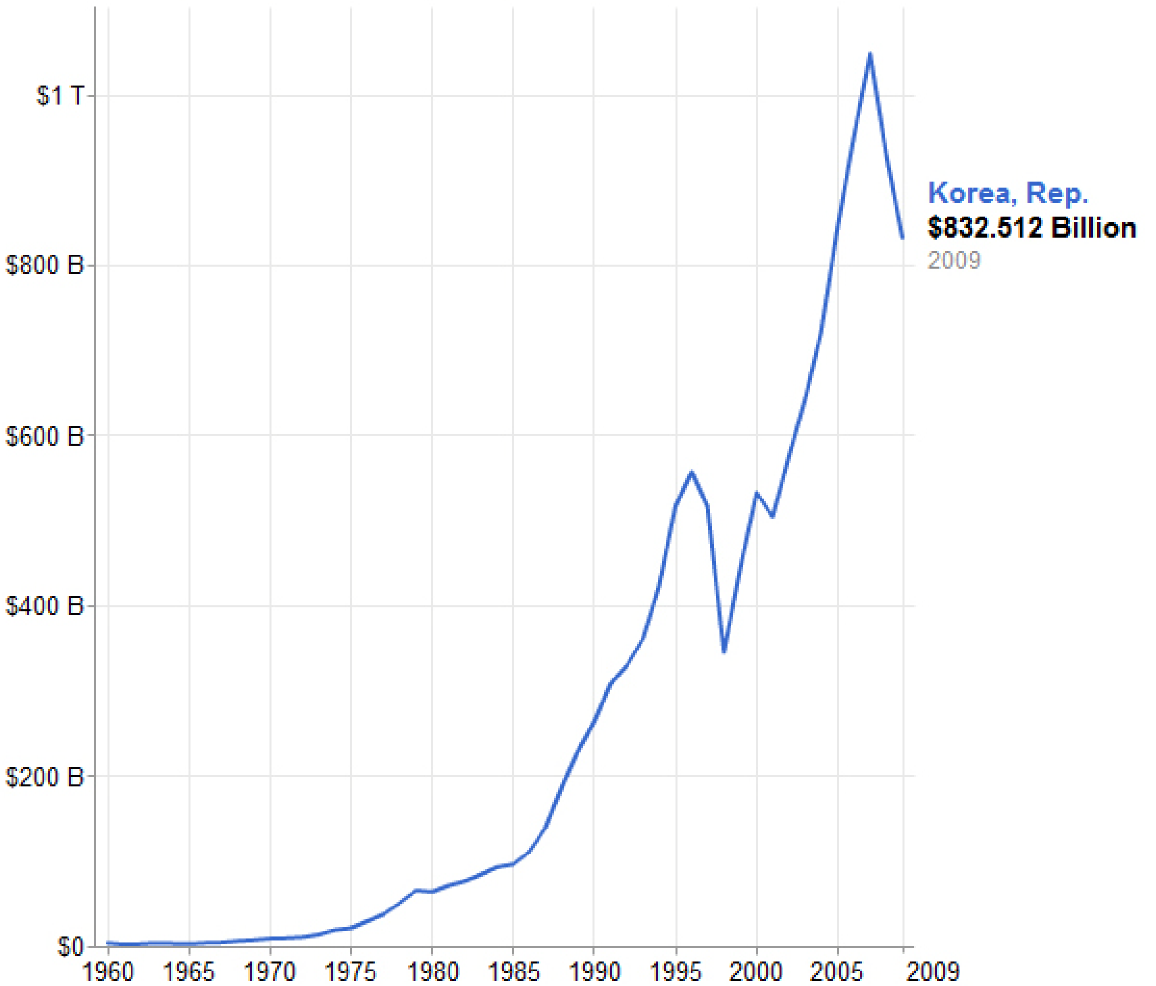
235 Embassy of the United States, *[Case Study] South Korea: From Aid Recipient to Donor*, State.gov (2015), last accessed 07.07.2015 <http://seoul.usembassy.gov/p_rok_60th_econ_18.html>

236 Tran, Mark, *South Korea: a model of development?*, The Guardian, Guardian News and Media Limited (28 November 2011), last accessed 07.07.2015 <http://www.theguardian.com/global-development/poverty-matters/2011/nov/28/south-korea-development-model>

237 Forbes, *South Korea*, Forbes.com LLC (2015), last accessed 07.07.2015 <http://www.forbes.com/places/south-korea/>

chemical industries, and as a result its capability for producing steel and refining oil increased remarkably. There also started to appear shipbuilding facilities and cars began to be exported. This strategy to drive economic growth by export-oriented activities had unfortunately also negative consequences. Already in late 1970s South Korea was suffering from the lack of domestic consumer goods. As the demand for those commodities was increasing, accompanied by rising wages and inflow of hard currency due to export, the country had to face the problem of inflation. As a counter-action there have been undertaken measures to lower the rate of economic growth and investments into light industries. As opposed to the expectations, it triggered recession and numerous small and medium enterprises went bankrupt.[238] In 1980s there has taken place a growth in chaebols' importance. They were granted subsidies and low-interest-rate loans, trade preferences and monopoly rights, thus lowering the economy's competitiveness. The country managed, however, to fight its way out of the temporary hardship and to grow further. In 1997-1998 it was hit hard by the financial crisis, which exposed poorly regulated financial system. Authorities counteracted by introducing new reforms aiming at strengthening respective institutions. Nowadays South Korea relies on high productivity of its human capital and emphasizes the role of technology.

Figure 17: South Korea's GDP between 1960-2009

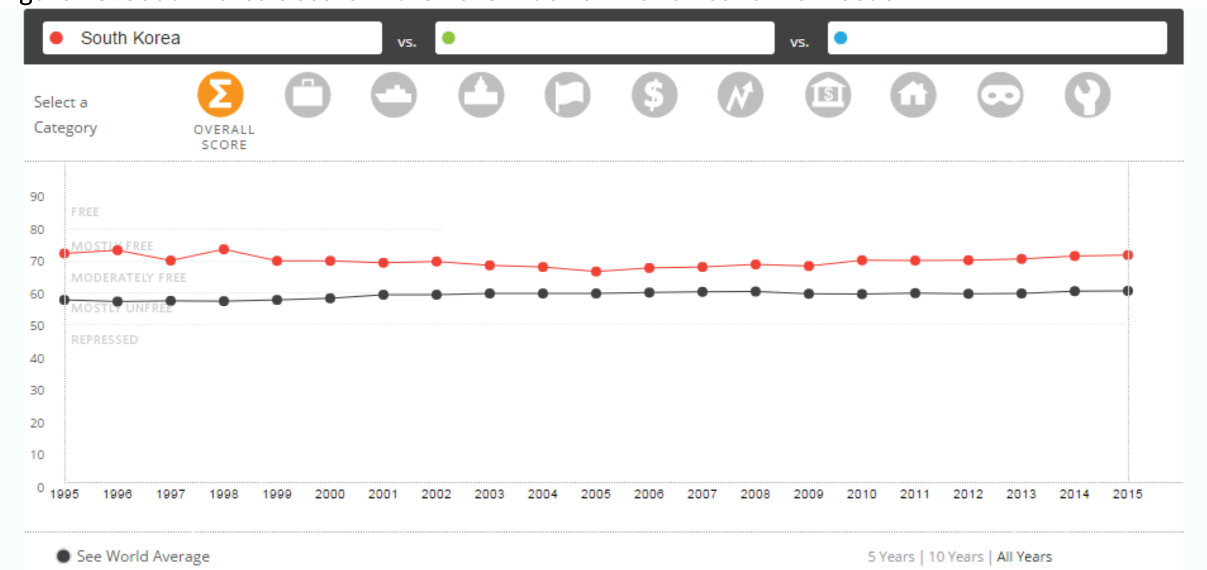


Source: usglc.org

[238]Savada, Andrea Matles and Shaw, William, *South Korea: A Country Study*, GPO for the Library of Congress, Washington (1990), last accessed 07.07.2015 <http://countrystudies.us/south-korea/15.htm>

Currently South Korea is regarded as highly developed country, performing well in terms of the rule of low or creation of the favorable business environment. According to the 2015 Index of Economic Freedom, the country scores 71.5 out of 100 regarding its economic freedom, being ranked on the 29th place overall and constantly improves its standing. Therefore South Korea belongs to the category "mostly free" and manages to perform well (above world's average) in the majority of the Index's economic freedoms. Particularly important for its growth seem to be openness to the international trade together with strong desire to attract investments. Despite improving the transparency and efficiency of regulations, there occurs serious problem of both corruption and a low level of labor freedom. The first one appears to be extremely damaging when it comes to trust in authorities, while the latter problem is manifested through decreased competitiveness and underemployment. Additionally costs of hiring and dismissing employees remains high. Fortunately, property rights seem to be properly protected, backed up by a well-functioning and independent judicial system. The formation of business is relatively easy (no minimum capital) and innovation both much supported and facilitated (for instance government subsidizes renewable energy or healthcare system projects). Moreover, monetary stability is very satisfactory. Coming to the fiscal system, the top individual income tax rate and top corporate tax rate are about average, amounting 35 percent and 22 percent respectively, thus making with other existing taxes (e.g. VAT) the overall tax burden equivalent to 26.8 percent. An important factor for foreign investors, tariff, is equal to 8.7 percent. Consequently, the country tries to follow the strategy of "World's Best Customs". However FDI are sometimes limited to given industries or sectors.[239]

Figure 18: South Korea's score in the 2015 Index of World Economic Freedom



Source: heritage.org

3.4.2. Attractiveness of the South Korea's tax system for the FDIs inflow

In South Korea the roots of the modern tax system can be traced back to the late 1940s, when the Government of the Republic of Korea was formed and the Tax Law Committee was established. The Korean War from 1950s forced the government to introduce some hitherto non-existent taxes to provide stream of fiscal revenue. However, as the war passed, the taxation system was changed again in order to accommodate better to the needs of a modern society. During the times of postwar reconstruction, early phases of economic development of 1960s, which later transformed into the sustained economic growth, and through the times of financial crisis in the 1990s until now, South Koreas has undergone extremely high number of tax reforms (even on a

[239] 2015 Index of Economic Freedom, *South Korea*, The Heritage Foundation (2015), last accessed 07.07.2015 <http://www.heritage.org/index/country/southkorea>

yearly basis) which aimed at adapting the fiscal system to the state's current needs and to steer the direction of development. As the importance of foreign capital became obvious, in 1998 there has been enacted the Foreign Investment Promotion Law (FIPL) and thus in May of the following year there appeared final provisions regarding tax incentives for certain kinds of foreign direct investments (for instance they were embracing 7 years long tax holidays for investments made in R&D, supplemented by 50% tax exemptions after the tax holidays were over and many others preferential treatments).[240]

Currently, in South Korea the government derives revenue from both national and local taxes. There is a broad range of taxes imposed on both levels. While the national ones embrace for instance corporate tax, internet tax, custom duties and education tax, the local ones consist of property tax, automobile tax, license tax or registration tax. The main respective authority is the National Tax Service, which is not only responsible for the legislation aspects but also conducts audits in equal time intervals within large companies (with the revenue over KRW 500 billion annually). Overall, the South Korean tax system seems somehow complex and to be undergoing constant huge reforms as well as minor changes. However, one of the key drivers of tax policy change in the near future is the goal to make the tax code more transparent and understandable, also for non-professionals.

Corporate tax

The tax due is calculated upon the company's yearly income and the fiscal year lasts from the 1st January until the 31st of December. As the majority of foreign investors operate on the South Korean market in form of corporations, corporate tax accounts for the biggest share of all the taxes the foreign companies have to pay. The domestic Korean corporations (head office is located in Korea) are taxed on their worldwide income. The corporate tax is levied also on revenues gained by their foreign branches. However, not only the revenue of the enterprises considered as permanently established (e.g. branches, warehouses or stores) is taxable, but also of those firms who run their businesses through an agent. Additionally, joint ventures with Korean partners, wholly-owned Korean subsidiaries and Korean branches of a foreign company are also subjects to corporate taxation. Corporations with a foreign status are taxed only on Korean-sourced income.

Currently, the corporate tax rate in South Korea equals 24.2% for the revenue of over KRW 20 billion. When the income is lower than KRW 200 million it is 11% and in between those two thresholds it is 22%. During the last decade the top rate has been lowered and heightened few times and thus the rate averaged 27.38% from 1997 until 2015. The highest point leveled at as much as 30.8% in 1998 (during the Asian financial crisis) and it reached the lowest point only for one year in 2011 at 22%. The relatively high rate together with its frequent changes (what decreases the predictability and thus increases the potential firm's risk), probably does not positively contribute to the investors' perception on the South Korean fiscal system.[241] On the other hand, the tax base remains narrow and the final tax burden is somehow lower due to preferential tax treatments. Taxes as a part of the overall fiscal revenues account for only 20% of GDP, being among the lowest in the OECD. However, in order to sustain the sufficient flow of financial resources to the national budget, there are already plans to broaden the current tax base.

South Korea tend to support the inflow of foreign capital through tax incentives. Nevertheless, because of the shrinking budget revenues, the government was forced to curb some of the preferential tax treatments, particularly in the area of the corporate tax. For instance, the previously allowed deduction of a company's reserve used for the future expenses on R&D is not valid any more. However, South Korea still supports foreign investments to the extent perceived as acceptable when considering the needed tax revenues. Thus, under the Tax Incentives Limitation Law

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[240] Ministry of Strategy and Finance Korea, *2012 Korean Taxation*, Tax Treaties Division of the Ministry of Strategy and Finance of Korea (2012): 1-61

[241] Trading Economics, *South Korea Corporate Tax Rate*, Trading Economics (2015), last accessed 28.07.2015 <http://www.tradingeconomics.com/south-korea/corporate-tax-rate>

it grants up to seven years of tax holidays for high-tech industries or in terms of the high technology tax incentive and Foreign Investment Zone (FIZ) tax incentive, companies are given the tax exemption for five consecutive years beginning with the first profitable year and enjoy the 50% tax rate reduction for the next two years. Under the Free Economic Zone (FEZ) tax incentive similar exemptions are valid for the first three years and reduced rate for the next 2 years as well. The mentioned tax holidays are a subject to the possible extension under specific circumstances. Interestingly, depending on how much share of a company is owned by the foreign investors, the scope of exemption (or tax holiday) available is determined.[242] There are available also other incentives, among others for investments in technology innovation SMEs and venture businesses, such as introduction of tax credits for technology innovation M&A or deferral of capital gains tax on shareholders. Lately there has also taken place an expansion of businesses eligible for tax credits embracing for example energy saving facilities, environment protection facilities and drug quality control improvement facilities. On the other hand, to the companies' detriment is the fact that the tax exemption on dividends received by a foreign investor has been abolished, the allowance of FDI tax exemptions for certain non-treaty countries was also a subject to withdrawal. Additionally, there are separate bookkeeping requirements for FDI incentives and post-investment reporting obligations and some other harmful regulations.[243]

Exemptions

To the most meaningful local taxes in South Korea belong real estate related taxes, transfer tax, stump duty and environmental taxes. Companies that own land, buildings, ships or aircraft need to pay property taxes on those. The real estate related taxes embrace taxes imposed on properties at different stages such as at purchasing (acquisition tax and value added taxes), holding (property or real estate holding tax) and sales (transfer income tax and value added tax). The tax rates vary accordingly from 0.24% up to 0.6%. To the benefit of foreign investors there is available a broad range of preferential tax treatments. For instance foreign companies might be exempted or refunded from the value added tax at the purchasing stage. Also, acquisition tax, registration tax and property tax rates are lowered for real estates, destined for industry-supporting service businesses and high technologies services (under the Foreign Investment Promotion Act).[244] The transfer tax, also known as a Securities Transaction Tax (STT), is imposed on selected transactions embracing the sale of listed shares (equaling 0.3%) and unlisted ones (0.5%). The taxpayer in this case is the seller. The transfer of shares in a South Korean company listed on selected overseas stock exchanges such as NYSE, NASDAQ and alike, being the American and global depository receipts, is tax exempted. Stump duty is a tax imposed on the transactions relating to the creation or transfer of assets rights. From the taxpayer's point of view, stamp duty remains negligible when considering the overall tax burden as its value varies only from KRW 100 up to KRW 350,000. Environmental taxes constitute much more noticeable tax burden than stump duty. This group of taxes consists of the following fees: environmental improvement charge, quality improvement charge, ecosystem conservation charge and traffic energy environment tax. The first one must be paid by either owners or occupiers of estates of floor space exceeding 160 square meters and diesel automobiles which directly cause the environmental pollution. The second one refers to the drinking water extractors and importers, while the third charge is due by excavators or operators of businesses requiring EIAs. The tax payment is proportional to the volume extracted or imported or to the damaged area's size respectively. The traffic energy environment tax is levied on companies producing or importing gasoline, diesel oil and alike. The tax equals either KRW 475/L or KRW 340/L for gasoline and diesel oil respectively. No

[242] EY, *Worldwide Corporate Tax Guide 2014*, EYGM Limited (April 2014): 724-731

[243] Baik, WH and Rhee, JM, *South Korea*, World Tax, Euromoney Institutional Investor PLC (2015), last accessed 29.07.2015 <http://www.itrworldtax.com/Guide/1084/South-Korea.html>

[244] Invest in Korea, *Real Estate Related Tax*, Korea Trade-Investment Promotion Agency (2006), last accessed 29.07.2015 <http://www.investkorea.org/ikwork/iko/eng/cont/contents.jsp?code=102040905>

information on available exemptions has been found, however, the important fact is that there is no carbon tax.[245]

In South Korea custom duties are imposed on imports. The rate has been shaped at the level of 8% on average (one of the lowest worldwide) and is calculated upon the value consisting of price paid to exporters, freight and insurance (the so called CIF price). South Korea uses the Harmonized System, meaning that all duties and taxes refer to the CIF value. Duties are non-cumulative, while import excise taxes are cumulative. Therefore apart from the already mentioned custom duties there are 6 types of taxes depending on the imported items including: special excise tax, liquor tax, transportation tax, education tax, special tax for rural development and value-added tax. There come additionally port entry fees, which are not fully standardized. Generally, excise duties are imposed on the luxury goods, petrol and diesel fuels. The rate may vary in this case from 5% up to 20%. Fortunately for companies, the government offers preferential programs such as World Tariff Organization for General Countries, World Tariff Organization Developing Countries, Asia Pacific Trade Agreement for General Countries and numerous others. For the preferential rates are entitled imports from the tax jurisdictions with which South Korean authorities have entered into free trade agreements. It is due to the fact, that South Korea is perceived as export-oriented and strives towards high competitiveness. Also according to the Korean Customs Law, there is a possibility of either reduction or exemption from duties for some kinds of items such as goods for the governmental use, preservation of environment or for donation. The reduction is also available in special cases regulated by the Foreign Investment Promotion Act, Tax Exemptions and Exceptions Act and Offshore Minerals Development Act.[246]

Write-offs for investment expenditures

South Korea gives the entrepreneurs the possibility of choosing the most suitable depreciation method from the set embracing straight-line, declining balance and unit-of-production (output) depreciation method. This applies for tangibles, as for intangible assets there is no choice and straight-line method must be used. Companies must comply with the tax laws when specifying the assets useful lives and after selecting the right method, they are obliged to inform tax authorities about their decisions in their first annual income tax return. If not, then there are automatically prescribed specific methods and useful lives periods in accordance with the tax regulations regarding the class of asset. Unfortunately, there have been found no relevant information on the possibility of the accelerated write-offs.

Change of the whole fiscal system (decreasing the effective tax rate)

The effective tax rate in South Korea in 2009 equaled 22%, what oscillates about the global average. From the investors' perspective moving business into this country is neither extremely viable nor it is particularly unprofitable. It means that as the taxation system does not present a clear advantage in a form of a low effective rate, investors may consider other factors, such as business environment as a crucial one in the decision making process.

Although the top corporate tax rate has been ultimately lowered by few percentage points during the last decades, it has undergone many fluctuations. It seems that the government does not perceive taxes as the main tool to attract the foreign capital, but rather as means for the regulating its internal fiscal situation. As already mentioned, South Korean tax system is characterized by continuous reforms and thus many changes take place within the legislation. Although some kinds of taxes have been abolished, some new were introduced into their place. To the investors' favor act

[245] Park, Keum Sub and Min, Se Dong and Kim, Mi Hyun, *Environmental law and practice in South Korea: overview*, Practical Law Company, Thomson Reuters (2015), last accessed 29.07.2015 <http://us.practicallaw.com/2-508-8379#a660636>

[246] KPMG, *Republic of Korea*, KPMG Advisory (China) Limited (2015), last accessed 29.07.2015 <http://www.kpmg.com/cn/en/aspac-trade-and-customs/pages/trade-customs-republic-of-korea.aspx>

the fact, that South Korea offers relatively broad spectrum of preferential tax treatments, which can potentially decrease the effective tax rate to the much extent. On the other hand, the very complex and intricate legislation may hamper the possibility of deriving benefits from exemptions and other means of lowering the tax burden.

Becoming a tax haven

South Korea is not a tax haven, nor was it ever close to be included on such a list.

Export Processing Zones

The first export processing zones in South Korea have been established already in the early 1970s. In their beginnings they were supposed to attract labor-intensive industries, not necessarily characterized by the use of sophisticated technologies, because there was an abundance of unskilled workers available. Because at the time of establishment of the aforementioned EPZs South Korea was a country in transition, government believed it was also a step towards shifting the policy focus from inward to an outward orientation. With the time, the country managed to transform the EPZs' domain from the low-skill labor-intensive industries to the more advanced ones. Currently there are several export processing zones in South Korea. The most known one is the Masan Free Trade Zone (MFTZ). The most common incentives that are offered by the export processing zones are the corporate tax reductions and exemptions. For instance logistics and manufacturing companies investing at least U.S. $5 million may count on a full corporate tax exemption during the period of three years, followed by the 50% exemption during the next two years. Specific enterprises are also entitled for the 100% exemptions from the local taxes embracing local acquisition, registration, property and aggregate land taxes and similarly to the national corporate tax 50% exemption for the following two years. Firms within the export processing zones can additionally benefit from customs duties deferral on goods imported to the zones. Moreover, such goods are exempted from the Value Added Tax (VAT). In case of the trade taking place within the export processing zones, VAT is excluded as well. Except for those measures there are available other non-tax related incentives such as rent exemptions or cash grants, which will be not addressed here however.[247]

Harmonization of tax systems

On the one hand, South Korea has the average tax rates when comparing to the majority of countries located in the region. It does not explicitly follow the tax competition, thus complying with the present norms of setting similar tax rates. Moreover, it has signed numerous bilateral tax treaties with other countries, thus facilitating the cooperation among them and benefiting investors who can avoid the double taxation. The aforementioned agreements are based mainly on the standard OECD treaty model. Also, despite the somehow intricate custom and excise duties regulations, the taxes which are due are calculated upon the commonly used CIF price, what might also somehow facilitate the whole import and export process for the companies, by not requiring from them additional outlays on determining the tax due. On the other hand, the legislation regarding taxes is highly complicated and there occur frequent changes, which might cause confusion among investors. Additionally, South Korea still imposes high taxes on a narrow base, what is against the international trends regarding shaping the taxation systems. Thus, generally it can be stated, that although there are some premises speaking for the partial harmonization, mainly reflected by the lack of the tax competition, there are many signs against such state of affairs. Particularly complex regulations and somehow obsolete (although continuously undergoing reforms) taxation system are not showing the country's inclination towards its full harmonization.

[247] Western Economic Diversification Canada, *Korea – Masan* (12 December 2012), last accessed 05.08.2015 <http://www.wd.gc.ca/eng/11151.asp>

Bilateral tax treaties

As for 2013 South Korea has signed tax treaties for the double tax avoidance with over 80 tax jurisdictions scattered on all continents. Apparently, the tax treaty network is very vast and embraces in its scope (alphabetically) Albania, Algeria, Australia, Austria, Azerbaijan, Bangladesh, Belarus, Belgium, Brazil, Bulgaria, Canada, Chile, China, Croatia, Czech Republic, Cook Islands, Denmark, Egypt, Estonia, Fiji, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Iran, Ireland, Israel, Italy, Japan, Jordan, Kazakhstan, Kuwait, Laos, Latvia, Lithuania, Luxembourg, Malaysia, Marshall Islands, Malta, Mexico, Mongolia, Morocco, Myanmar, Nepal, Netherlands, New Zealand, Norway, Oman, Pakistan, Panama, Papua New Guinea, Philippines, Poland, Portugal, Qatar, Romania, Russia, Saudi Arabia, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Thailand, Tunisia, Turkey, Ukraine, United Arab Emirates, United Kingdom, United States, Uruguay, Uzbekistan, Venezuela and Vietnam.[248] The majority of treaties is based upon the OECD model treaty and is endowed in provisions regarding the OECD-compliant exchange of information. Companies with the Korean sourced income, wishing to benefit from the reduced tax (allowed by the respective treaty), must timely apply for such possibility, namely before paying the income tax. Otherwise, the relief is not automatically granted. Additionally, South Korea, in order to enable the avoidance of the double taxation for companies, applies the unilateral relief. The tax authorities offer tax credits for tax paid on the foreign income. Those can be used against the tax liability which arises in South Korea. On the one hand, there are some limitations regarding the amount of granted credits. On the other hand, those credits which have not been used in the current year, may be kept and used within the five next consecutive years.

Tax anti-avoidance strategies

South Korea is not considered to be a tax haven. Enterprises do not shift their income there, as the tax rates are not as low as in Hong Kong or Singapore. Therefore abusive tax practices seem not to be a serious problem in South Korea.

Generally there are in force some transfer-pricing rules. Companies can choose mainly between comparable uncontrolled price, resale price, costplus, profit-split and the transactional net margin methods and are allowed to reach such agreements with the respective tax authorities already in advance (also APAs). The adjustments are made to the resident's income in case that the transactions with the foreign related party is either under- or overvalued, thus not in accordance with the arm's length principle. There must be made and kept the relevant documentation for the audit's purposes. The appropriate documents must be also submitted with the tax return and should include statement of international transactions with the determined arm's length price as well as a summary income statement for the foreign related parties.

In South Korea there are also thin capitalization rules, which require a 3:1 debt-to-equity ratio and specifically 6:1 for the financial companies. In case that such proportions are not preserved, the interests that have aroused on the excessive part are not deductible. This is valid for the foreign related firms and sister companies. Except for thin capitalization rules, there are also controlled foreign companies (CFC) rules in force. According to them, companies which are both located in the low tax jurisdictions and are characterized by the average effective income tax rate of at most 15% in the time period of 3 consecutive years as well as which are owned either directly or indirectly (no less than 10% of firm's shares) by Korean residents, are required to pay the tax on such profits to the Korean tax authorities. Thus, CFC income becomes a part of the Korean parent company taxable income.

In line with the general anti-avoidance regulations there in in force the substance-over-form rule. Therefore transactions may be, so to say, recharacterized, based on their substance. As a consequence, if the respective tax authorities notice a company's attempts to avoid tax payments through the inappropriate evaluation of the transactions between related parties, there will be made

[248] KPMG, *Korea Tax Profile*, KPMG International Cooperative (February 2013): 1-18

an adjustment consisting in estimating their market value and thus determining the right income, which would ensue from the transaction conducted between unrelated parties under similar conditions.[249] As opposed to the general rules, there are no other specific anti-avoidance rules. Nevertheless, South Koran government has additionally engaged in the anti-treaty shopping by undertaking renegotiations with several tax jurisdictions, with which it has previously entered in such treaties.

Generally, South Korea has relatively well developed regulations aiming at hindering the tax evasion. The problem of profit shifting to Korea takes rather no place because of its moderate tax rates and moving profits out of or to Korea does not seem to be an urgent problem.

3.4.3. Summary

South Korean tax system is perceived as relatively complex and undergoing continuous reforms. Although the government has realized the importance of taxes as a tool serving the attraction of the foreign capital, seemingly it puts more emphasis on using it to regulate its inner economic situation.

The top corporate tax rate is nor low, nor extremely high, being shaped just at the average level of the 24.2%. It has been constantly lowered throughout last decades, with some exceptions embracing the last change in 2012, when it was slightly heightened. Additionally there have been simultaneously made some steps towards broadening the hitherto very narrow tax base, what together with further lowering of the current tax rates, could take the excess burden from the companies. Nevertheless, as for now, there have taken place only initial changes leading to such a state of affairs. Investors can count on some exemptions and tax holidays, particularly within the free economic zones it has established within its borders. Those target mainly enterprises in a field of technological innovations. To the investors' detriment, many of the incentives have been abolished due to the deterring fiscal situation and decreasing tax revenues to the national budget.

Except for a whole range of national taxes, in South Korea there are numerous local taxes. They seem, however, to constitute a relatively small burden for the taxpayers, particularly as also here are offered exemptions. There is a similar situations with the custom and excise duties. South Korea can be perceived as very export and import friendly, as it has one of the lowest duties worldwide of only 8%. Additionally, investors might count on exemptions when importing or exporting some specific goods. Moreover, the government has signed numerous bilateral agreements and entered into international preferential trade programs.

Regarding the system as a whole, South Korea, despite fluctuations in the tax rates' levels, managed to gradually decrease the effective tax rate, which equaled in 2009 22%. It has been done by introducing preferential tax treatments. Nevertheless, the final effect, which could have been much better, was somehow damaged by abolishing part of the previously introduced exemptions and by the already mentioned changes of the top corporate tax rate. This state of affairs definitely contributes to the fact that South Korea is not a tax haven and has never been close to be perceived as such.

South Korea is one of the countries that decided to establish export processing zones within its borders. There are several of them and they target mainly logistics and manufacturing related industries. The zones offer standard preferential tax treatments such as partial and full tax exemptions, customs duties deferral and some other non-tax related incentives.

When considering the aspect of the taxation system harmonization, it cannot be univocally stated whether South Korea follows such a route or not. On the one hand, it does comply with some internationally accepted standards, like keeping the moderate tax rates (in a sense of not undertaking the tax competition) or regarding the tax treaties with other countries or determining bases for the calculation of custom duties due (by sticking to the commonly used rules by other tax jurisdictions). On the other hand, South Korea has highly complicated tax regulations and it has excessive requirements regarding the type of necessary documentation for the respective tax

[249] Deloitte, *Taxation and Investment in Korea 2013*, Deloitte Touche Tohmatsu Limited (2013): 6-11

authorities. Also somehow obsolete taxation system seemingly cannot keep up with the newest trends to shift as much emphasis as possible from the direct towards indirect taxation and to simplify the legislation so as to make it more transparent to the taxpayers.

South Korea has signed extremely high number of bilateral tax treaties with other countries (over 80), which aim at the avoidance of the double taxation. It effectively exchanges information with the tax authorities from other jurisdictions and uses the standard OECD treaty model when entering into such agreements. This fact definitely boosts its attractiveness for the foreign investors as they do not have to be concerned about the excessive tax burden and thus would engage in the not always lawful tax strategies. There has been implemented a system of granting tax credits. Additionally, except for the bilateral one, there exists also a possibility of the unilateral relief. The very favorable solution consists in the fact, that credits which have not been entirely used in the respective year, can be kept for the future (up to 5 years). Generally, in South Korea the problem of abusive tax strategies does not seem to be a very widely spread issue. Except for the moderate tax rates (which cannot present such an incentive in itself to make companies moving their income into South Korea), there have been implemented numerous regulations regarding transfer pricing and other general anti-avoidance rules. A whole range embracing among others thin capitalization rules, controlled foreign companies (CFC) rules or substance-over-form rule, effectively eliminate the possibility of the tax evasion.

All in all, the South Korean tax system can be described as moderately investors' friendly. Although it does offer preferential tax treatments to attract foreign capital, it somehow limits the companies' ability to apply tax strategies aiming at the reduction of a tax burden, has no transparent legislation and undergoes numerous and frequent changes. Above all, it seems that it rather uses fiscal policies to regulate and steer its inner economic situation instead of utilizing it as an explicit tool to attract foreign investors.

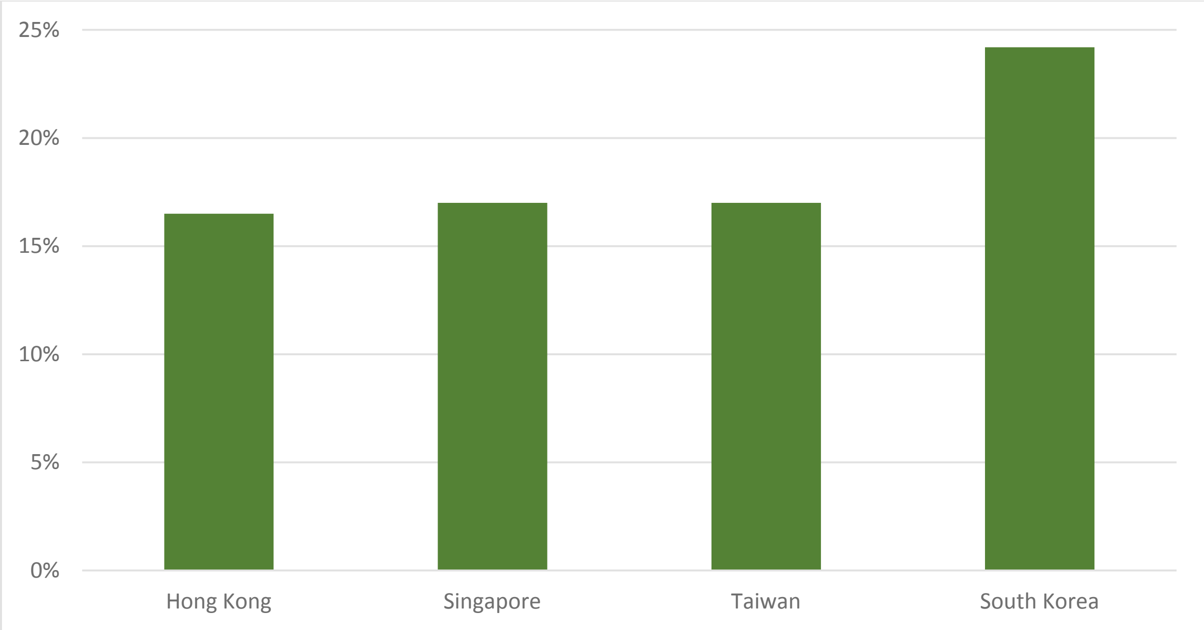
4. Conclusion

In this research paper, there has been undertaken an attempt to compare four Asian Tigers, namely Hong Kong, Taiwan, Singapore and South Korea, in terms of their taxation systems and how attractive they are for the foreign investors. Although there are detectable some common patterns, each region has followed an individually shaped route and applied specific fiscal solutions corresponding to its needs. More or less, all of the aforementioned regions rely on the foreign direct investments (in order to sustain the economic growth) and thus all of them try (to some extent) to use their taxation systems so as to attract the foreign capital. The variety of available fiscal means allows targeting specific investments in terms of their forms and industries in which they are active. The framework created by Morriset and Pirnia provides the list of tax related incentives that can boost the country's attractiveness in the eyes of investors. Those are the rate of the corporate tax and related aspects such as available exemptions or deductions (and alike), available exemptions from local taxes as well as custom and excise duties, the possibility of accelerated write-offs for investment expenditures, the tendency towards lowering the effective tax rate, being a tax have, establishing export processing zones, harmonizing the existing tax system with the internationally accepted norms and signing tax treaties with other tax jurisdictions in order to avoid the double taxation. The more measures from this set are available to the foreign companies, the better chances there are that more foreign capital will be attracted.

Governments creating the favorable investment environment are aware of the fact, that companies might use it to avoid paying taxes or to use transfer pricing methods to shift their profits into the low-tax jurisdictions. Therefore they put emphasis on developing the appropriate legislation which would eliminate such abusive tax strategies.

As already mentioned, each of the investigated region has its own strategy how to form the taxation system. Regarding the corporate tax, Hong Kong has the lowest rate of only 16.5%, followed by Singapore and Taiwan with the rate of 17%. As the difference between Hong Kong and the two latter ones is negligible, South Korea with its 24.2% presents itself relatively unfavorably.

Figure 19: Current corporate tax rates in Asian Tigers



Although in all of those regions there has been observable a trend to lower the corporate tax rate, in South Korea there have been occurring some fluctuations. Hong Kong and Singapore additionally apply the territorial basis for determining the corporate tax payment, meaning that profits derived from foreign companies are not subject to taxation. In Taiwan the situation is slightly different, as it relies exclusively on the place of incorporation to determine company's residence and thus whether it is liable to the corporate tax or not. As a result, domestic entities incorporated under Taiwan Company Law are taxed on a worldwide basis. Same rules apply for South Korea. Consequently, investors considering only this aspect would be choosing between Hong Kong and Singapore, particularly when they operate as multinational corporations active in many countries. However, in all countries it is noticeable, that the main tax burden it has been slowly redirecting from the direct to the indirect taxation. And although the tax base remains quite narrow, the rates are not extremely high (except for South Korea, where the corporate tax rate explicitly cut off from the other analyzed regions).

Figure 20: Territorial basis for taxation in Asian Tigers

All of the Asian Tigers do offer preferential tax treatments within the scope of the corporate tax. The difference lies in their forms. And so Hong Kong focuses on excluding from taxation capital gains, offshore profits, bank deposit interests and dividends as well as granting exemptions to the specific services (mainly financial) and special tax deductions for capital expenditures on chosen fixed assets (such as production machinery, IT soft- and hardware and environmentally friendly vehicles), intellectual property rights and R&D. Although there are no tax holidays, nor tax allowances as such, the applied solutions in the current form do contribute to the flourishing of SMEs and to would-be entrepreneurs. As opposed to Hong Kong, Singapore except for tax exemptions does offer tax holidays. Those favor particularly start-ups and therefore there has been implemented a special Start-up Tax Exemption (SUTE) scheme, guarantying extremely beneficial conditions for firms incorporating in Singapore. Apart from this, government has recently excluded the foreign sourced dividends, foreign branch profits and foreign-sourced service income from taxation (under some specific terms). Additionally, Singapore in order to attract investors to given sectors, has applied the aforementioned tax exemptions and very long (up to 15 years) tax holidays. Those are available to companies active in financial services industry, banks, fund management industry, global trading companies, shipping and maritime industries, tourism industry, event organizers, e-Commerce industry, some approved ventures, insurance companies, processing services' companies, legal firms as well as R&D, innovation and product development activities. Additionally, firms aiming at building their factories in Singapore, acquisition of know-how and patent rights as well as new or second-hand productive equipment, can count on generous investment allowances. In those terms, Singapore offers very specific and accurately targeted incentives. However, they embrace many different industries, thus there is a huge chance to attract investors operating in various sectors and to count on even development across the whole economy. In Taiwan there are also present tax exemptions and tax holidays, nevertheless shorter than in Singapore (only up to 5 years). They can be used by firms operating in sectors perceived as emerging and strategic and those are, above all, transport infrastructure as well as at scientific and technical enterprises. Special tax deferrals and tax exemptions are available to logistic and distribution centers and warehousing companies, simple processing of goods enterprises and their delivery. Apparently, the range of sectors that can count on preferential tax treatments is more limited than in case of Singapore. Moreover, Taiwanese authorities have introduced set of measures that can potentially scare off foreign investors. Those are a 10% profit retention tax and income basic tax, which cause numerous problems with determining the tax due and which definitely act to the companies' detriment as firms have to pay the higher amount of tax. South Korea, as already mentioned, has the highest corporate tax rate among the analyzed regions. Similarly to others, it offers tax exemptions and tax holidays, particularly within the free economic zones and which are mainly eligible for companies active in technology innovation sector. However, many of the incentives have been abolished due to the deteriorating fiscal situation. Such behavior can effectively stop foreign companies from entering the market as they can expect negative changes after they settle down. Importantly, as opposed to Hong Kong and Singapore, South Korea does impose taxes on capital gains. There are also unclear regulations and post-investment reporting obligations entailing both time and financial costs for entrepreneurs. As a result, out of all analyzed regions, Hong Kong followed by Singapore seem to be the most investors' friendly in terms of the corporate tax and related to it aspects. Taiwan, although having comparable tax rate with the latter ones, has introduced more forms of tax burden (e.g. profit retention tax) and offers fewer incentives. At least favorably presents itself South Korea, with much higher tax rate, unstable situation (namely the frequent changes in legislation) and limited scope of exemptions and other fiscal tools lowering the corporate tax burden.

All the regions under scrutiny impose more or fewer local taxes. It is in the investors' best interest that the tax authorities offer some tax exemptions or at least that the imposed local taxes are characterized by low rates, limited range of tax bases and clear regulations. Hong Kong has only 2 meaningful local taxes, namely property tax and stamp duty. The first one has the rate of 15% of the rental profit, while the second one is the fixed fee. Importantly, the property tax is due only in case of rental activities and not when acquiring property for own occupation. It means that investors aiming at building factories and similar buildings (what is often the case by foreign companies) are not obliged to pay it. Except for the fact that those two local taxes account for a rather negligible tax burden to the taxpayers, there is also a whole range of available exemptions. Singapore has a somehow more expanded system of local taxes than Hong Kong, but still relatively limited. Stamp duty, property tax, motor vehicle taxes, betting tax and the foreign worker levy are the most important ones. Except for the betting tax, which rate oscillates between 25% - 30%, the other taxes' rates do not exceed 16%. Additionally the government, in order to facilitate the process, has introduced the taxpayer's friendly IRAS' e-Stamping system for the payment of a stamp duty. The exemptions are also offered especially when the taxable actions lead to the increase in competitiveness. Although the solutions presented by the Singaporean tax authorities seem to be extremely investors' friendly, one must remember that penalties for not paying for instance the stamp duty can be very severe, reaching even 400% of the tax's initial value. The Taiwanese system of local taxes is even more expanded and similarly as in both previous cases, companies are entitled to several exemptions. The respective regulations seem to be somehow complicated and numerous guidelines need to be considered when determining the tax due or when checking the eligibility for reliefs. The rates vary from the very low (0.1% for stamp duty) to very high (100% for the amusement tax). It seems as if the more local taxes were introduced (accompanied by the development of more regulations), the more reliefs and other preferential tax treatments were also appearing as available. Nevertheless, the complexity of legislation acts to the investors' detriment. In South Korea the situation is very similar to the Taiwanese one. Many local taxes are complemented by tax reliefs. Again the legislation is characterized by the detailed regulations and some proficiency in decoding them is required. Therefore, in terms of local taxes, the unchallengeable region is Hong Kong with its very transparent structure. Singapore is right after with the limited range of local taxes and available exemptions. Taiwan and South Korea remain somehow behind. Admittedly, investors may count on exemptions, but the multitude of local taxes and the legislation, which somehow lacks transparency, may discourage foreign investors.

Regarding custom and excise duties, both Hong Kong and Singapore are known as free ports. It means that they are particularly open towards international trade and flows of capital. The average tariff rate equals 0% and there are almost no custom and excise duties imposed on import and export, except for the very few items such as alcohol, tobacco, hydrocarbon oil and methyl alcohol (and on motor vehicles in Singapore). From the investors' point of view such situation is extremely favorable, facilitating the international exchange of all kinds of goods and services. As opposed to those regions, Taiwan applies extremely different policies in this field. Custom duties embrace almost all imported goods, very few exemptions are available and the custom rules are very intricate. It can be said that tax authorities do not consider this field as appropriate for attracting foreign investors. South Korea has also slightly different approach to this issue. Similarly to Taiwan it does impose custom duties, but simultaneously offers a range of exemptions and additionally it has one of the lowest average tariffs rate worldwide of only 8%. To the companies detriment is the fact, that there are also required port entry fees, which are not standardized and thus vary greatly from case to case. Therefore, comparing Asian Tigers in terms of their custom (and excise) duties policies, Hong Kong and Singapore remain unchallenged. South Korea, although not extremely favorable, is not very detrimental neither. Companies exporting chosen goods to South Korea can count on exemptions decreasing the overall financial burden. Taiwan definitely does not encourage investors through the legislation on custom duties it has enacted. There are almost no preferential tax treatments in this area.

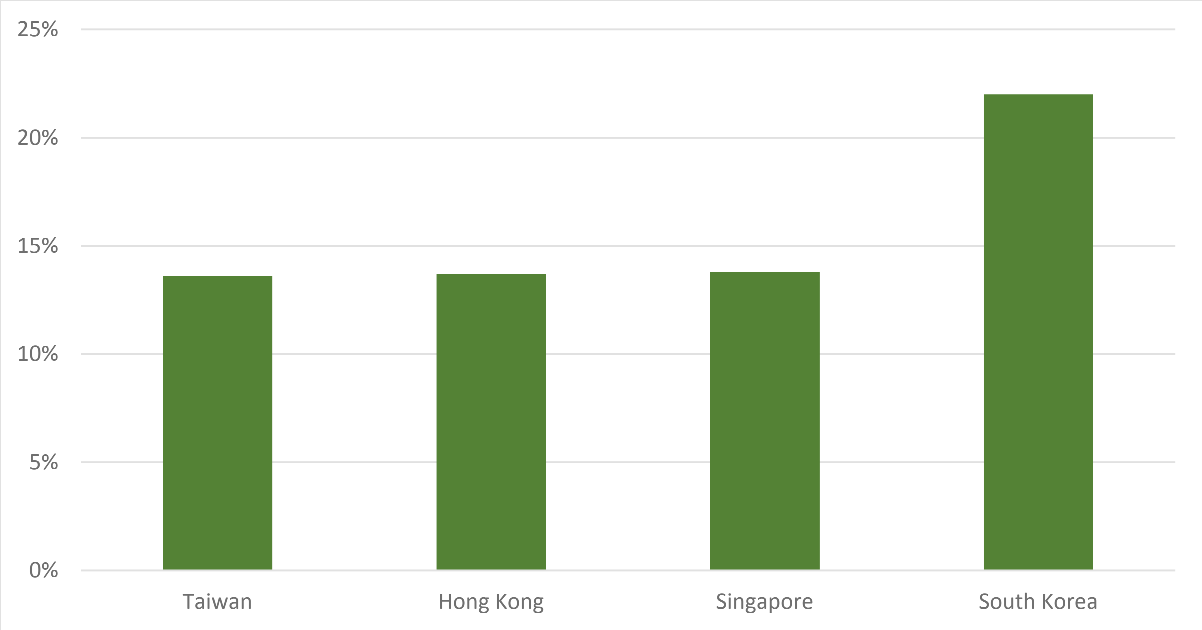
Figure 21: Asian Tigers as free ports

The next issue that has been taken into consideration in this analysis is the possibility of accelerated write-offs for investment expenditures (and related aspects). South Korea does not allow accelerated depreciation of assets or at least no information on that has been found. All the other regions offer more or fewer opportunities for fast write-offs. Hong Kong grants such right to companies active in manufacturing and IT (full depreciation within one year of specific assets), while Singapore focuses on rather on R&D, automation equipment, robots, power generators, pollution control and energy efficient equipment, chosen diesel driven goods, websites and small assets of a maximal value of SGD1.000. Capital allowances are also granted when purchasing property rights or industrial buildings. Taiwan targets similar sectors as Singapore but not all of them. The possibility of an accelerated depreciation is given to companies dealing with R&D as well as energy production and conservation. Clearly, the broadest range of assets eligible for fast write-offs has Singapore. Those are particularly favorable circumstances for investors that need to incur high investment costs on fix capital as they can lower their taxable income and sustain financial liquidity in the same period as the expenditure has been made. Hong Kong and Taiwan although offering an accelerated depreciation, allow it to a much narrower scope of assets. Being much behind, South Korea does not predict in its legislation such possibility.

Figure 22: Possibility of accelerated depreciation in Asian Tigers

In all of the Asian Tigers there can be noticed a trend leading to the decrease of the effective tax rate. It has been achieved not only by lowering the most relevant tax rates (in this case particularly the corporate tax rate), but also through the gradual introduction of more and more tax exemptions, tax holidays and other preferential tax measures. The lowest effective tax rate is ascribed surprisingly to Taiwan and equals 13.6%, followed by Hong Kong with 13.7%, Singapore with 13.8% and South Korea with relatively distinctive on such background 22%. Despite the fact that so far Taiwan did not seem to be the leading region in terms of available preferential tax treatments, it is apparently the winner in this category. One must note however, that Hong Kong and Singapore lose by only fraction of a percent and thus such a small difference should not have significant consequences for investors' decision where to invest while looking at this indicator. On the other hand, South Korea clearly cuts off from the rest in a negative way.

Figure 23: Effective tax rates in Asian Tigers



The next analyzed aspect in this paper was whether regions under scrutiny are (or are considered to be) tax havens. While in case of Taiwan and South Korea which are not, and Hong Kong which is a tax haven the categorization is obvious, the Singaporean case remains somehow unclear. Shortly referring to the first two regions, there are no indications or characteristics of being a tax haven. Therefore, particularly big international companies cannot derive an advantage of moving there their income with the aim of either reducing or even eliminating the tax due. Hong Kong, on the other hand, is the very clear example of a secret jurisdiction. Besides the very transparent tax system with the very few taxes imposed (and very low rates), it does offer much secrecy. Singapore with its very investors' friendly tax regulations, low tax rates and possibilities to evade taxation is perceived by the international society as an example of a tax haven. However, Singaporean authorities deny it and claim the region to be a value-adding hub. In order to be cleared from such (somehow harmful) accusations, Singapore has signed numerous information exchange agreements with other tax jurisdictions and also possess in its legislation tax anti-avoidance regulations. From this perspective, investors looking for the most eligible place for establishing their businesses would incline to choose between Hong Kong and Singapore (maybe to the latter one more as it fights with the harmful opinion and instead presents its legislation as a very competitive), while Taiwan and South Korea would rather stay beyond the companies' consideration.

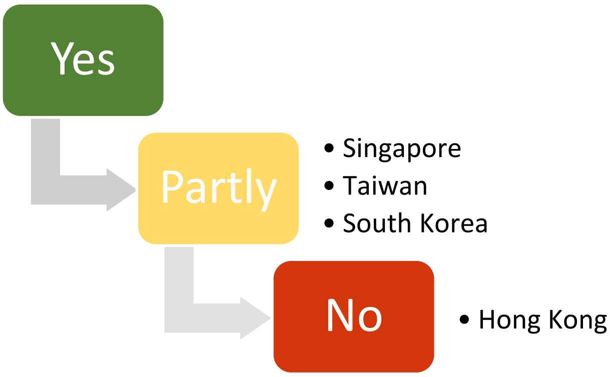
Figure 24: Asian Tigers as tax havens

While Hong Kong and Singapore have not established any export processing zones within their boundaries, Taiwan and South Korea are perfect examples of regions which have relied much on such zones throughout the time period of their economic development and intensified industrialization. South Korea has few of them and offers standard preferential tax treatments such as tax holidays and other reliefs. Taiwan also has several zones, however they seem to be much more famous and better organized (for instance much more information have been found on those, while data on South Korean export processing zones was much more limited and hardly accessible). In Taiwanese export processing zones there are available numerous tax incentives embracing exemptions from the whole range of taxes and custom duties. Also it seems as many industries were eligible for such tax measures, embracing above all capital intensive and hi-tech sectors. Comparing the presence and organization of the export processing zones, the unchallengeable region is Taiwan. South Korea is considered as a second one, but solely because it has such zones. Hong Kong and Singapore cannot be taken into consideration in this case.

Figure 25: Export Processing Zones located in Asian Tigers

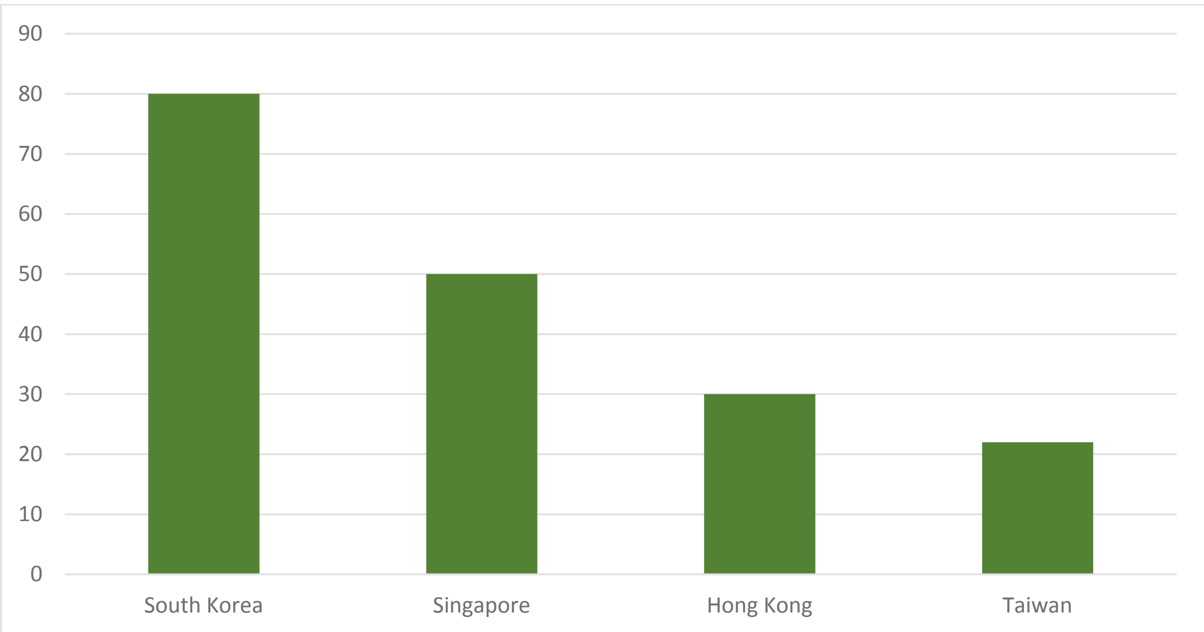
Harmonization of tax systems is important for investors as it facilitates conducting transnational businesses and reduces the need of possessing deep knowledge about each country's tax system separately. None of the regions under scrutiny is characterized by the clear trend towards full harmonization. Particularly Hong Kong, following the strategy of tax competition acts against the commonly accepted rules of tax rates' unification. Singapore, acting similarly to Hong Kong, has however entered into Free Trade Agreements aiming at the standardization of rules and thus facilitating conducting businesses. Taiwan and South Korea, although associated with the tax competition to the much lesser extent than the two other Asian Tigers, do have very complicated legislation and introduce kinds of taxation solutions that are not commonly used by other countries (e.g. income basic tax). Thus, if investors decide to establish companies there, must be prepared for dealing with intricate regulations and much proficiency will be required from them. In this sense it is hard to point out the single region that is superior to the rest. Probably Singapore does the most to harmonize its tax rules with the simultaneous preservation of some of its characteristic for the tax competitive jurisdiction features.

Figure 26: Harmonization of Asian Tigers' tax systems



Hong Kong, Singapore, Taiwan and South Korea have all entered into bilateral tax treaties with other countries. Such agreements are important for investors, as they can avoid double taxation and hence retain more profits for themselves. Each of the Asian Tigers has used the OECD treaty model. The difference lies therefore only in a number of treaties each one has signed. Undeniably, South Korea has entered the highest number of treaties, namely over 80. Placed on the second place, Singapore have over 50 agreements. Hong Kong has nearly 30 treaties, while Taiwan only 25. The more tax treaties have been signed, the smaller the investors' discrimination due to their home country. South Korea is the most attractive region in those terms.

Figure 27: Number of bilateral tax treaties signed by each Asian Tiger



The very important aspect, also addressed in this research paper, is the investors' possibility of avoiding taxation in each of the analyzed regions. In some of them, the problem seems to be clearer, while in the others rather negligible. However, all the regions have introduced specific measures against the tax evasion. Hong Kong has enacted legislation on transfer pricing accompanied by severe fines if not following it. It has however not implemented the thin capitalization nor CFC rules. Additionally the secrecy provided by institutions can effectively hinder the process of successful detection of tax evasion. Singapore's situation is relatively similar. The absence of thin capitalization and CFC rules is supplemented by general and specific anti-avoidance rules and penalties (including even imprisonment up to half a year time period). Taiwan and South Korea face fewer problems regarding the tax evasion. It is not necessary due to the fact that the anti-avoidance regulations are so effective, but could be the result of a less attractive fiscal environment for shifting income or avoiding the tax payment there. Nevertheless, they have introduced all forms of the most common regulations, (also those absent in Hong Kong and Singapore, aiming at fighting off the harmful tax practices). The arrangements between tax authorities and taxpayers seem to be relatively flexible and penalties for unlawful acts are a bit less severe. Regarding Hong Kong and Singapore, on the one hand, they definitely enable investors to apply more tax avoidance methods, as the legislation is more relaxed. On the other hand, the penalties are harsh. Reality shows that companies do practice tax evasion in those regions, although governments try to limit such behavior. Taiwan and South Korea face fewer challenges in terms of tax evasion. They have well developed regulations which effectively impede tax avoidance attempts. Therefore, from the companies' perspective, rather Hong Kong and Singapore than Taiwan and South Korea, seem to be more attractive as they allow more tax savings.

Objectively speaking it is hard to indicate one region that is far superior to the others. The analysis shows that each of the Asian Tigers has some strong and weak points. Though, it can be easily stated that the South Korean tax system is the least friendly one for investors. Although it has a strong advantage in form of export processing zones and numerous bilateral tax treaties, its complicated regulations accompanied by frequent changes, relatively high tax rates and fewer preferential tax treatments (when compared to the other Asian Tigers), it classifies South Korea as the least favorable place for foreign investors. Taiwan performs somehow better. It offers broad range of tax exemptions, tax holidays, export processing zones and very low effective tax rate. It performs badly in terms of introduction of additional taxes and intricate legislation. Investors counting on preferential tax treatments can expect them indeed, however they must show much proficiency and knowledge about the existing laws. Hong Kong and Singapore are both characterized by very liberal attitudes reflected in extremely friendly fiscal policies. They definitely outperform their competitors in terms of legislation clarity, well targeted tax incentives, low tax rates and very few types of taxes imposed as well as by the fact that they are (or are perceived) as tax havens, thus allowing tax savings. Taiwanese low effective tax rate somehow loses on its importance, as both Hong Kong's and Singaporean effective tax rates are almost the same, but outweigh Taiwan in other aspects. Choosing between Hong Kong and Singapore is problematic. Hong Kong is extremely attractive for investors, but generally it perceives its tax system as so favorable that it does not necessitates to introduce more incentives targeting very specific kinds of investments. Singapore is also characterized by creating investors' friendly environment, however it shapes this situation more consciously. Namely, it specifically targets chosen industries by the use of fiscal tools so as redirect the foreign capital to sectors that it considers important. Additionally, as opposed to Hong Kong, it tries to deny the fact of being tax haven and to prove that it is just very competitive instead. This fact is important, as international coalitions and organizations try to fight down the practices of tax havens and thus countries holding this title can be harmed by attempts to discourage investments in such jurisdictions. As a consequence, this aspect of being tax haven (offering many possibilities for avoiding tax payments) brings an advantage to Hong Kong because it lures companies. Simultaneously, trying not to officially be a tax haven benefits Singapore, who denies being a secret jurisdiction, because companies' image is exposed much less to harmful accusations of unlawful tax evasion practices.

In the table below there have been summarized the most important findings. Although the structure and content of the table differs from the analytical framework, this conscious transformation serves the better presentation of the offered (or lacking) preferential tax treatments by (in) each region. This table should facilitate the process of comparisons between the analyzed Asian Tigers and more clearly indicate the level of their tax system attractiveness towards FDI.

Table 3: Summary of tax systems' attractiveness towards FDI

	Hong Kong	**Taiwan**	**Singa-pore**	**South Korea**
Corporate tax exemptions	√	√	√	√
Tax holidays		√	√	√
Exemptions from local taxes	√	√	√	√
Friendly custom and excise duties policies	√		√	√
Accelerated depreciation and investment tax allowances	√	√	√	
Low effective tax rate	√	√	√	
Tax haven	√		√ (?)	
Export Processing Zones		√		√
Full harmonization of tax system				
Bilateral tax treaties	√	√	√	√
Tax anti-avoidance measures	√	√	√	√
Clear and understandable tax regulations	√		√	
Relatively few taxes imposed on enterprises	√		√	

All in all, in an attempt to rank four Asian Tigers in accordance to the degree of their tax systems' friendliness towards investors, both Hong Kong and Singapore would be ranked first, Taiwan right after as a second one and South Korea much behind on the last place. One must remember nevertheless, that specific companies active in given industries are prone to different incentives. And although Hong Kong and Singapore tax systems might seem superior, a foreign investor dealing for instance with renewable energy sources might decide to establish its company in Taiwan as it can count there on more favorable tax incentives in energy conservation than in the other regions. Therefore, most probably, investors will pay attention to specific advantages they are interested in, rather than solely consider the overall tax system. Thus, it is not surprising that despite one's system supremacy over the other, investments come to all of the analyzed regions. It is also important to perceive the taxation system as a supplementation of the overall economic situation and infrastructure and not as a separate, independent system.

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6. List of tables and figures

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Abstract

Hong Kong, Taiwan, Singapore and South Korea, commonly known as Asian Tigers are the perfect examples of economic miracles. Beginning in 1960s, they have undergone rapid industrialization process and nowadays they are among the most developed regions worldwide. Much of their success can be attributed to the increased inflows of foreign direct investments (FDI). Governments wanting to attract more and more foreign capital have been trying to create a business friendly environment. One of its important components is the taxation system. This thesis investigates the attractiveness of each Asian Tiger's tax system for the foreign investors. Based on the framework provided by Morriset and Pirnia, several components of a fiscal system, which are considered as the most important in attracting foreign capital, have been singled out, thoroughly analyzed and compared between regions. It has been found, that both Hong Kong's and Singapore have the most investors' friendly taxation systems. Taiwan, although offering numerous preferential tax treatment to foreign companies, is slightly behind the first two regions. South Korea turns out to be the least friendly country. While the difference between Taiwan and the two city states of Hong Kong and Singapore is not extreme, South Korea clearly cuts off from the rest in negative terms.

Zusammenfassung

Hong Kong, Taiwan, Singapur und Südkorea, allgemein bekannt als Asian Tigers, sind die perfekten Beispiele von Wirtschaftswunder. Beginnend in den 1960er Jahren, haben sich diese Regionen einer schnellen Industrialisierung untergezogen und gehören heute zu den am meisten entwickelten Regionen weltweit. Ein Großteil ihres Erfolges kann auf die erhöhten Zuflüsse von ausländischen Direktinvestitionen (FDI) zurückgeführt werden. Die Regierungen, die immer mehr ausländisches Kapital anzuziehen möchten, versuchen ein unternehmensfreundliches Umfeld zu schaffen. Eine der wichtigsten Komponenten ist das Steuerwesen. Diese wissenschaftliche Arbeit untersucht die Attraktivität des Steuersystems jedes Asian Tigers für die ausländischen Investoren. Basierend auf dem Modell von Morriset und Pirnia, es wurden mehrere Komponenten eines Steuersystems (die als die wichtigsten im Anziehen des ausländisches Kapitals wahrgenommen werden) herausgegriffen und danach gründlich analysiert und verglichen zwischen den Regionen. Es wurde festgestellt, dass beide Hongkong und Singapur die freundlichsten Steuersysteme in Bezug auf ausländischen Investoren haben. Taiwan, trotz der Tatsache, dass es auch zahlreiche Steuervergünstigungen den ausländischen Unternehmen offeriert, ist ein bisschen hinter den ersten beiden Regionen. Südkorea entpuppt sich als die am wenigsten freundliches Land. Während der Unterschied zwischen Taiwan und den beiden Stadtstaaten, Hongkong und Singapur, ist nicht extrem, Südkorea schneidet sich deutlich von dem Rest in negativer Hinsicht ab.

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