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THE (UN)CERTAIN FUTURE OF TAX SPARING CREDIT IN INTERNATIONAL TAX TREATY LAW

Tax sparing clause emerged in double taxation treaties 63 years ago. Despite criticisms, it can presently be found in about 15% of all treaties, with Serbia having this clause in 46% of its double taxation agreements. It is the authors' view that this provision represents a confirmation of the right to introduce tax incentives as a part of a country's right to tax, while pointing out the necessity of preventing abuses of the provision. After conducting an analysis of the effects of tax sparing on foreign direct investments in Serbia and outgoing investments of Serbia's residents, the remaining portion of the paper

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is dedicated to exploration of the interaction between GloBE Income Inclusion Rule and tax sparing. Their incompatibility, which implies that tax sparing would be annulled under BEPS 2.0, may be overcome via a specific carve-out, but at present such initiative is not endorsed by Inclusive Framework on BEPS.

Key words: *Tax sparing credit*. – *Double tax treaty*. – *Foreign direct investments*. – *Income inclusion rule*. – *Substance-based carve-out*.

1. INTRODUCTION

Serbia is a state with a relatively developed network of double taxation treaties, and its representatives are active in the Organisation for Economic Cooperation and Development (OECD) Committee on Fiscal Affairs – together with representatives of 30 other non-member states – in the continuous efforts to advance the OECD Model Tax Convention on Income and on Capital (hereinafter: OECD Model Tax Convention).[1] Taking into account its involvement in the preparation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, as well as in the Framework on BEPS (Base Erosion and Profit Shifting), it could be said that Serbia's role in the creation, interpretation and implementation of international tax law order is, to say the least, notably cooperative and based on the professionalism of its representatives in the working bodies.

One of Serbia's objections is related to the tax sparing credit clause, which is not contained in the OECD Model Tax Convention. In this respect, Serbia has reserved the right to include such stipulations in its tax treaties.[2] The circumstance where it achieved this in nearly 50% of its double taxation treaties – despite the nearly quarter-century-long criticism of tax sparing credit by the OECD – demonstrates that, in addition to six members of the OECD with which Serbia has tax treaties that include tax sparing credit clauses, a significant number of countries with a similar level of economic development as Serbia (or even lower) have demonstrated the readiness to support the other contracting state (Serbia) through tax sparing credit, in its effort to attract foreign direct investments through tax incentives. This has most commonly been met by a reciprocal concession on the part of Serbia.

[1] Serbia has stated its position in regard to 17 articles of the OECD Model Tax Convention (the 2017 version) and in regard to the commentary to three articles.

[2] Eleven other non-member states have done the same.

The aim of this paper is primarily to establish what is tax sparing credit and what are its forms in contemporary international tax treaty law, as well as to analyse the evolution of the position of the OECD, academic circles, and developing countries authorities regarding this institute. The fourth part of the paper explores the true objective of the tax sparing credit and its effects in Serbia. The fifth part of the paper analyses the relationship between the tax sparing credit and the announced income inclusion rule in the BEPS 2.0 measures. The concluding considerations are given in the final part.

2. CONCEPT AND TYPES

In international tax law, tax credit represents the sum of the income or capital tax paid in the source country that can be deduced from the tax the residence country determines on the global income or capital. Some double taxation treaties do, however, contain a type of tax credit – a tax sparing clause – which does not include the condition that the sum of the tax for which the tax obligation of the resident may be reduced must be *paid* in the source country. In the case of the tax sparing credit, the tax that is paid in the other contracting state entails also the tax that *would have been paid* in the other country, had it not been reduced or written off in accordance with its legal stipulations pertaining to tax incentives.[3] It is sometimes called *contingent relief* because its extent depends on the degree of relief in the source country (Li 2017, 547).

A similar instrument to the tax sparing credit is the *crédito presumido* (Tavares, Crispim 2017), which in English is most commonly called *matching credit*, and less often *fixed relief method* (Holland, Vann 1998, 1014). It involves the residence country accepting to provide credit for a foreign tax on certain types of income, in the amount determined in the tax treaty, and

[3] Some states (e.g. United Kingdom) insist that the tax treaty cite the laws of the source country whose stipulations prescribe tax incentives, with the possibility of accepting subsequent minor amendments to the stipulations that do not affect their overall nature. Should a different provision, which recognises a given tax relief, be subsequently adopted, the competent authority of the contracting state is to concur that it is similar in nature to the provisions cited in the tax treaty. Furthermore, the competent authority of the source country is required to provide confirmation that the tax relief was granted with the aim of improving the country's development. *See* Convention between the United Kingdom of Great Britain and Northern Ireland and the Socialist Federal Republic of Yugoslavia for the Avoidance of Double Taxation with respect to Taxes on Income, *Official Gazette of the SFRY – International Treaties* 7/1982, Art. 22, paras. 3 and 4. This tax treaty applies to Serbia, as one of the successors of the SFRY.

which is usually higher than the maximal tax sum that is otherwise permitted to the source country in the said treaty or the sum stipulated in its national legislation.[4] Therefore, the sum of the tax credit approved by the residence country does not depend on the tax relief regulations in the source country. The greater the difference between the contracted credit and the tax rate that is applied in the source country, the greater the tax benefit for the taxpayer. The tax sparing credit and matching credit differ in that the former's "fictional" tax that is recognised in special situations as credit is defined by the relief granted in the source country, while in the latter case the "fictional" tax is not necessarily linked to the level of taxation in the source country nor to the relief that it provides.[5] The tax sparing credit is most commonly related to the waived taxation of those parts of the income and capital that the source country could subject to its taxation, while the matching credit is usually confined to withholding taxes on passive income (dividends, interest, and royalties) (Holland, Vann 1998, 1014).[6] Exceptionally, e.g. in the 1993 tax treaty between the Netherlands and Bangladesh, the matching credit is

[4] For example, Article 3 para. 3 of the 1975 tax treaty between Sweden and Brazil stipulates that in the case of dividends that companies that are residents of Brazil pay to companies (with the exception of partnership and entrepreneurs) that are residents of Sweden, and of royalties, it will be considered that the rate of Brazilian tax (which may be claimed in Sweden as a credit against the tax that it applies as the residence country) is 25%, and 20% for interest, regardless of the fact that Arts. 10–12 of that tax treaty limit the tax on intercompany dividends, interest (with the exception of when the recipient is an individual, partnership or entrepreneur), and royalties (with the exception of trademark), applicable by the source country, to 15%. See: *https://research. ibfd.org/#/doc?url=/data/treaty/docs/html/tt_br-se_01_eng_1975_tt__td1.html* (last visited 15 February, 2022).

[5] There are no significant disagreements regarding the definition of tax sparing credit in tax law literature, but the same is not the case with the definition of matching credit. Therefore, the position of the French Council of State (*Conseil d'État*), that the implementation of the matching credit clause contained in the 1971 tax treaty between France and Brazil requires at least a minimal level of taxation in the source country, is no surprise. *See:* Conseil d'État, *Société Natexis Banques Populaires v. France*, No. 284930, 26 July 2006. *https://www.legifrance.gouv.fr/ceta/id/CETATEXT000008244748/* (last visited 20 February, 2022). However, certain Brazilian and South American authors in general do not agree with such an interpretation (Schoueri 2013, 109; Barreto 2021, 65–66), believing that the matching credit does not depend on the tax relief in the source country and that therefore the minimal tax level condition, which is applied in the source country for enforcement of the matching credit clause, should not exist.

[6] A rare exception is found in Article 24(5) of the 1979 tax treaty between Argentina and Italy. *https://research.ibfd.org/#/doc?url=/data/treaty/docs/html/tt_ar-it_02_spa_1979_tt__td2.html%23tt_ar-it_02_spa 1979_tt__td2_a24* (last visited 22 February, 2022) Its provision stipulates that if, based on Argentinian law, the Argentinian tax on corporate profits is not entirely or partially collected during a certain period of time, it will be considered that this tax, for the purposes of

enhanced by tax sparing credit elements. If, due to the special relief granted based on Bangladeshi law with the intention of encouraging investment in Bangladesh, a tax with a rate lower than 10% has been imposed on interest and royalties in Bangladesh (which the Articles 11(2) and 12(2) of the tax treaty stipulate is the limit to which the source country may tax these two types of income), it will be considered that the tax paid in Bangladesh on those interests and royalties is 10%. However, if according to Bangladeshi law the general tax rates that apply to interest and royalties are reduced below 10%, the lower rates will apply in these cases.[7]

Some authors consider tax sparing credit and matching credit to be the variants of the same mechanism – tax sparing credit in the broader sense, while considering the former as tax sparing credit *stricto sensu* (Schoueri 2013, 109). In our further analysis we will predominantly discuss tax sparing credit *stricto sensu*, which will not be emphasised unless the need arises to differentiate it from matching credit. Furthermore, this variant is the only one that exists in Serbia's tax treaties.

3. DEVELOPMENT OF THE TAX SPARING CREDIT IDEA: DOUBTS, ACCEPTANCE, REASSESSMENT

The explanation for why taxpayers would be recognised the right to a tax deduction in their residence country for the sum that they did not pay in the source country can be found in the nature of tax credit as a method for eliminating double (juridical) taxation. In its original form it annuls the effect of tax incentives provided by the source country with the aim of attracting foreign investors: the relief that it achieved in the country of investment would be lost by the taxpayer in its residence country, which would first determine the tax on its global income, and then only recognise as tax credit the sum of the tax paid in the country of investment. A reasonable assumption is that in the situation when the source country provides the tax relief, the patriotic "urge" – caused by the tax revenue ending up in the treasury of its residence country and not in the treasury of the source

application of the tax credit by the Italian side, has been collected at a rate of 15%. Incidentally, Article 25(4) sets the "standard" matching credit of 15% for dividends, and 20% for interest and royalties.

[7] Article 23(4) of the Convention between the Netherlands and Bangladesh for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income. *https://wetten.overheid.nl/ BWBV0001126/1994–06–08* (last visited 22 February, 2022).

country – will not especially motivate investors to invest in the source country. However, if the tax sparing credit clause is contracted, the residence country will suffer the "fiscal sacrifice" and the source country will achieve the desired goal, because its tax incentive will actually benefit the taxpayer. This "sacrifice" may be in solidarity with the developing country, as support for its intentions to stimulate foreign direct investments, but the source country is often asked in return to lower withholding tax rates or provide stricter permanent establishment rules (OECD 1998, 13).

Discussions on the efficiency of the tax sparing credit have been ongoing since the emergence of the idea of introducing this institute into international tax law. It was first mentioned in 1953 in the report of the British Royal Commission on the Taxation of Profits and Income,[8] which discussed the justification for providing this type of support to the efforts of the British colonies and countries of the Commonwealth to attract (British) investors through tax reliefs. However, in 1957 (conservative) Chancellor of the Exchequer Peter Thorneycroft turned down the proposal by the Royal Commission to introduce tax sparing credit (Surrey 1957, 7). Nonetheless, already in 1961, the United Kingdom ratified a tax treaty with Pakistan that included the tax sparing credit clause, after the UK Parliament previously enacted legislation that approved such support to developing countries, in order to maintain the effects of their tax relief programmes aimed at promoting industrial, trade, scientific, educational, and other development (OECD 1998, 15). Therefore, even though the concept of tax sparing credit was created in the UK, the first treaties for the avoidance of double taxation to included it had been concluded back in 1959, between FR Germany and India, and between Sweden and Israel (Pepper *et al.* 1972, 3–25). The treaty with Pakistan was not ratified by the United States Senate in 1957, specifically because of the tax sparing credit clause, since it had been significantly swayed by the arguments presented by Harvard Professor Stanley Surrey to the Committee on Foreign Relations (Surrey 1957, 1–25).[9] This has shaped the US negative view of tax sparing credit, which continues

[8] Great Britain. Royal Commission on the Taxation of Profits and Income 1953, 3. See especially Prest 1956, 366–374.

[9] Surrey pointed out that the tax sparing clause was in contradiction with the approach adopted by US domestic law not to make concessions in the case of taxes on foreign corporate profits; that the concession provided for Pakistan would create a precedent for many future such concessions; that the tax sparing credit violates the tax credit mechanism; that it is fundamentally unnecessary taking into consideration the benefit of postponing the tax liability enjoyed by the subsidiaries of American corporations for business in foreign states where they are residents; that the tax sparing credit clause encourages irrational shaping of taxes in the foreign state and corruptive acts by foreign governments; etc.

to this day: not a single double taxation treaty concluded by the US contains a tax sparing clause. Further contributing to this was the fact that Surrey became Assistant Secretary of the Treasury for Tax Policy in the Kennedy and Johnson administrations (1961–1969), and especially the specific position of the US as a country with a vast domestic market, which "has always taken a strong stance in favour of 'investment at home.' Also, of course, because of its large potential capital-exporting position, the United States has greater revenue loss concerns than many other countries." (Brooks 2009, 521).

The commentary to Article 23 of the 1963 OECD Draft Double Taxation Convention on Income and Capital, which defines the methods for eliminating double taxation, mentions that if a developing country provides tax incentives, the other contracting party can either exempt the income from activities that the developing country is striving to encourage, or provide a tax sparing credit *lato sensu*, where the contracting states themselves choose the form of the provisions on that credit. We agree with the opinion in Brooks (2009, 522) that the OECD had at the time provided "lukewarm" endorsement of the tax sparing clause. A similar opinion was presented in the 1977 OECD Model Tax Convention, specifically in the commentary to Article 23: if two contracting states agree that the benefits that the source country has provided should not be annulled, it is possible to choose between matching credit, tax sparing credit *stricto sensu*, and the exemption method, and the contracting states may develop another formula. The commentary points out that the source country (developing country) in such a context should accept the limitation of its withholding tax rates for dividends, interest and royalties, and limiting the duration of the provided benefits in the form of tax sparing credit or exemption. Alternatively, those benefits should be provided only for investments that are contracted after the tax treaty comes into effect.[10]

Despite the weak support of the OECD – or perhaps thanks to it – the last third of the 20th century became the "golden age" for tax sparing credit. During that time around 1,500 tax treaties were in force (OECD 1998, 14). For example, between 1961 and 1999, the United Kingdom accepted tax sparing clauses in 47 tax treaties (Brooks 2009, 517–518), but in subsequent years – only in two tax treaties. Taking the OECD data as a whole, 31% of the treaties on double taxation between members and developing countries stipulated tax sparing credit, most of them concluded prior to 2002 (Azémar, Dharmapala 2019a, 6). The absence of a stronger commitment by the OECD

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[10] *Model Double Taxation Convention on Income and on Capital*, OECD, Paris 1977, Commentary on Articles 23A and 23B, paras. 70–76.

regarding this clause is understandable taking into account that the Model Tax Convention was primarily intended for the organisation's member states as a model for concluding tax treaties between themselves and which as a rule did not include tax sparing credit because they had developed economies. Also, one should not neglect the influence of the US in the OECD Committee on Fiscal Affairs, which was significantly shaped by Surrey's arguments against the institute of tax sparing.

The initially "lukewarm" endorsement of the OECD was transformed into opposition to introducing tax sparing credit provisions into tax treaties.[11] The report *Tax Sparing: A Reconsideration* (OECD 1998) particularly lists the following reasons:

(1) ineffectiveness – from the viewpoint of the great majority of OECD member states – of the tax sparing credit as an instrument for encouraging foreign investments and achieving national economic goals (OECD 1998, 12);

(2) broad space for abuse: (a) through transfer prices, (b) through establishing a conduit company by the investor from the third country, who takes advantage of the benefits from the tax treaty the residence state has with the source state and invests into the source country through that company, which has been granted benefits in the form of tax sparing credit, (c) through routing, where a resident bank provides a loan to a foreign investor through the bank in the developing country, in order to take advantage of tax sparing credit on withholding taxes stipulated in the tax treaty between the country or residence and the developing country; (d) through artificially increasing tax rates in the source country, in order to apply pressure on the residence country to provide greater tax sparing credit (OECD 1998, 29, 36–37);[12]

[11] The OECD report does not contain the explicit recommendation that the member state abandon the tax sparing credit clause, but it clearly indicates the need for them to revise its contracting (OECD 1998, 42–43).

[12] The report states that the treaty should explicitly envision that domestic anti-abuse norms will apply also to the tax sparing credit clause, and it also recommends that in addition to this provision, special anti-abuse clauses be embedded with the aim of preventing the abuse of the tax sparing credit. Subsequently, in the BEPS era, anti-abuse rules were created in the form of a principal purpose of transaction or arrangement test, and the clause on limitation of benefits, which are embedded in tax treaties and also apply to the tax sparing clause.

(3) the circumstance that the tax incentive provided by the source country – even without the tax sparing credit – will not be lost if the profit of the subsidiary of the resident investor, which is the resident of the source country, remains unrepatriated (OECD 1998, 42);

(4) possible harmful effects on the source country if the tax sparing clause encourages increased repatriation of profit, therefore reducing its reinvestment (OECD 1998, 22–23);

(5) the impossibility for the residence country to determine the expense (i.e. loss of tax revenue) of providing support to the source country through tax sparing credit (OECD 1998, 22);

(6) the absence of a need to provide further support, in the form of tax sparing credit, to states that are not members of the OECD, because many of them have grown economically stronger in the meantime (OECD 1998, 21);

(7) the weaknesses of tax incentives in principle, since they are considered distortive and complicated (OECD 1998, 25–28);

(8) poorly formulated provisions in tax treaties on tax sparing credit can encourage harmful tax competition, i.e. support benefits that erode the tax basis of the residence country (OECD 1998, 41);

(9) administrative difficulties in the implementation of provisions on the tax sparing credit, especially in proving that the taxpayer has actually achieved tax benefit based on the regulations of the source country that stipulate tax incentives (OECD 1998, 30);

(10) objections by developing countries that in negotiations pertaining to the conclusion of tax treaties, in the part related to the tax sparing credit, they are asked to additionally lower rates of withholding taxes in return (OECD 1998, 13). This argument is cynical to some extent, because Article 12 para. 1 of the OECD Model Tax Convention stipulates that the source countries cannot introduce withholding taxes on royalties;

(11) the potential disabling of the local Controlled Foreign Corporation (CFC) legislation due to the ban in principle, in Article 27 of the Vienna Convention on the Law of Treaties[13] that the contracting party may cite stipulations of its domestic law for the purpose of

[13] Decree on the ratification of the Vienna Convention on the Law of Treaties, *Official Gazette of the SFRY – International Treaties* 30/1972.

> justifying the failure to implement the treaty.[14] This is why the 1998 OECD report proposes that tax treaties include explicit stipulations regarding the supremacy of national CFC rules over the tax sparing credit clause (OECD 1998, 38–39; Ferreira 2021, sec. 10.4).[15]

The OECD report also influenced subsequent versions of the OECD Model Tax Convention, including the latest version, from 2017. The commentary to Article 23B (OECD 2017a, paras. 75–78.1) points out the fundamental highlights from the report: the potential for abuse created by tax sparing credit, the (in)effectiveness of tax sparing credit as an instrument for foreign assistance in the development of the source country, and the concern that tax sparing may stimulate states to use tax incentives for the purpose of harmful tax competition. The commentary also does not explicitly insist that the inclusion of a tax sparing credit clause should cease, but it does emphasise that such clause could be found – nearly as *ultimum remedium* – only in treaties where the economic level of the other contracting state is significantly beneath the level of the OECD member states. Therefore, it is not surprising that in the 21st century there are relatively few new tax treaties between OECD member states and developing countries that include a tax sparing credit clause. We estimate that since 2000, more than 2,000 treaties for the avoidance of double taxation have been concluded.[16]

[14] See *infra*, section 5.1 for a discussion on the possible justification of the application of domestic CFC rules to the profit of a non-resident company, even though Article 7 of the tax treaty, based on the OECD Model Tax Convention, stipulates that the profit of the company from the contracting state will be taxed only in that state (unless the company operates in the other contracting state through a permanent establishment).

[15] If the CFC measures were to apply only to passive income, income of conduit companies, income from highly mobile sources, and income from jurisdictions with low taxes (Barker 2007, 356), and the tax sparing credit clause were to apply only on active income – there would be no collision. However, in practice the provisions on the tax sparing credit also often apply to passive income, and some CFC legislations (such as in Brazil) do not limit themselves only to passive income or to income from jurisdictions with low taxes, but to the total profit of controlled foreign companies. The legislator does not call it "profit" but rather "variation in the value of investment equivalent to profits" (orig. "variação do valor do investimento equivalente aos lucros"), in order to create the illusion that it is not taxation at the level of a foreign company but at the level of a Brazilian one, therefore avoiding challenges to the constitutionality of the CFC rules and incompatibility with Article 7 of the OECD Model Tax Convention and UN Model Double Taxation Convention.

[16] The study covering the 1997–2013 period (Wijnen, De Goede 2014, 118), shows that at the time 1,854 tax treaties were concluded (1,811 were analysed and 43 were not available to the authors). We believe that Andrade (2020, 14) gives an incorrect exaggerated estimate that between 2000 and 2020 around 4,000 treaties for the

During the 2000–2020 period, the common law countries (United Kingdom, Canada, Australia, and New Zealand), which were very active in the last third of the 20th century in providing tax sparing credit clauses in the tax treaties that they concluded at the time, signed a total of only seven such tax treaties with developing countries and two with other OECD members. A similar treatment can be noted in other OECD member states, which had previously been prepared to provide a tax sparing clause (Andrade 2020, 14, 16–18, 20–21).[17] Overall, tax sparing credit clauses exist in more than 5% of all tax treaties concluded since 2000, but one should not neglect the circumstance that most clauses from the treaties signed in the last third of the 20th century are still in force, raising their presence in treaties for the avoidance of double taxation closer to 15%.

On the other hand, 12 countries, including Serbia,[18] have presented their position regarding Article 23 of the OECD Model Tax Convention, retaining the right to add tax sparing credit provisions related to tax incentives prescribed in their national legislations. This is why the Draft treaty for the avoidance of double taxation, which is the starting point for Serbia's representatives in negotiations on concluding tax treaties (predominantly based on the OECD Model Tax Convention, but also to some extent on the UN Model Double Taxation Convention), includes a tax sparing credit clause (Dabetić 2008, 188). However, the final outcome of the negotiations depends on the relative bargaining powers of the two sides, therefore Serbia does not condition the conclusion of the treaty on the acceptance of this provision, provided that it receives concessions on some other provisions, nor can it insist on this provision in negotiations with countries that have greater bargaining power. In the course of the current century, Serbia has concluded 17 tax treaties

avoidance of double taxation were signed, because the most common number is somewhat above 3,000 treaties, which also includes those from the 20th century. Compare OECD 2017b; International Centre for Tax and Development 2021.

[17] According to the calculation of the authors of this article, based on the overview provided by Andrade (2020, 14–16), during the 2000–2020 period 17 other members of the OECD (Turkey, Spain, Ireland, Italy, Luxembourg, Greece, Germany, Korea, Portugal, Norway, Latvia, Slovakia, Estonia, Poland, Austria, Finland, and Switzerland) concluded a total of 27 such tax treaties with countries that are not members of the organisation, and three with other members. In total, between 2000 and 2020 the OECD member states concluded tax treaties with 34 developing countries, containing a tax sparing clause *lato sensu*, while it also appears in round 70 tax treaties concluded between states and jurisdictions that are not OECD members. One should bear in mind that Andrade states that the list is not comprehensive.

[18] Albania, Argentina, Brazil, India, Ivory Coast, Malaysia, Morocco, China, Serbia, Thailand, Tunisia, and Vietnam.

that contain a tax sparing clause, comprising a significant 38.6% of the total number of tax treaties concluded during that period (44), but only one of them was with an OECD member state (Hungary).

Despite the generally unfavourable attitude of the OECD, we conclude that the tax sparing credit has not been completely marginalised, because its implementation continues in numerous previous tax treaties, and it is also included in some new treaties, particularly those where one of the contracting states is an emerging influential economic power, such as China, India, Vietnam, or (until recently) Brazil, which could also find itself in the role of a capital exporting country, as well as a capital importing country. The theoretical foundation for disputing the OECD attitude can be found primarily in South American tax law literature. Bearing in mind that due to the long-term insistence of leading South American countries on the tax sparing credit clause and persistent refusal by the United States of America, the US now has only one treaty for the avoidance of double taxation with a country in that region (Venezuela)[19] and one with a Central American partner (Mexico) – where both countries are large oil exporters (Avi-Yonah 2019, 3).[20]

Advocating the revision of the OECD attitudes, Brazilian tax legal scholar Luís Eduardo Schoueri summarised the arguments in favour of the matching credit and tax sparing credit *stricto sensu*. In his opinion, the aim of the matching credit it to ensure that in the situation when the source country unilaterally limits its right to tax and stipulates a tax relief in the form of a lower tax rate (e.g. from 25% to 15%), the residence country will continue providing the tax credit, as if the tax relief did not exist, where the taxpayer will exact privilege directly from the tax treaty, reflected in the difference between the "standard" rate that the residence country recognises for the use of the tax credit (25%) and the lower rate that is applied by the

[19] The tax treaty between the US and Venezuela was signed on 25 January 1999 – eight days before Hugo Chávez came to power in Venezuela. The Senate ratified it and it came into force on 1 January 2000.

[20] Avi-Yonah (2019, 4) believes that the refusal to accept the tax sparing clause is a fake clue when attempting to explain the absence of a wide network of tax treaties between the USA and Latin America. In his opinion, the true reason is the highly unequal flow of investments, which would lead to the one-sided loss of tax revenue in the source countries. It is therefore no surprise that the only two US tax treaties are with Mexico and Venezuela, states that, due to their oil exports, have more balanced investment flows with the USA, compared to other Latin American countries. The arguments that applied to Venezuela in 1999 have become invalid since the USA imposed sanctions on it due to human rights violations by the Nicolás Maduro regime.

source country (15%). In this case it is not a matter of support, i.e. type of development assistance by the residence country to the source country, but the acceptance of the right of the source country to autonomously set the tax rate. At the same time, the right of the residence country to taxation begins only at the rate of 25%, therefore its position remains unchanged: it would have to provide a tax credit of 25% even in the situation where the tax relief has not been provided in the source country (Schoueri 2013, 110–111). In regard to the tax sparing credit *stricto sensu*, Schoueri resonates that in principle the source country taxes to a certain level, and the residence country provides a tax credit for the tax paid in the source country, based on the tax treaty. If the source country decides not to tax a non-resident to the extent permitted by the tax treaty (i.e. to provide him a tax relief), the residence country is required to respect such a decision and provide a tax credit equal to the maximal amount that the source country could have taxed (Schoueri 2013, 111).

Analysing the specific objections from the OECD report, Schoueri believes that the argument regarding the ineffectiveness of the tax sparing credit as an instrument for promoting foreign investments is indefensible, and further points out that there is no empirical evidence that would corroborate the discontent of most states by the tax incentives. In his opinion, the argument regarding the "free rider", according to which tax sparing credit is provided even though without it the investor would have made the same decision to invest, because tax reasons are of lesser importance than other factors (political, market and infrastructure circumstances in the country of investment), cannot be accepted at face value either. Namely, the question could be raised whether tax treaties then have any significance in making decisions to invest, and studies do not provide a conclusive answer. Speaking against the arguments that developing countries must pay the price for gaining tax sparing credit by making concessions to the sum of the withholding taxes on dividends, interest, and royalties, Schoueri points out the abovementioned remark that the OECD itself advocates the lowering of these rates, including a zero tax rate for withholding taxes on royalties, which we have labelled as specific cynicism. He also disputes the thesis that some countries that are not members of the OECD have become economically strong in the meantime, and that therefore there is no need to provide them further support in the form of tax sparing credit, adding that numerous developing countries are still very vulnerable. The argument that the tax sparing credit clause can be abused is unacceptable, in Schoueri's opinion. His view is that a more consistent approach to this issue would be to generally review the issue of "treaty shopping" and to adopt solutions that were reached sometime later, as part of the BEPS Actions (the principal

purpose of transaction or arrangement test or limitation on benefits clause) (*see* Popović, Ilić-Popov 2019, 7–34; Andrade 2020, 21–22).[21] The fact that abuse may occur is not sufficient to reject the tax treaty provision, which would otherwise be in the interest of both contracting states. Finally, according to Schoueri's review, the OECD objection that the tax sparing credit clause is harmful to the source country because it stimulates repatriation of profits at the expense of re-investment, is invalid, unless the clause has a sunset clause. Otherwise, the investor's decision on whether to reinvest the profit or repatriate it depends primarily on commercial reasons (Schoueri 2013, 113–117).

It is a fact that the tax sparing credit has in a way been pushed into the background, following the 1998 OECD report, and that the member states accept it significantly less often when negotiating new tax treaties. However, it is indisputable that such a clause is still present in many treaties for the avoidance of double taxation that are still in force.

[21] One should bear in mind that the objection regarding the possibility of abuse was made 17 years before the OECD (together with the G20) announced its anti-BEPS actions. As part of the BEPS project Article 29 (Entitlement to benefits) was added to the OECD Model Tax Convention (the version from 2017), containing a principal purpose of transaction or arrangement test, and other anti-abuse measures. Furthermore, the commentary on Article 29 para. 175 explicitly mentions the tax sparing clause as a benefit (in the form of limitation of the contracting state's right to tax) to which this article applies. On the other hand, Andrade points out that it is necessary to differentiate between abuse of the provisions of the tax treaty on tax sparing credit and abuse of domestic regulations on tax incentives. Several actions were developed as part of the BEPS project in connection with the latter case: (1) BEPS Action 3, pertaining to CFC measures, which allows for the application of a minimal effective tax rate (*https://read.oecd-ilibrary.org/taxation/designing-effective-controlled-foreign-company-rules-action-3–2015-final-report_9789264241152-en#page65*, last visited 5 March, 2022); (2) BEPS Action 4, which stipulates methods for preventing excessive interest deductions; (3) BEPS Action 5, addressing harmful tax competition; (4) BEPS Action 6, focusing on the abuse of tax treaties; and (5) BEPS Actions 8–10, and 13, which aim to prevent abuse of transfer pricing. Tax treaty law includes different measures related to the abuse of the tax sparing credit clause, which have been mentioned above [*supra*, fn. 12 and at the beginning of this footnote, in the context of Art. 29 of the OECD Model Tax Convention (2017)].

4. TAX SPARING CREDIT: MEASURE FOR SUPPORTING DEVELOPING COUNTRIES OR REFLECTION OF FISCAL SOVEREIGNTY?

The scope of the problem that could be resolved by the tax sparing credit clause depends on the method of eliminating double taxation chosen by the contracting state other than the state providing the tax incentives. In the event that the former state, the residence country, applies the exemption method from Article 23A of the OECD Model Tax Convention, the issue would not even exist for the income and capital that is exempt (unless a subject-to-tax clause is contracted) (Nilsen 2013, 17; Marchgraber 2014, 293–302),[22] but rather only for the income that the source country can tax, to which the exemption does not apply and requiring "additional" application of credit method (dividends, interest, royalties, etc.). However, if the residence country has opted for the credit method from Article 23B of the OECD Model Tax Convention, the effect of the tax incentive would be annulled for all types of income and capital that could have been taxed (but were not) in the source country.

Let us take a look at the structure of the provisions on tax sparing credit in the treaties for the avoidance of double taxation that are binding for Serbia.

In 2022 the tax sparing credit clause exists in 29 out of the 63 tax treaties that Serbia has entered into (46%). In three of the tax treaties (out of the 29), tax sparing credit is not stipulated as Serbia's obligation, but only for the other contracting state. The tax sparing credit provisions initially existed also in treaties for the avoidance of double taxation that the Socialist Federal Republic of Yugoslavia (SFRY) had entered into with Denmark (1981) and Norway (1983), which were replaced by new treaties between Serbia and these countries, as well as in the treaties between the former Yugoslavia and Sweden and Finland, which continues to apply to Serbia, but they include a sunset clause regarding the tax sparing credit norm of ten years from the treaty entering into force in the treaties with Denmark, Norway, and Sweden, and five years in the case of the treaty with Finland. The current tax treaty with the United Kingdom also includes a sunset clause, however, it pertains to the specific taxpayer, who may enjoy benefit in the form of tax sparing credit for a period of ten years, starting with the tax period when the taxpayer is first granted a tax relief. Such a formulation does not limit the

[22] Serbia has inherited a number of tax treaties from the former SFRY, based on which it applies exemption as a method for avoiding double taxation (with Belgium, France, the Netherlands, Italy, Cyprus, Germany, Sri Lanka, Sweden, and the United Kingdom), but they do not include a subject-to-tax clause.

Table 1. The tax sparing credit clause in Serbia’s tax treaties

No.	Other contracting state	Signatory state “on our part”	Scope of application*	Date of conclusion of the tax treaty	Date of entry into force	Tax sparing credit	Article of the tax treaty	Method of eliminating double taxation
1	Albania	Serbia–Montenegro	I + C	22 December 2004	1 January 2006	Reciprocal	25 (3)	Credit
2	Armenia	Serbia	I + C	10 March 2014	1 January 2017	Reciprocal	24 (3)	Credit
3	Azerbaijan	Serbia	I + C	13 May 2010	1 January 2011	Reciprocal	24 (3)	Credit
4	Bosnia and Herzegovina	Serbia–Montenegro	I + C	26 May 2004	1 January 2006	Reciprocal	24 (3)	Credit
5	Bulgaria	FR Yugoslavia	I + C	14 December 1998	1 January 2001	Reciprocal	24 (3)	Credit
6	China	FR Yugoslavia	I + C	21 March 1997	1 January 1998	Reciprocal	24 (3)	Credit
7	Cyprus	SFR Yugoslavia	I + C	29 June 1985	1 January 1987	Reciprocal	22 (3)	In Serbia: exemption;[1)] in Cyprus: credit
8	Egypt	Serbia–Montenegro	I	31 July 2005	1 January 2007	Reciprocal	23 (3)	Credit

No.	Other contracting state	Signatory state "on our part"	Scope of application*	Date of conclusion of the tax treaty	Date of entry into force	Tax sparing credit	Article of the tax treaty	Method of eliminating double taxation
9	Greece	FR Yugoslavia	I + C	25 June 1997	1 January 2011	Reciprocal	24 (2)	Credit
10	Hong Kong	Serbia	I + C	14 August 220	12021	Reciprocal (limited to 1 January 2027)	23 (3)	Credit
11	Hungary	FR Yugoslavia	I + C	20 June 2001	1 January 2003	Reciprocal	24 (4)	In Serbia: credit; in Hungary: exemption[2)]
12	India	Serbia–Montenegro	I + C	8 February 2006	1 January 2009	Reciprocal	25 (3)	Credit
13	Indonesia	Serbia	I	28 February 2011	1 January 2019	Reciprocal	23 (3)	Credit
14	Italy	SFR Yugoslavia	I + C	24 February 1982	1 January 1986	Obligates only Italy (explicitly) Maximum: 25%	23 (4)	In Serbia: exemption; in Italy: credit

No.	Other contracting state	Signatory state "on our part"	Scope of application*	Date of conclusion of the tax treaty	Date of entry into force	Tax sparing credit	Article of the tax treaty	Method of eliminating double taxation
15	Korea, PDR	FR Yugoslavia	I + C	25 December 2000	1 January 2002	Reciprocal	24 (3)	Credit
16	Kuwait	FR Yugoslavia	I + C	2 April 2002	1 January 2004	Reciprocal	24 (3)	Credit
17	Libya	Serbia	I	12 November 2009	1 January 2011	Reciprocal	23 (3)	In Serbia: credit; in Libya: exemption[3)]
18	Moldova	Serbia–Montenegro	I + C	9 June 2005	1 January 2007	Reciprocal	23 (3)	Credit
19	Montenegro	Serbia	I	20 July 2011	1 January 2012	Reciprocal	23 (3)	Credit
20	North Macedonia	FR Yugoslavia	I + C	4 September 1996	1 January 1998	Reciprocal	24 (3)	Credit
21	Pakistan	Serbia	I	21 May 2010	1 January 2011	Reciprocal	23 (3)	Credit
22	Poland	FR Yugoslavia	I + C	12 June 1997	1 January 1999	Reciprocal	24 (4)	In Serbia: credit; in Poland: exemption[4)]

No.	Other contracting state	Signatory state "on our part"	Scope of application*	Date of conclusion of the tax treaty	Date of entry into force	Tax sparing credit	Article of the tax treaty	Method of eliminating double taxation
23	Qatar	Serbia	I	2 October 2009	1 January 2011	Reciprocal	23 (2)	Credit
24	Romania	FR Yugoslavia	I + C	16 May 1996	1 January 1998	Reciprocal	25 (3)	Credit
25	Sri Lanka	SFR Yugoslavia	I + C	7 May 1985	1 January 1987	Reciprocal	23 (3)	In Serbia: exemption;.[5)] in Sri Lanka: credit
26	The Netherlands	SFR Yugoslavia	I + C	22 February 1982	1 January 1984	Obligates only the Netherlands (explicitly)	23 (2)	In Serbia: credit; in the Netherlands: credit
27	Tunisia	Serbia	I + C	11 April 2012	1 January 2014	Reciprocal	25 (3)	Credit
28	United Kingdom	SFR Yugoslavia	I	6 November 1981	1 January 1983	Obligates only the UK (explicitly)	22 (3)	In Serbia: exemption; in the UK: credit
29	Vietnam	Serbia	I	1 March 2013	1 January 2014	Reciprocal	23 (3)	Credit

[*] I + C: income and capital; C: capital

[1)] In Serbia the tax sparing applies only to dividends, interest, and royalties.

[2)] In Hungary the tax sparing applies only to dividends, interest, and royalties.

[3)] In Libya the tax sparing applies only to dividends, interest, and royalties.

[4)] In Poland the tax sparing applies only to dividends, interest, and royalties.

[5)] In Serbia the tax sparing applies only to income from using ships in international transport, dividends, interest, and royalties.

general effect of the provision on tax sparing credit that the United Kingdom offered the former SFRY, therefore the tax sparing norm continues to apply to taxes that have not been paid in Serbia due to the application of tax incentives. It is our belief that providing a time limit on the tax sparing credit provisions may lead to distorted stimuli. Namely, the general sunset clause leads to the accelerated repatriation of profit from the source country, while the time limit that applies to the specific taxpayer encourages the founding of "new" companies or the transfer of profit to associated companies by way of transfer prices.

The fact that nearly 90% of Serbia's tax treaties that include the tax sparing credit clause define this provision as reciprocal, shows that the role of tax sparing as an instrument for providing assistance to developing countries has been reduced, if not completely lost. In the 1980s as many as six tax treaties of the SFRY with developed countries included a unilateral clause that was not binding for the Yugoslav side, and only one tax treaty included binding reciprocity.[23] The fact that in the 21st century two thirds of tax treaties containing a tax sparing credit clause have been concluded between countries that are not members of the OECD, i.e. which are either developing countries or emerging economies, indicates a change of emphasis on a much broader scale. Tax sparing credit is increasingly perceived as a mechanism of supporting national tax policies in the domain of investment incentives. In line with such an approach, the right to provide tax relief to taxpayers constitutes part of every state's right to tax, and the interference of other states, or the OECD, in that right violates fiscal sovereignty. Let us recall Schoueri's thesis that the residence country is required to respect the decisions of the source country not to tax the non-residents to the level permitted by the tax treaty (i.e. to provide them a tax relief) and to provide tax credit equal to the maximum sum of the tax that the source country could have levied. It is clear that whether a tax sparing credit clause will be included in the tax treaty depends on the relative bargaining powers of the states drafting the treaty. We cannot accept the thesis that such double non-taxation – stemming from the legitimate (non-abusive) provision of tax incentives – is contrary to the object and purpose of tax treaties. Nevertheless, the preamble to the 2017 (post-BEPS) version of the OECD Model Tax Convention states that two countries intend to conclude a

[23] Unilateral clauses exist today in current tax treaties with the United Kingdom, the Netherlands, and Italy, and they existed in the treaty with Sweden (which has expired), as well as in previous treaties with Denmark and Norway. Only the treaty with Finland contained a reciprocity clause, but it too has expired, as mentioned previously. In the treaties with Cyprus and Sri Lanka, Serbia opted for the exemption method, while the other party provides tax sparing credit.

treaty for the avoidance of double taxation of income and capital "without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance". The non-abusive tax incentive, supported by tax sparing credit, does not fall under such a defined object and purpose of the tax treaty; accordingly, the commentary to Article 23B also does not contain the disqualification of a tax sparing clause.

Table 2, on incoming foreign direct investments during the 2011–2021 period, where the "fiscal sacrifice" is borne by the treasury of the investor's residence country, and the benefits are achieved by the investor and the Serbian state (to the extent to which the tax sparing credit contributed to the investor deciding to invest in it), indicates that the stake of investments from states and jurisdictions with which Serbia has a tax sparing credit clause, in its total foreign direct investments, has varied. In 2011 it was low (19.6%), because in that year 25% of the total foreign direct investments came from Luxembourg (a total of EUR 885 million) based on the sale of the Delta Maxi company to the Delhaize company, where the tax treaty with this country does not include a tax sparing credit clause. This was followed by three years of growth – up to 54.1%, influenced by the significant proportion of investments from the Netherlands, which provides a tax sparing credit. In 2015 the sudden increase in *total* foreign direct investments, which continued in the subsequent years, lead to the proportion of investments from countries with which Serbia has a tax sparing credit clause in the total foreign direct investments decreasing to 30% (2015 and 2016), with an increase to 47.4% in 2017, due to the significant proportion of investments from the Netherlands and Italy. A decrease was recorded in 2018 (28%) since as much as 55.1% of the foreign direct investments was from France (a total of EUR 716.3 million), primarily based on the concession for the Nikola Tesla Airport in Belgrade granted to French company Vinci – and the tax treaty with France does not include a tax sparing credit clause. In 2019 and 2020 the stake increased to 46.3% and 44.6%, respectively, reaching 56.6% in 2021, in part due to the fact that the tax treaty with Hong Kong entered into effect.

The state through which the most foreign direct investments entered Serbia during this period was the Netherlands, which was regularly ranked first, with the exception of 2011, 2012, and 2018.[24] The tax sparing credit may have played a role in this, but one should not overlook the fact that the

[24] At the time most foreign direct investments came from Luxembourg (2011) and France (2018), which has been mentioned previously. In 2012 investments from Russia topped the list, because of the one-off growth of the stake of investment in crude oil exploitation in total foreign direct investments.

Table 2. Foreign direct investments from countries with which Serbia has a tax treaty with a tax sparing credit clause

Other contracting state	**2011**		**2012**		**2013**		**2014**		**2015**		**2016**	
	mil. EUR	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**	**Rank**
The Netherlands	*215*	4	*153*	3	*380*	1	*373*	1	*362*	1	*342*	1
Italy	*136*	7	*79*	9	*67*	10	*101*	4	*145*	4	–	–
China	–	–	–	–	–	–	*83*	7	–	–	*70*	11
Cyprus	*166*	7	*4*	20	*26*	15	*10*	19	*51*	12	*61*	12
Hong Kong	*13*	20	–	–	*23*	16	–	–	*42*	14	*122*	6
United Kingdom	*70*	10	*7*	17	*80*	8	*58*	9	–	–	*40*	16
Hungary	*63*	11	–	–	*35*	13	*56*	10	*32*	17	*33*	17
Bosnia and Herzegovina	*15*	19	*13*	14	–	–	–	–	–	–	–	–
Bulgaria	–	–	*40*	10	*36*	12	*22*	15	–	–	–	––
Greece	*31*	16	–	–	*37*	11	*90*	5	–	–	*43*	14
Montenegro	–	–	*9*	16	–	–	*19*	16	*45*	13	*49*	13
Poland	–	–	*5*	18	*14*	19	–	–	–	–	–	–
Romania	–	–	–	–	*68*	9	–	–	–	–	–	–
Total FDI in Serbia	***3,544***		***1,009***		***1,548***		***1,500***		***2,114***		***2,127***	
Percentage of total FDI	**19.6%**		**30.7%**		**48.0%**		**54.1%**		**30.0%**		**30.0%**	

Other contracting state	2017		2018		2019		2020		2021	
	mil. EUR	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**	**Rank**
The Netherlands	*543*	1	*351*	3	*804*	1	*591*	1	*683*	1
Italy	*196*	3	*169*	9	*108*	10	*175*	5	*27*	19
China	*103*	10	*192*	8	*264*	7	*410*	3	*569*	3
Cyprus	*49*	14	–	–	–	–	*139*	6	*147*	8
Hong Kong	*36*	17	*458*	2	*74*	12	*118*	7	*205*	6
United Kingdom	*118*	9	*151*	10	–	–	–	–	*335*	5
Hungary	*142*	18	*40*	17	*521*	3	–	–	*145*	9
Bosnia and Herzegovina	–	–	*37*	18	*45*	17	–	–	*43*	15
Bulgaria	–	–	–	–	*24*	20	*40*	17	*32*	17
Greece	–	–	*30*	20	–	–	–	–	–	–
Montenegro	–	–	–	–	–	–	–	–	–	–
Poland	*58*	12	–	–	–	–	–	–	–	–
Romania	–	–	–	–	–	–	–	–	–	–
Total FDI in Serbia	***2,548***		***3,465***		***3,815***		***3,039***		***3,863***	
Percentage of total FDI	**47.4%**		**28.0%**		**46.3%**		**44.6%**		**56.6%**	

The grey fields indicate data for years where the tax treaty was still not in force.

Source: National Bank of Serbia, Balance of Payments (*https://www.nbs.rs/sr_RS/drugi-nivo-navigacije/statistika/platni_bilans*, last visited 24 April 2022).

overall tax regime in the Netherlands, especially the institute of participation exemption in its tax law, along with the broad network of tax treaties (101),[25] makes this country extremely attractive for registering holding companies, through which foreign direct investments are made in third countries. In reviewing the role of tax sparing credit, the OECD reported that many US companies have acknowledged that "it is rather the absence of a tax treaty, not the absence of tax sparing, that deters further investment" (OECD 1998, 25).

The outbound investments are several times lower than the inbound, and are presented in Table 3. In these cases, the "fiscal sacrifice" is borne by Serbia's treasury, while the benefit is reaped by the resident investor and the state or jurisdiction in which the investment was made (to the extent to which the tax sparing credit contributed to the investor investing in it). The share of the investments in the states or jurisdictions with which Serbia has a tax sparing credit clause in total foreign direct investments by its residents increased significantly during the 2012–2015 period, from around 40% to around 90%, due to the expansion of investments in Montenegro (which in 2015 reached as much as 61.8% of the total net increase in financial assets). This was followed by a downward trend, reading 41% in 2020.[26] In 2021 this stake increased to 55%, primarily due to the significant increase in investments in Montenegro and Bosnia and Herzegovina.

The state that received the most foreign direct investments from Serbia during this period was most often Bosnia and Herzegovina, followed by Montenegro, but since 2018 Switzerland, Slovenia, and Russia have topped the list.[27] This indicates that when choosing the destination for investing capital, Serbia's residents were more motivated by other factors (commercial, ethnic, political or evasion reasons, as well as favourable withholding taxes from applicable tax treaties) rather than the (non-)existence of a tax sparing credit clause.

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[25] *https://taxsummaries.pwc.com/netherlands/individual/foreign-tax-relief-and-tax-treaties* (last visited 24 April, 2022).

[26] The deterioration of political relations between Serbia and Montenegro was accompanied by a decrease in Serbian investments in Montenegro (from EUR 192 million in 2015, in 2016 they saw the withdrawal of EUR 2.7 million, and the modest investment of around EUR 20 million per year during the 2017–2020 period). After a government that did not include the Democratic Party of Socialists was formed in Montenegro in late 2020, direct investments from Serbia in Montenegro in 2021 more than quadrupled compared to 2020.

[27] *https://www.nbs.rs/sr_RS/drugi-nivo-navigacije/statistika/platni_bilans* (last visited 14 March, 2022).

Table 3. Direct investments from Serbia in countries with which it has tax treaties with a tax sparing credit clause

Other contracting state	**2011**		**2012**		**2013**		**2014**		**2015**		**2016**	
	mil. EUR	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**	**mil. EUR**	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**
Bosnia and Herzegovina	*62*	1	*90*	2	*103*	1	*64*	2	*52*	2	*73*	1
Montenegro	*39*	3	*92*	1	*77*	2	*146*	1	*192*	1	–	–
Greece	–	–	*2*	12	*2*	12	*2*	12	*2*	13	*3*	11
Cyprus	*1*	18	–	–	–	–	–	–	*8*	6	*6*	8
Hungary	–	–	*9*	6	*9*	5	–	–	*10*	4	*19*	5
Poland	–	–	–	–	–	–	–	–	–	–	–	–
Romania	–	–	*10*	5	*45*	3	*5*	8	*8*	9	*11*	7
Bulgaria	*18*	5	*41*	3	*5*	6	*23*	4	*2*	13	*2*	16
China	–	–	–	–	–	–	–	–	–	–	*1*	18
Hong Kong	–	–	–	–	–	–	–	–	–	–	–	–
Albania	*6*	8	–	–	–	–	–	–	*1*	15	–	–
N. Macedonia	*2*	13	–	–	–	–	–	–	*3*	11	*5*	9
Total DI from Serbia	***225***		***256***		***250***		***264***		***310***		***228***	
Percentage in total DI	**39.6%**		**95.3%**		**96.4%**		**90.9%**		**89.7%**		**52.6%**	

Other contracting state	**2017**		**2018**		**2019**		**2020**		**2021**	
	mil. EUR	**Rank**	**mil. EUR**	**Rank**	**mil. EUR**	**Rang**	**mil. EUR**	**Rank**	**mil. EUR**	**Rank**
Bosnia and Herzegovina	*45*	1	*55*	3	*30*	4	*11*	6	*69*	3
Montenegro	*22*	3	*43*	4	*23*	5	*18*	2	*76*	2
Greece	*5*	7	*7*	9	*9*	10	*8*	7	*20*	5
Cyprus	*2*	13	*7*	10	*5*	12	–	–	*8*	7
Hungary	*1*	16	*2*	15	*9*	9	*4*	10	*6*	9
Poland	–	–	–	–	*2*	18	*6*	8	–	–
Romania	–	–	*28*	5	*31*	3	*2*	11	*9*	6
Bulgaria	–	–	–	–	–	–	*-8*	18	*-30*	20
China	–	–	–	–	*4*	14	–	–	–	–
Hong Kong	*2*	12	*2*	16	*2*	19	–	–	–	–
Albania	–	–	–	–	–	–	–	–	*1*	17
N. Macedonia	*4*	8	–	–	*5*	13	–	–	*-28*	19
Total DI from Serbia	***130***		***308***		***264***		***100***		***238***	
Percentage in total DI	**60.8%**		**46.1%**		**44.7%**		**41.0%**		**55.0%**	

The grey fields indicate data for years where the tax treaty was still not in force.

Source: National Bank of Serbia, Balance of Payments (*https://www.nbs.rs/sr_RS/drugi-nivo-navigacije/statistika/platni_bilans*, last visited 14 March, 2022).

The data from Tables 2 and 3 sheds a different light on the role of tax sparing credit as an instrument that by supporting the efforts of the country of investment to attract foreign investments contributes to their growth and consequently the economic growth of the country. There is no contracted tax sparing with countries that are the source of the greatest individual investments, e.g. Germany and Austria, and it appears that the most prominent support is for investors from the Netherlands, who are most commonly represented by conduit companies. The Dutch Centre for Research on Multinational Corporations (*Stichting Onderzoek Multinationale Ondernemingen* – SOMO) has shown that direct foreign investments contribute to economic development and the increase in public revenue depending on: (1) the sum of the capital leaving the country through the repatriation of profit, interest on inter-company loans, and royalties; (2) the balance between the imports based on foreign direct investments (e.g. machines and semi-finished products) and the exports generated by foreign direct investments; (3) the balance between the taxes paid by multinational companies and the subsidies granted to them by the government in order to attract them; and (4) the extent of the abuse of transfer prices aimed at avoiding taxation. For example, if the investment was made in Serbia, but the generated profit is either untaxed (or taxed at a low rate), due to the transfer of profit through the abuse of tax treaties (e.g. by introducing a conduit company), the state will not collect revenue based on the tax on corporate profits. In such a context, foreign direct investments cannot be equated with development (McGauran 2013, 19–20). Regardless of the efforts to reduce the scope of tax evasion through base erosion and profit shifting, it is our conclusion that in addition to the foreign direct investments and tax incentives for such investments, there are also many other factors that contribute to economic development (legal and political stability of the state, possibility of activating domestic savings, etc.). Therefore, we will repeat that the right to introduce tax incentives is primarily part of the subjective right to tax of every state and that tax sparing credit is a reflection of the respect that the investor's residence country shows to the right of the source country by permitting the deduction from the tax on the investor's global income of the maximum amount that the source country could have taxed.

5. TAX SPARING CREDIT AND THE INCOME INCLUSION RULE

5.1. The Prospect of Relying on Past Experience Involving CFC Legislation

The BEPS project did not discuss tax sparing credit. However, preparations for BEPS 2.0, and especially for the introduction of the Pillar Two, which stipulates the prescription of a minimal 15% profit tax rate, as well as the implementation of the Income Inclusion Rule, create new dilemmas regarding tax sparing credit.

The implementation of the Income Inclusion Rule should begin in 2023.[28] We note that in October 2021, 137 states and jurisdictions from the Inclusive Framework on BEPS agreed to start reforming the rules of international taxation through the implementation of a two-pillar plan, which would ensure that multinational companies pay a fair tax portion regardless of where they operate.[29] The measures from Pillar One redefine the allocation of the right to taxation of profit from operations at an international level; the rights to tax will be granted to states where the consumers are located, on the part of the residual profit (in excess of 10% of the revenue), provided that the multinational company has a global turnover in excess of EUR 20 billion and profitability above 10% (OECD 2021b, 1). The aim of Pillar Two is for qualified multinational companies to pay a minimum tax regardless of where their seat is located or in which state or jurisdiction they operate, in order to suppress harmful tax competition and reduce the motivation to transfer profit to states and jurisdictions with low tax rates (OECD 2021b, 4).[30] In order to achieve this goal, two Global anti-Base Erosion Rules (GloBE)

[28] At the time of the great crisis caused by Russia's aggression against Ukraine, it is difficult to judge whether this will lead to the postponement of the BEPS 2.0 measures or their possible revision.

[29] Only four states from the Inclusive Framework on BEPS (Pakistan, Nigeria, Kenya, and Sri Lanka) have not supported this agreement.

[30] This is a group of multinational companies that have an annual revenue of at least EUR 750 million in the consolidated financial statement of the ultimate parent entity, in at least two of the four fiscal years immediately preceding the fiscal year in which the testing occurred. This threshold is also used for country-by-country reporting for the assessment of transfer prices. See OECD 2015, 21. It has been adopted in Serbian tax law in article 61v of the Law on Corporate Profit Tax, *Official Gazette of the RS* 25/2001, ..., 118/2021. It is estimated that such a high limit excludes 85%–90% groups of multinational companies from the obligation to report country-by-country for the assessment of transfer prices, but it applies to the remaining groups of multinational companies, which control around 90% of the global corporate revenues.

are proposed to be incorporated in national law – an Income Inclusion Rule and an Undertaxed Payment Rule – as well as a Subject to Tax Rule in the tax treaties (OECD 2021b, 3).

The income inclusion rule grants the residence state of the parent entity the right to attribute to the parent company in the multinational group of enterprises, a top-up tax for every constituent entity (company–group member, or permanent establishment) that has been taxed too low in the state of its residence, thus fighting the harmful tax competition. In simple terms, the top-up tax would correspond to the difference between the stipulated minimal tax rate of 15% and the effective rax rate in the residence country of the low-taxed constituent entity (OECD 2021c, 29). Without going into the details of the proposal for defining the GloBE income (OECD 2021c), we will mention that in determining the basis to which the top-up tax will be applied in the residence state of the parent entity, a substance-based income exclusion is applied, consisting of two carve-outs: based on payroll costs and based on the carrying value of the tangible assets. The carve-out will initially be 10% of the payroll costs and 8% of the carrying value of the tangible assets, lowered 0.2 percentage points per year during the first five years, and then 0.8 percentage points per year for payroll costs and 0.4 percentage points of the carrying value of the tangible assets, for the next five years (OECD 2021b, 4).

The analysis should answer the question whether the tax sparing credit provisions in Article 23 of the OECD Model Tax Convention could limit the application of the GloBE rules on income inclusion. Since at the time of the submission of this article the rule is still in its draft phase, the assessment of its future interaction with the tax sparing credit will apply the decades of experience involving the CFC rules, whose effects are similar to the effects of the rule on income inclusion (OECD 2020, 14). Both rules attribute the income generated by a controlled foreign corporation to its parent company, which is a resident of a different state, thus granting this other state the right to tax the income generated by the company that is not its resident. However, the differences are significant. CFC rules are most often aimed at passive income (dividends, interest, and royalties) of the controlled companies that are the residents of states and jurisdictions with low tax rates,[31] and the tax that will apply to it in the state of residence of the parent company will have the same rate as the company's income from other sources. The Income Inclusion Rule, however, grants the right to the parent entity's residence country to tax *all* income of the constituent entities that are subject to an effective tax rate that is lower than 15% in other states and jurisdictions,

[31] For an exception, see *supra*, fn. 15.

and the top-up tax is equal to the difference between 15% and the effective tax rate in the residence country of the constituent entity. Also, one should bear in mind that the income subject to CFC rules is determined based on the national regulations of the parent company's residence country, while the rule on income inclusion stipulates that attributed income should be determined uniformly (e.g. in accordance with the International Financial Reporting Standards) (Navarro 2021, 10).[32]

From a legal point of view, however, one could consider the analogy with CFC rules to be inappropriate. Namely, some authors (De Wilde 2022, 4–5) believe that the top-up tax cannot be equated with the CFC measure. Unlike the CFC legislation, the aim of Pillar Two is not to ensure that the domestic income is taxed, despite the fact that in the context of aggressive tax planning (which is only the extreme example), it has been moved to the base company with the intention of postponing the application of tax by the shareholder's residence country. The top-up tax from the GloBE rules is essentially "an extraterritorial tax on foreign corporate profits produced by foreign group member companies" (De Wilde 2022, 4). Pillar Two is aimed against tax competition – specifically "The global minimum tax agreement does not seek to eliminate tax competition, but puts multilaterally agreed limitations on it" (OECD 2021a). The aim of the top-up tax is for the income that is sourced abroad, regardless of its nature, to be subject to a minimal tax, therefore introducing a new dimension to a system that has been established for decades, resting on the postulate from Article 7 of the OECD Model Tax Convention, with certain limitations (e.g. CFC measures) in order to prevent abuse.

Regardless of the above-mentioned differences in the structure of the CFC norms and income inclusion rules, or in their objectives, the position of the doctrine on the relationship between CFC rules and tax treaties can serve as a guideline for how to resolve issues of compatibility of the income inclusion rules with the tax sparing clause.

The commentary to Article 1 of the 1992 OECD Model Tax Convention states that measures such as CFC rules "are part of basic domestic rules set by national tax law for determining which facts give rise to a tax liability.

[32] Navarro also states that CFC rules may also be based on the deemed dividend approach, according to which it is deemed that the shareholders have received dividends that have in fact not been distributed to them, or the notional sum approach, which leads to the increase in the tax base of the parent company equal to the fair value of its stake in the subsidiary, while the rules on income inclusion always imply that the parent company is attributed income that the constituent (controlled) entity *obtained* – in accordance with the rules of private law and accounting.

These rules are not addressed in tax treaties and are therefore not affected by them" (OECD 1992, para. 23). However, such a general assessment was confronted with the explicit provisions of Article 7 para. 1 of the OECD Model Tax Convention, that "profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein," as well as the explicit norm in Article 10 para. 5 that "where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not [...] subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State." Therefore, it could be understood that Article 7 para. 1 of the OECD Model Tax Convention prohibits the residence state of the controlling company to tax profit derived in a controlled foreign company, because the profit of the controlled company can only be taxed by the country of its residence, unless the controlled company has a permanent establishment in the residence country of the controlling company. The provisions of Article 10 para. 5 could be interpreted as limiting the right of the residence country to tax a controlling company regarding the profit arising in the controlled company that remains undistributed (Navarro 2021, 13). The commentary to Article 1 of the 2000 OECD Model Tax Convention only states that there is a "large majority" of OECD member states that to not accept the interpretation of the mentioned provisions meaning that they prevent the application of national CFC rules, but also states a "dissenting view" (OECD 2000, para. 23) that was given a specific weight by the decision of the French Conseil d'Etat in the *Société Schneider Electric* case, regarding the incompatibility of the national CFC rules with the tax treaty between France and Switzerland.[33]

Therefore the 2003 commentary (in the part pertaining to the two mentioned provisions) attempted to use additional words to confirm the previous position that there is no impediment to the residence country taxing its residents based on its national CFC legislation because such a tax does not reduce the profits of the company from the other contracting state, and may not, therefore, be said to have been levied on such profits (OECD 2003, Art. 7 para. 10.1). Neither is valid the objection that the residence country's CFC measures tax undistributed profits, since Art. 10 para. 5 pertains to the taxation at the source, and not in the residence country, and applies only to the taxation of companies, not shareholders (OECD 2003,

[33] Conseil d'Etat, Assemblée, du 28 juin 2002, No. 232276. *https://www.legifrance.gouv.fr/ceta/id/ CETATEXT000008092462/* (last visited 11 March, 2022).

Art. 10 para. 37). The commentary to Article 1 of the 2003 OECD Model Tax Convention omits the views of the "large majority" and "minority" of the member states, but explicitly states that the CFC measures "are now internationally recognised as a legitimate instrument to protect the domestic tax base" and that "whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign company legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign corporation legislation structured in this way is not contrary to the provisions of the Convention" (OECD 2003, Art. 1 para. 23). Lang (2003, 54–55) presented the argument that just as it must be accepted that one contracting state taxes a partnership, while the other taxes the partners, in accordance with their respective laws, thus it must be accepted that one state taxes the controlled foreign company and another state taxes the shareholder in regard to the income of the controlled foreign company that it attributed to them based on its CFC legislation. Tax treaties do not decide on attribution, but simply accept the attribution as it has been implemented in domestic laws. In other words, tax treaties do not influence how the contracting states will arrange the attribution of income in their law, which is done through CFC rules. The profit of the contracting state's company (in this case company that controls a foreign entity), which in accordance with Article 7 para. 1 of the OECD Model Tax Convention, must be taxed only in that state,[34] whose right to taxation therefore must not encroach on the profit of the company that is a resident of the other contracting state, encompasses the entire profit determined in accordance with the state's national law, including the part that is attributed in accordance with the national CFC legislation.

International tax law literature includes criticism of the legality and legitimacy of the technique applied by the OECD Council and Committee on Fiscal Affairs, when they backed their opinions by general claims through which they strived to "kill" the minority view that the CFC legislation is not compatible with tax treaties (Martin Jiménez 2004, 23–26). In order to eliminate dilemmas regarding the compatibility of the local CFC legislation and tax treaties, at least *pro futuro*, Article 1 para. 3 of the 2017 version of the OECD Model Tax Convention incorporates a *saving clause*. According to it "This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7,[35] paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28". We draw attention to the fact that such a conclusion does not apply to

[34] With the exception of the permanent establishment.

[35] The corresponding adjustment regarding the implementation of the arm's length principle in determining the profit of the permanent establishment.

the rules of tax sparing credit from Article 23B, to which the saving clause does not apply. The commentary to Article 1 of the 2017 OECD Model Tax Convention repeats the argumentation pertaining to CFC measures from the commentary to the 2003 version (OECD 2017a, para. 81).[36]

In summarising the discussion on the compatibility of CFC measures with tax treaties, we can conclude that the implementation of the saving clause eliminates any dilemma, and that without it there is no consensus, whilst the commentary to the OECD Model Tax Convention claims that there are no doubts, which is supported by a number of authors (Lang 2003, 51–58; Canè 2017, 521–563) and part of the jurisprudence of administrative courts,[37] while part of the doctrine (Navarro 2021, 6–19; Martin Jiménez 2004, 17–30) and jurisprudence of administrative courts believes[38] that national CFC legislation is not compatible with tax treaties, with the exception of cases when they include the saving clause. The OECD report on the Pillar Two blueprint points out that "In subjecting a domestic taxpayer to tax on its share of the foreign income of a controlled subsidiary, therefore, the [Income Inclusion Rule] operates in a way that is closely comparable to a CFC rule and raises the same treaty questions. Although there are a number of differences between the [Income Inclusion Rule] and the CFC rules of many jurisdictions, these do not alter the analysis" (OECD 2020, 173). One of these differences is that the Income Inclusion Rule may also be applied to the *business profit* of the constituent entity (if it is taxed at a low rate), while the CFC rule predominantly applies to low-taxed *passive income* of controlled foreign companies.

5.2. How to Harmonize the Income Inclusion Rule with the Tax Sparing Credit Clause?

The question of whether the residence country, in applying the income inclusion rule, should provide relief to its resident (the ultimate parent company) in the form of credit for the tax that was spared in the source

[36] Reservations regarding Art. 1 para. 3 of the OECD Model Tax Convention were voiced by France, Germany, Hungary, Ireland, Luxembourg, and Switzerland, whilst Costa Rica (which in 2017 was still not a member of the OECD), Serbia, and Singapore presented their positions in the form of reservations regarding this provision.

[37] Supreme Administrative Court of Finland, Case A Oyi Abp, 20 March 2002 (*Finland–Belgium Tax Treaty*), KHO:2002:26, *International Tax Law Reports*, 2002, 1009 *et seq*.

[38] Conseil d'Etat of France, 28 June 2002, No. 232276.

country, by a separate taxpayer (the constituent company). In this case no support can be expected from the saving clause, because it does not apply to the provisions of Article 23B, which defines the tax sparing credit. A dilemma emerges whether the ultimate parent company should be taxed for the income of the constituent entity, with or without taking into consideration the tax sparing of that entity when calculating its effective tax rate. In some states, such as the United Kingdom, judging according to the administrative practice applied to CFC rules,[39] one could expect the answer to this question to be affirmative. However, on one hand, Andrade Rodríguez and Nouel indicate the incompatibility of the tax treaties that include the tax sparing clause with the rules of Pillar Two, because unlike the British tax authorities, they do not see the space where the tax sparing could be included in the calculation of the effective tax rate (Andrade Rodríguez, Nouel 2021, 256). On the other hand, Chand, Turina and Romanovska start from the new formulation of Article 23B para. 1 of the 2017 OECD Model Tax Convention:

"Where a resident of a Contracting State derives income [...] which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State [...]), the first-mentioned State shall allow: a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State; [...]"

In the opinion of these authors (Chand, Turina, Romanovska 2021, 15–16), since the stipulations of the national law on income inclusion (or CFC rules) tax the income of the constituent entity (or controlled foreign company) – i.e. a different taxpayer – in the hands of the ultimate parent company (or shareholder), Article 23B para. 1 of the 2017 OECD Model Tax Convention does not require the second state to provide relief for the tax paid in the first country, including for tax that has *not been paid*, which is indicated in the tax sparing credit clause. This is because it is not the ultimate parent company (or shareholder) that pays taxes in the source country, but rather the constituent entity (or controlled foreign company).

Navarro points out the flaw in the commentary to Article 23 of the OECD Model Tax Convention, when it claims that – even without the previously given text in parenthesis, which was added in 2017 – the formulation of Article 23

[39] Where the terms of a double taxation agreement provide for credit to be given against UK tax in respect of tax "spared" in an overseas territory, any tax "spared" by the overseas territory in relation to a CFC should be included in the company's creditable tax up to the limit specified in the double taxation agreement. (Taxation /International and Other Provisions/ Act). *https://www.gov.uk/hmrc-internal-manuals/international-manual/intm 230300* (last visited 13 March, 2022).

logically inferred that both states are not reciprocally required to provide credit for the other's tax, which is introduced solely based on the residence of the taxpayer, and not based on the source or location of the permanent establishment (OECD 2017a, para. 11.1). He believes that by implementing a "policy through interpretation" approach (Navarro 2021, 16), the OECD is attempting to impose the view that the non-application of the tax credit provision in the case of CFC measures (as well as future income inclusion rules) would be quite logical also in tax treaties based on previous versions of the OECD Model Tax Convention (Navarro 2021, 15). Such an approach is in contravention with Article 31 para. 1 of the Vienna Convention on the Law of Treaties, which states that "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose", as well as Article 26 "*Pacta sunt servanda.* Every treaty in force is binding upon the parties to it and must be performed by them in good faith". The effort to influence the application of the tax sparing clause by changing the commentary must be dismissed as contrary to the legitimate expectations of the contracting states (Navarro 2021, 17).

Discrepancies with the approach to this issue (so far only in the domain of CFC measures) also exist in the jurisprudence in a single state. In the *Lin* case, the court of first instance in New Zealand ruled that a resident of New Zealand, who had an ownership stake in a controlled foreign company in China, could claim the spared tax granted to the controlled company based on Chinese law on tax relief, as a tax credit against the New Zealand tax determined in accordance with the national CFC law, in accordance with Article 23 para 3 of the 1986 tax treaty between New Zealand and China.[40] The Court of Appeal, however, took the position that in the case of CFC measures this is a matter of *economic* double taxation (two legally different entities, i.e. the controlled foreign company and the resident shareholder, taxed in two states with a tax on the same income), and that Article 23 of the tax treaty applies to the elimination of double *juridical* taxation. The provision of Article 23 para. 2, point (a) of the tax treaty stipulates that the Chinese tax paid on income that the New Zealand resident derived from a source in China can be allowed as a credit against the tax that is to be paid in New Zealand in respect of that income. Adhering to the linguistic interpretation of Article 23 of the tax treaty, the Court of Appeal stated that "tax spared in China" is not "Chinese tax paid" by the New Zealand resident.

[40] *https://research.ibfd.org/#/doc?url=/data/treaty/docs/html/tt_cn-nz_01_ eng_1986_tt__td2.html%23tt_cn-nz_01_ eng_1986_tt__td2_a23* (last visited 19 March, 2022).

The New Zealand resident (Mrs. Lin) did not "derive" the income of the controlled foreign company in China, therefore "the tax paid or spared to the CFC was not payable, paid by or spared to Mrs. Lin. The tax imposed on two different persons is 'in respect of' two different income streams".[41]

Let us take a look at what the effects of the tax sparing credit would be if the income inclusion rule is applied. For example, Article 24 para. 3 of the 1998 tax treaty between Serbia and Bulgaria stipulates that for the purpose of allowance as a credit in one contracting state the tax paid in the other contracting state shall be deemed to include the tax which is otherwise payable in that other state but has been reduced or waived by that state under its legal provisions for tax incentives. If Serbia were to offer tax exemption to the Company A founded by an investor – a Bulgarian resident, who invested capital in excess of RSD 1 billion (approx. EUR 8.5 million) and employed no fewer than 100 new workers for an indefinite period of time – then Bulgaria would be required to recognize for this investor as tax credit the tax that would have been paid in Serbia on the business profit had there been no tax exemption. However, the effective tax rate on that investment is 0%, therefore if Bulgaria introduces the GloBE rule on income inclusion, its top-up tax of 15% would ensue. If we accept the position that the provisions from the 2017 OECD Model Tax Convention commentary cannot apply to the interpretation of the 1998 treaty, there will be incompatibilities between the stipulations of the tax treaty on tax sparing credit and the stipulations of the Bulgarian national law on income inclusion. The aim of the former norm is to support tax incentives, and, due to the suppression of tax competition, the aim of the latter is to indirectly prevent the effective tax rate in the source country from being lower than 15%. Only in the case where the formulation of the tax credit provision from para. 1 of the article of the tax treaty, which corresponds to Article 23B of OECD Model Tax Convention (Art. 24), were to be as in the 2017 version – which is not the case at the moment – the incompatibility would be avoided because Bulgaria would not be required to implement the tax sparing credit clause, since the provisions of the national law on income inclusion tax the income of the constituent entity, i.e. a different taxpayer, controlled by the ultimate parent company, and in that case Article 23B para. 1 from 2017 does not require the second state to provide relief for the tax paid in the first country, not even for taxes that have not been paid, as stipulated by the tax sparing credit clause. This is

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[41] Court of Appeal of New Zealand, CA 308/2017 [2018] NZCA 38 (*Commissioner of Inland Revenue v. Patty Tzu Chou Lin*). *https://forms.justice.govt.nz/search/Documents/pdf/jdo/3b/alfresco/service/api/node/content/workspace/SpacesStore/ae028be3–23bc-462a-a35f-9e82eedcb0f5/ae028be3–23bc-462a-a35f-9e82eedcb0f5.pdf* (last visited 19 March, 2022).

because it is not the ultimate parent company (a resident of Bulgaria), but rather the constituent entity that is subject to taxation in the source country (Serbia).

The analysis has shown that only one of the Serbia's 29 tax treaties that include a tax sparing credit clause (the 2020 treaty with Hong Kong) contains the stipulation on tax credit with limitation introduced in Article 23 para. 1 of the 2017 version of the OECD Model Tax Convention. It is not present in any of the other tax treaties that Serbia has concluded since 2017 (with San Marino, Israel, Japan, and Singapore) and which, as previously pointed out, do not contain the tax sparing clause. The limitation contained in Article 23 para. 1 of the tax treaty between Serbia and Hong Kong is nonreciprocal because in the negotiations leading up to the conclusion of the treaty only Hong Kong had an interest in protecting its local CFC legislation, since Serbia has none.

The actual effect of the income inclusion rule on the tax sparing credit clause depends on whether the state applies the *worldwide foreign tax credit blending rule*[42] or whether it relies on the *jurisdictional/entity blending approach*.[43] In the former case, it may happen that the income that is taxed according to an effective rate that is lower than the stipulated minimal rate (15%) is not subject to the top-up tax because the "excess" credit generated in the country where taxes are higher than in the residence country of the parent entity will "fill the valley" created by the difference between 15% and the lower effective tax rate that applies to the constituent entity. In the latter case, which is applied more often, there will be no such effect – the top-up tax is applied and a conflict arises between domestic law and the tax treaty in the part that contains the tax sparing clause.

The relationship between the two sets of rules can therefore manifest itself in three forms.

In the first situation the tax sparing credit is not recognised and only the tax that the constituent entity had actually paid can be deducted. An incompatibility arises in such circumstances.

[42] This is a mechanism with which the taxpayer can average out the income and taxes paid in all the foreign jurisdictions, which leads to the situation where multinational enterprise operating in jurisdiction with high taxes (higher than in the residence country) may have a position with excess credit, eliminating the residual income tax achieved in jurisdictions with low taxes.

[43] This is a mechanism where the tax credit is determined only for the situation of the taxpayer in the given tax jurisdiction, without the possibility of the "excess" credit achieved in a country with higher tax rates than in its residence country being used at the expense of a small or non-existent tax credit from countries with low taxes.

In the second situation, if the worldwide foreign tax credit blending rule is applied (this is rarely the practice), income subject to the effective tax rate lower than 15% due to a tax relief may not accrue a top-up tax so there would be no incompatibility.

In the third situation, if the tax sparing credit were to be taken into account when calculating the credit applied for the purpose of determining the minimal paid tax – and that is not foreseen in the Pillar Two Model Rules – there would be no conflict between the income inclusion rules and the tax sparing clause (Andrade 2020, 25).

We can conclude that from the legal standpoint, the tax sparing credit clause is not compatible with the GloBE rules. The application of income inclusion without limitation would annul the provisions of the tax treaties that contain such a clause. This is why carve-out is recommended in literature, which GloBE rules should provide for in cases where tax treaties include tax sparing credit provisions. Pistone *et al.* (2020, 17, 20) are in principle against the application of a carve-out because it violates the neutrality and renders the tax system more complex.[44] However, they also believe that an exception should be made in the case of tax sparing credit, considering that "carve-outs may be the only way to prevent the GloBE from triggering a treaty override vis-à-vis treaties containing clauses relating to tax sparing and tax exemption backed up by anti-abuse provisions" (Pistone *et al.* 2020, 18). The impression is that they actually propose a special carve-out for the case of tax sparing credit, which would prevent the tax relief provided in the form of a tax sparing clause in the developing country – which has not economically developed in the meantime (Pistone *et al.* 2020, 20 fn. 82) – from being lost by disregarding that clause.[45]

The Pillar Two Model Rules contain, however, a general carve-out – the substance-based carve-out based on payroll costs and based on the carrying value of tangible assets.[46] It is also designed as a type of "relief" for developing countries whose policy of providing tax incentives for foreign investments, along with tax sparing credit, could fail if the parent company's residence country applies the top-up tax from the income inclusion rules, and the tax

[44] In the opinion of these authors, the rare exceptions where carve-out should be permitted are tax incentives for investments by mining companies in countries with low income (provided that environmental protection standards are met) and for R&D activities that facilitate technology transfer.

[45] At the time of the submission of this paper, the documentation prepared by the Inclusive Framework on BEPS, under the auspices of the OECD, does not include a solution in the form of a special carve-out in the case of tax sparing credit.

[46] See *supra*, section 5.1.

Table 4. Impact of substance-based carve-out on top-up tax

<table>
<tr><td rowspan="2"><u>Example 1a:</u>
Constituent entity A</td><td>GloBE income</td><td>Statutory tax rate</td><td>Effective tax rate</td><td>Top-up tax rate</td><td colspan="2" rowspan="2">Without substance-based carve-out</td><td>Final top-up tax</td></tr>
<tr><td>1.000</td><td>25%</td><td>0%</td><td>15%</td><td>150</td></tr>
<tr><td colspan="8"></td></tr>
<tr><td rowspan="2"><u>Example 1b:</u>
Constituent entity B</td><td>GloBE income</td><td>Statutory tax rate</td><td>Effective tax rate</td><td>Top-up tax rate</td><td colspan="2" rowspan="2">Without substance-based carve-out</td><td>Final top-up tax</td></tr>
<tr><td>1.000</td><td>25%</td><td>10%</td><td>5%</td><td>50</td></tr>
<tr><td colspan="8"></td></tr>
<tr><td rowspan="2"><u>Example 2a:</u>
Constituent entity A</td><td>GloBE income</td><td>Statutory tax rate</td><td>Effective tax rate</td><td>Top-up tax rate</td><td>Total carve-out</td><td>Profit in excess of carve-out</td><td>Final top-up tax</td></tr>
<tr><td>1.000</td><td>25%</td><td>0%</td><td>15%</td><td>230</td><td>770</td><td>115,50</td></tr>
<tr><td>Payroll costs A</td><td colspan="2">Carve-out based on payroll (10%)</td><td colspan="2">Carrying value of tangible assets A</td><td colspan="2">Carve-out based on carrying value of tangible assets (8%)</td><td>Total carve-out</td></tr>
<tr><td>1.500</td><td colspan="2">150</td><td colspan="2">1.000</td><td colspan="2">80</td><td>230</td></tr>
<tr><td colspan="8"></td></tr>
<tr><td rowspan="2"><u>Example 2b:</u>
Constituent entity B</td><td>GloBE income</td><td>Statutory tax rate</td><td>Effective tax rate</td><td>Top-up tax rate</td><td>Total carve-out</td><td>Profit in excess of carve-out</td><td>Final top-up tax</td></tr>
<tr><td>1.000</td><td>25%</td><td>10%</td><td>5%</td><td>230</td><td>770</td><td>38,50</td></tr>
</table>

Payroll costs B	Carve-out based on payroll (10%)	Carrying value of tangible assets B	Carve-out based on carrying value of tangible assets (8%)	Total carve-out
1.500	150	1.000	80	230

Example 2c: Constituent entity C	GloBE income	Statutory tax rate	Effective tax rate	Top-up tax rate	Total carve-out	Profit in excess of carve-out	Final top-up tax
	1.000	25%	0%	15%	820	180	27

Payroll costs C	Carve-out based on payroll (10%)	Carrying value of tangible assets C	Carve-out based on carrying value of tangible assets (8%)	Total carve-out
5.000	500	4.000	320	820

Example 3: Constituent entity D	GloBE income	Statutory tax rate	Effective tax rate	Top-up tax rate	Total carve-out	Profit in excess of carve-out	Final top-up tax
	1.000	25%	0%	15%	1.000	0	0

Payroll costs D	Carve-out based on payroll (10%)	Carrying value of tangible assets D	Carve-out based on carrying value of tangible assets (8%)	Total carve-out
6.800	680	4.000	320	1.000

sparing is not classified as "included taxes" (and it is not) when calculating the effective tax rate of the constituent entity. The proposed substance-based carve-out based on payroll costs (initially 10%) and based on the carrying value of tangible assets (initially 8%) will somewhat mitigate the negative effects in the domain of tax incentives, but it will not eliminate them. Let us take a look at Table 4.

Example 1 demonstrates that in the case where there is no substance-based carve-out the extent of the top-up tax depends on the top-up tax rate, which is equal to the (positive) difference between the minimal tax rate of 15% and the effective tax rate of the constituent entity. In variant 1a, when the constituent entity is provided a tax exemption in the country where the statutory tax rate is 25%, it is shown that the effective tax rate is 0% and that the top-up tax is 150 (15% of 1,000). If the relief is lesser, and the effective rate is 10% (variant 1b), the top-up tax in the parent company's residence country will be lower, as expected, at 50 (5% of 1,000).

Example 2 illustrates the effect of carve-out. In variants 2a and 2c, when tax exemption was provided and the top-up rate was 15%, we conclude that the grater the total substance-based carve-out (i.e. if the payroll costs and carrying value of the tangible assets of the constituent entity are greater), the lower the final top-up tax in the parent company's residence country (115.50, as opposed to 27). Example 2b, compared to Example 2a, shows that with the same total carve-out the final top-up tax will be lower if the relief provided to the constituent entity is lower (38.50, as opposed to 115.50), which confirms the finding from Example 1.

Finally, from Example 3 we can deduce that such a "substance-based presence" in the constituent entity, which would lead to the carve-out equal to the GloBE income (1,000), would annul the top-up tax in the parent company's residence country. Then the tax sparing credit could continue to fulfil its role, because the substance-based carve-out, whose application would prevent the parent company's residence country from introducing a top-up tax based on its national law, would not derogate the norm of the tax treaty. It can be concluded that new non-neutrality would be incorporated in tax incentive law: the payroll costs and the carrying value of the tangible assets, and the recognised carve-out percentage (which should gradually decrease during the first ten years of the implementation of Pillar Two Model Rules) will determine how effective the tax sparing credit will be.

If a developing country were to agree to accept lower rates of withholding taxes during the negotiations on the treaty for the avoidance of double taxation (as compensation for the tax sparing credit clause), and the application of the income inclusion rule were to degrade its tax incentives policy to a great

extent and the top-up tax plays the same role that was previously (without the existence of the tax sparing clause) performed by tax credit as a method that the residence country applied in order to avoid double taxation (for tax sparing not to be a tax incentive but rather the revenue of the investor's residence country) – then it should reassess its further participation in such a tax treaty (Sharma 2022, 7). The question remains whether the other contracting country will accept to negotiate new solutions, and some other issues are also raised – primarily those arising from the bilateral investment treaty (Kostić, Jovanović, Ilić-Popov 2017, 483–504).

6. CONCLUSION

Regardless of whether the criticism is "mild" or "increased", whether it primarily targets the institute of international tax treaty law or its "object of protection", i.e. tax incentives, the tax sparing credit has demonstrated unexpected resilience. Coming under attack even before it had been first implemented in practice and ostracised in the policies of the leading OECD member state, the tax sparing credit has managed to survive for already 63 years. At the end of the 20th century it enjoyed significant support among many developed countries that believed they had the obligation to also use this method to support the efforts of developing countries to escape backwardness by attracting foreign direct investments through tax incentives. What followed was a period of reassessment – of the effectiveness of tax incentives in general, of the need to support such measures, and of the risks of abuse that lead to tax avoidance – and the number of tax treaties contracted between OECD members and developing countries that include a tax sparing clause has decreased in the 21st century. Emerging economies and many developing countries, including Serbia, have opted for tax sparing and continued to include the appropriate provisions in newer tax treaties, whenever the other party was willing to accept them – most often in reciprocal relations. We can conclude that the tax sparing credit has been transformed from a measure that manifests the fiscal "sacrifice" of the developed country benefitting the developing country (albeit, compensated by lower withholding tax rates and stricter permanent establishment rules) into a measure that confirms the fiscal sovereignty of the state exercising its right to tax, related to tax incentives, regardless of the level of development of the contracting states.

Even though an economic analysis of the effects on economic development of foreign direct investments in general, and tax treaties in particular, would be demanding, and certainly is beyond the scope of this paper, research has

shown that there is no firm link between the tax sparing credit clause and the country of origin of the most significant investors in Serbia. Even the high ranking of the Netherlands (with which Serbia has a tax treaty that includes a tax sparing clause) is more likely to be explained by its tax law system, favouring holding structures (owing to affiliation privilege) and broad network of tax treaties, which in the pre-BEPS world stimulated the founding of conduit companies, more so than the attraction of the clause itself. Had the tax sparing credit played a dominant role in the adoption of investment decisions, some other countries – with which it had been contracted – would have been closer to the top of the list of countries of origin of foreign direct investments. The literature gives the example of the increase in German investments in Brazil after the 1975 tax treaty between the two countries, which included a matching credit clause, ended in 2005 (Schoueri 2013, 115). Of course, it would be wrong to conclude that this tax treaty represented an impediment to German investments. Namely, the economic prosperity in 2006 and 2007 and increased activity in the large Brazilian market played a decisive role, therefore even the loss of the matching credit, i.e. termination of the treaty for the avoidance of double taxation, could not stop the expansion of German investment in Brazil. Barthel, Busse, and Neumayer (2010, 366–377) determined that there is a positive relationship between the tax treaty and foreign investments in the source country, but also asserted that a slightly different formulation of the econometric model and reliance on bilateral, as opposed to aggregate data on foreign direct investments, does not yield the same result. Speaking of relationship between the tax sparing credit and foreign investments, there is a study that shows that the tax sparing credit clauses are associated with a 97% higher stock of bilateral foreign direct investments (Azémar, Dharmapala 2019a, 5). The estimated effect is concentrated in the year after the treaty (containing such a clause) comes into effect, and was non-existent in prior years (Azémar, Dharmapala 2019b). However, whatever the results of the empirical studies and regardless of how much the OECD Committee on Fiscal Affairs distanced itself, there are states that still believe in the role of tax sparing credit, and treaties that include this clause are estimated to account for around 15% of all tax treaties currently in effect worldwide. For such countries this provision is not only a factor that helps stimulate foreign direct investments, but also confirmation of their fiscal sovereignty from the standpoint of tax incentive policy. It should be noted that despite the commitment to the tax sparing credit (which is confirmed by the presence of a tax sparing clause in 46% of all tax treaties), tax law circles in Serbia do not insist on its significance in the domain of fiscal sovereignty, stressing only the role as an incentive (Dabetić 2008, 185, 188; Popović 2021, 285–286). The reason for this is that Serbia had signed a Stabilisation and

Association Agreement with the European Communities and their member states,[47] even before gaining the status of candidate for membership in the European Union, and it has been in force since 1 September 2013. Article 100 para. 3 of this Agreement stipulates that Serbia will complete the network of bilateral tax agreements with the member states, along the lines of the latest update of the OECD Model Tax Convention on Income and on Capital, to the extent that the requesting member state subscribes to it. Since the newer versions of the OECD Model Tax Convention and its commentary do not support tax sparing credit (even though it has not been completely abandoned), the South American authors were apparently given a free hand to develop and defend the thesis of the protection of fiscal sovereignty, while back in 2005, without excessive vocalisation, Serbia had chosen to express the position on Art. 23 of the OECD Model Tax Convention that it maintains its right to include tax sparing credit provisions in its tax treaties, provided that the other contracting state consents.

The prolonged existence of the tax sparing clause will be seriously jeopardised by the BEPS 2.0 initiative – the measure that aims for a group of qualified multinational companies to pay at least a minimal tax on corporate profit based on the rule on income inclusion, that is reminiscent of the Serbian folk poem "What was passed up by the child Grujica (the residence country of the constituent entity), was snatched up by Old man (Starina) Novak (the residence country of the parent company)". Based on our analysis, we can conclude that the national law norm on income inclusion is not compatible with the tax sparing credit clause, and that the foundations for the legitimisation of the supremacy of national law over international treaties were laid much earlier, in the justification of the application of domestic CFC rules. The conducted study showed that the efforts to explain in the commentary that it is in fact permitted to tax the profit of the other contracting state's resident (provided there was no permanent establishment) was insufficiently persuasive, therefore a new formulation of the tax credit clause from Article 23B para. 1 was incorporated in the 2017 version of the OECD Model Tax Convention. In future tax treaties, which will adopt this formulation, the first named contracting state shall be required to provide that the tax credit not apply to situations when the provisions of the tax treaty permit taxation in the second contracting state solely because the income of the resident of the first named state is also the income achieved by the resident of the second state. Since the provisions of the national CFC legislation (or future income inclusion rules) tax the income of the controlled

[47] *Official Gazette of the RS* 83/2008; *Official Gazette of the RS – International Treaties* 12/2014 and 1/2022.

foreign company (or constituent entity), i.e. a different taxpayer, at the level of the shareholder (or the ultimate parent company), Article 23B para. 1 in the version from 2017, does not require a state to provide tax benefits for taxes paid in a different state, including for taxes that have not been paid, as referred to in the tax sparing credit clause. However, since Serbia has not opted for this new formulation of the tax credit in any of its tax treaties to date, the incompatibility of numerous tax sparing credit provisions and the GloBE rules will remain an open question when the implementation of the Pillar Two measures goes into effect. A circuitous solution, contained in the OECD Model Tax Rules in the form of a substance-based carve-out based on payroll costs and the carrying value of the tangible assets, will create administrative difficulties and pave the way for the calibration of the value of these two parameters, with the aim of annulling the difference between the minimal tax rate of 15% and the effective tax rate of the constituent entity enjoying tax incentives. If this is successful, the payment of a top-up tax in the parent company's residence country would be avoided and this would preserve the tax sparing credit from the tax treaty. However, in that case there would be a new form of circumventing the law, which could create new challenges for tax authorities.

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