

## *Short Research Article*

# Tax Holiday as an Incentive Policy Tool

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### **Abstract**

*Tax holidays can be defined as elimination or reduction of the tax for a period of time. Countries may go for tax holiday practice primarily for promoting investments or for various purposes. However, tax holidays imposed by governments have been criticized in various ways. Because in practice, there is contradiction in terms about what tax holiday is and what exemption is and what should be included as an exception. Because in practice there is a conceptual ambiguity regarding what should be considered within the scope of tax holiday, what in exemption and what in exception. Therefore, the study primarily clarifies the concept of tax holiday and then discuss as to what should be understood from the concept of tax holiday.*

### **Keywords**

*Tax holiday, incentive, investments, exemption*

### **1. Incentive Policies and Tax Holiday**

Countries promote investments through their policies. In particular, it has been observed that incentive policies are being utilized for the development of low growth regions, employment creation, attracting investment to areas of high unemployment, technology transfer or export promotion and creating free trade zones (Holland & Owens, 2005). Incentive policies are mainly as follows: investment allowances, cheap labor, resource procurement, land allocation, accelerated depreciation and in particular tax incentives. It is noticed that tax incentives are put into practice in different modes such as tax deduction/tax credit, tax exemption, tax exception, tax return and tax holiday (OECD, 2019). Tax incentives are often the tools used to stimulate a particular behavior, and countries can often benefit from to tax instruments, particularly for the realization of development projects. In particular, tax reduction or tax holidays are considered as a means of incentives often brought to the agenda (Harris & Oliver, 2010).

General incentives tend to fall into four categories: tax abatements, tax exemptions, tax credits, and tax

increment financing. (i) Tax abatement is a reduction in a tax, usually a property tax, for given piece of real estate for a specified period of time. The period of abatement usually ranges from 5 to 25 years in most cases. (ii) Tax exemptions are exclusions from the tax code, i.e., specific property that is not taxed. Many homeowners are familiar with a homestead exemption that reduces the taxable value of a primary residence, resulting in a lower property tax bill. Two of the more common tax exemptions are: (1) the freeport exemption which exempts property in transit, that property imported from out-of-state and destined for export, and (2) the inventory exemption. (iii) Tax Credits applies a credit to a percentage of money recently expended for business purposes, usually applied to the corporate income tax. Tax credits are intended to reduce the cost of investments. (iv) Tax Increment Financing (TIF) is a creative application of tax law that diverts tax proceeds (usually property taxes) for a specified period to fund capital improvements within the TIF district. (v) Other incentives: Business cycle incentives assist firms to overcome impediments they may face at a particular point in their business cycle, e.g. start-up, expansion, or modernization (Scott, 2006).

Although it is possible to include the tax holiday in any of the five types of tax incentives listed above, in fact, it is more accurate to assess the tax holiday at a separate heading. Because the incentive has an upper limit related to the amount of the expenditure in all incentive types listed, whereas tax holiday to the shifting of large amounts of profits as a tax holiday is possible. Thus, it can be misleading to consider the tax holiday as simply as incentive policies (Holland & Owens, 2005).

## 2. Scope of Tax Holiday

In particular, developing countries offer incentives or permissions in the form of a tax holiday to companies to attract direct foreign investment. A tax holiday is generally intended to waive the tax for up to 10 years for the type of investments specified on it. Therefore, a tax holiday is the removal of income tax (corporate income) for a specified period in a developing country. *The effective rate is zero across the world*, which means that zero income tax is applied to a foreign investor within the specified time. According to another definition, the tax holiday is the failure to apply corporate tax against foreign investors in a period that may be limited to in accordance with a government decision (Larkins, 2004; McGee, 2008).

However, some authors say that actions taken by applying a low tax rate in addition to zero tax treatment of a developing country to conduct the flow of foreign investment are considered a tax holiday. Tax holiday practice (tax protective provision) considered a practical way of taxation across the world is defined as an inefficient investment policy instrument where tax income is transferred to developed countries according to those with opposing view to tax holiday. It is stated that the current policies will serve only the transfer of funds from developing countries to developed countries (Altshuler et al., 2001; Hines, 2001).

However, in return for this opinion, opinions are expressed in support of the tax holiday. Doyle and van Wijnbergen (1984) defended the tax holiday as compensation, which is paid by host countries within a

sequential bargaining model, in exchange for the earnings and investments that they have obtained as result of direct investment. They considered tax holiday as a lock-in method to compensate for the effects of irremediable sunk costs as a result of foreign investors' investment in a country (Altshuler et al., 2001). They also noted that, in order for foreign investors to benefit from tax holiday in the global tax system, the tax not paid due to the tax holiday in the investment country, that is to say, the phantom taxes are required to be deducted from the tax payable in the residing country. It is aimed to enable investors to operate in the same competitive conditions as similar country investors, which allow such adjustments (Larkins, 2004).

### **3. Investments and Tax Holiday**

The provision of incentives to attract direct foreign investments has been a boost since the mid-1990s. According to recent surveys, 45% of developing countries imposes tax holiday at the rate of 85% to promote investments or are directed toward incentive instruments such as corporate tax deduction (Tax Guide, 2018; World Development Report, 2004). Therefore, the tax obligations of a foreign company can be reduced through the use of any or all of the financial incentives. Reductions in corporate income tax rates, accelerated depreciation, capital goods and value-added tax reductions for purchasing raw materials, subsidies, benefiting from public funds and tax deductions made over employer premiums paid by employee and tax holiday practice are frequently encountered incentive methods (Cohen, 2007; QFC, 2015).

In general, companies consider many generous tax benefits as matter of negotiation during the production phase in order to operate. Thus, it is aimed to ensure that the benefits obtained from tax holiday are at a level that can be compensated after tax holiday. There are even requests for further incentives such as post-holiday, reduced tax rates, accelerated depreciation, investment credit. Therefore, it is aimed to maintain the benefits obtained from the tax holiday through various methods after the tax holiday (Wilson, 1993). In general, it has been observed that Andorra, Antigua, Bermuda, Bahamas, Barbados, British Virgin Islands, Cayman Islands, Channel Islands, Southern Cyprus, Gibraltar, Grenada, Grenada, Kiribati, Liechtenstein, Netherlands Antilles, Caribbean, Saint Kitts-Nevis, Saint Vincent and Vanut, which are listed as tax heaven, were considered significant tax holiday centers until yesterday (Harris et al., 1993). Today, in the United States, it has been known that there is a general sales tax holiday between federal and local governments and that they are competing against each other. Given that there are potentially 377 different sales tax rates in the United States, it is clear that the sales tax holiday is open to attractive opportunities between local and federal states (Carroll & Sharbel, 2006; Reddick & Coggbum, 2006).

Today, joint stock companies are making frequently use of accelerated depreciation and tax holiday practice. As firms intend to serve the local market, incentives are less attractive. Investments in export-specific sectors are more sensitive to tax holiday. However, despite all these matters, tax holidays are only a determining factor in rare circumstances (World Development Report, 2004).

Because, even if the tax holiday is offered to investors by host governments, after the end of the period, multi-national companies can leave the country, search for new sites or try to compensate for their losses through the transfer pricing mechanism through their affiliates (Cohen, 2007).

Finally, excessive tax holidays provided to attract new investments can impact on the overall tax revenues of countries unfairly. International organizations such as the World Bank and the IMF are denouncing the losses incurred by tax holiday, as it causes that least developed countries are deprived of the income they need. Because countries that have implemented effective tax holidays are potentially causing disadvantages for countries that do not have a tax holiday, increasing harmful tax competition (McGee, 2008).

Similarly, while there are some incentives offered to investors seeking to invest in Turkey, the incentives in question are specific to some regions, some exporters or some sectors by nature. However, it is difficult to mention the significant tax holidays provided to investors (Rosenblatt & Terterov, 2006). In Turkey, however, similar practices are possible without the name of a tax holiday. At the same time, both developed and underdeveloped countries in the world continue to implement new tax incentives, which are often supported by private sector lobbying activities. Recent examples include free zone activities in the United Arab Emirates, as well as Singapore, which includes a five-year tax holiday for accounting and legal firms. A similar example is the target effort to apply a corporate tax holiday for ten years on revenues generated by investments of at least \$150m in Turkey (Christians, 2009).

The tax holiday is conducted on corporate income, value added tax, customs duties, sales taxes and fees payments, as common in the US example. In practice, it is clear that the general trend is to promote foreign investment, although it is intended to encourage domestic or foreign investments. With tax holiday, the tax burden on the profit is eliminated for a period specified by governments (Christians, 2009). The tax holiday practice, one of the most effective incentives, is currently being imposed by many developed and developing countries. For example, tax holiday practices are in force in Barbados (15 years), China (5-10 years), India (10-15 years), Indonesian (20 years), and USA (vary by state and locality) (Tax Guide, 2018).

#### **4. Conclusion**

In practice, the tax holiday is used as a monetary policy instrument and is implemented in several countries. However, it is necessary to make it clear what the concept of tax holiday indicates. As highlighted above, zero tax rate as well as very low tax rate are considered a tax holiday. However, it would be more accurate to mention the tax credit mechanism and not the tax holiday, as low rate tax practice is considered within the scope of taxation. Thus, it would be more accurate to recognize the tax holiday as a full waiver (tax evasion) of taxation as used at this point.

In addition, tax incentive mechanisms such as tax exemption, tax exceptions, tax deduction, etc. have an upper limit depending on the expense amount. In fact, tax holiday allows for a large amount of income to be excluded from the taxation. In addition, in general, practices such as exceptions and

exemptions are determined annually or abolished by budget law. However, a tax holiday defines a waiver of long-term practices for an average period of up to ten years. It may be misleading to evaluate the concept of a tax holiday similar to other incentive policies due to these and similar reasons.

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