



Policy Brief

ADDRESSING THE NEEDS OF TAX INCENTIVE REFORM UNDER PILLAR TWO – GLOBAL MINIMUM TAX MODEL RULES

Task Force 7

International Finance and
Economic Recovery

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Riatu Mariatul Qibthiyyah (Institute for Economic and Social Research, Faculty of Economics and Business, University of Indonesia)

Christine Tjen (Tax Education and Research Center, Faculty of Economics and Business, University of Indonesia)

Yulianti Abbas (Department of Accounting, Faculty of Economics and Business, University of Indonesia)

Syahda Sabrina (Institute for Economic and Social Research, Faculty of Economics and Business, University of Indonesia)

Abstract

To address the tax challenges arising from the digital economy, the Organisation for Economic Cooperation and Development and the Group of 20 (OECD/G20) Inclusive Framework (IF) on base erosion and profit shifting (BEPS) formally agreed on the Two Pillar approach. While Pillar One focuses on revising the profit allocation and nexus rules, Pillar Two focuses on outstanding BEPS issues. Pillar Two aims to establish a global minimum tax rate of at least 15 percent for large multinational enterprises (MNEs) to end the race to the bottom and eliminate profit-shifting activities. At the same time, questions have arisen, such as the possible neutralising effect on tax incentives, increasing competition and unequal tax revenue distribution across countries. This policy brief explores the potential responses to gauge the impact of Pillar Two implementation in developing countries. As done in several countries, policy assessment using tax expenditure reports is crucial. The presence of a strong organisation with the ability to manage and coordinate Pillar Two implementation, such as the G20, would also help to ensure a global level playing field between countries.

Challenge

Existing international tax standards have been based on traditional business practices, which are mainly focused on the physical presence of the business. However, companies are increasingly operating digitally, eliminating the necessity for a physical presence. Rapid globalisation has also pushed multinational enterprises (MNEs) to conduct more integrated business operations. The development of digital adoption has accelerated even more rapidly in times of COVID-19 as consumers move dramatically towards online channels to avoid physical interactions. However, the shift in business model creates challenges related to taxation policy. Collecting taxes is convoluted since economies are still inexperienced in the digital transformation and many types of income are excluded from governments' tax bases. Base erosion and profit sharing (BEPS) continue to be significant challenges in taxation due to differing tax rates implemented across countries, particularly in a cross-border context. As a result, international tax standards must be adjusted to reflect how the modern company model is taxed.

The Pillar Two approach of the Organisation for Economic Cooperation and Development's (OECD) Two Pillar approach is likely to play a significant role in addressing fair taxation, particularly in response to the tax avoidance practice of shifting profits from high to low tax countries as well as the global races to the bottom of corporate income tax (CIT) rates between countries. Under Pillar Two, large MNEs will be assured to pay a minimum of 15 percent tax on the profit arising in each country where they operate. The minimum rate will put a floor on tax competition among countries, with the implementation to start effectively in 2023. The OECD (2021) estimated that the global minimum tax rate would increase CIT revenues globally by US\$ 150 billion per year. Additional benefits will arise from stabilising the international tax system and increased tax certainty for taxpayers and tax administrations.

Although Pillar Two would generate fairer competition due to fair taxation and the absence of a race to the bottom, some countries remain reticent to implement the model rules because of several factors, such as the potential challenges concerning tax incentives. To attract foreign investment, many developing countries are implementing a variety of tax incentives even though such incentives are not the primary best approach to stimulate overall investment (Zee et al., 2002). Countries have been relying on lower CIT rates and tax holidays to boost investment, as empirical studies have shown that those approaches are effective for increasing foreign direct investment (FDI) in some developing countries (Klemm et al., 2012).

The tax incentives offer businesses a lower CIT rate than those that apply elsewhere in a jurisdiction. Under the GloBE rules, the proposal of Pillar Two is most likely to counteract the benefits of giving such a low tax rate. Lowering a country's effective tax rate (ETR) below

the global minimum tax is only counterproductive because other countries where the ultimate parent entity (UPE) is registered will collect the difference (additional top-up tax) with the Pillar Two rules. Therefore, keeping such a low tax will only give away tax incentives while nullifying the effects of incentives on investment. According to a KPMG (2021) survey, the implementation of Pillar Two has the potential to affect more than 40 key tax incentives across the Asia-Pacific region. Most Asia-Pacific countries have implemented tax holidays for industries, notably manufacturing and electricity generation, with tax rates frequently being zero for a specified period of time. Furthermore, some countries even doubled tax incentives during COVID-19, aiming to promote more investment in the post-pandemic economic recovery.

Countries with lower applied tax rates than the global minimum tax are expected to gain the most with the Pillar Two rules. Pillar Two may allow low-tax countries to impose a global minimum rate, and the higher rate will generate direct tax revenue gains for them. According to Barake et al. (2021), tax revenue gains would be unequally distributed across countries because home countries would acquire more revenue than host countries under the Pillar Two implementation¹. Only if the home countries opt out of the global minimum tax will the home countries be permitted to collect the additional top-up tax. According to the OECD (2020), revenue gains from Pillar Two could be significant across all types of economies. Pillar Two would almost certainly reduce the intensity of MNE profit shifting, resulting in additional tax revenue gains to supplement the direct gains from the minimum tax rate in many countries. However, the distribution of revenue gains across countries depends on potential government reactions, particularly whether governments in some low-tax countries increase their ETR in response to the Pillar Two rules.

As the discussions over the tax incentives implications under Pillar Two continue, developing countries must comprehensively analyse the best policy responses to gauge any potential offset of the existing tax incentives. The OECD's Two Pillar solution rule, however, is still under development. A common understanding of the technical details of the Pillar Two implementation is essential for a precise analysis of the implications of the proposed rules for all countries, particularly developing countries which are the main focus of this study. Due to the still ongoing development of the OECD Implementation Framework to support tax authorities in the implementation and administration of GloBE rules, this policy brief reflects the relevant information in the OECD publication on 20th December, 2021, which contains nine chapters within 45 pages and another 15 pages of definitions. This policy brief has also

¹ The majority of large MNEs' home countries where the UPE is registered are developed countries

incorporated additional information from the OECD Commentary on the more detailed technical guidance of the Pillar Two model rules released on 14th March, 2022.

The description of large MNEs applicable to Pillar Two is the most notable available detail in the OECD Pillar Two rules. The MNEs subjected to Pillar Two must meet the minimum € 750 million threshold global turnover in at least two of the four fiscal years immediately preceding the tested fiscal year. The MNEs also need to have a foreign presence; otherwise, they are not included in the scope of the rules. Pillar Two excludes government entities, international organisations, non-profit organisations, pension funds and investment funds from the scope of Pillar Two. Some specific exclusions also apply to real estate investment vehicles: a UPE and entities majority-owned by the excluded entity.

The Pillar Two rules have at least two overall designs: first, an income inclusion rule (IIR) that imposes a top-up tax on a UPE in respect of the low taxed income of a constituent entity and an undertaxed payment rule (UTPR) that denies deductions or requires an equivalent adjustment to the extent the low-tax income of a constituent entity is not subject to tax under an IIR. Second, a treaty-based rule (Subject to Tax Rule [STTR]) allows source countries to impose limited source taxation on related party payments subject to tax at a rate less than the minimum rate. Under the GloBE rules, the STTR will be credited as a covered tax. Further, the OECD Commentary provided comprehensive guidance on the various design operations to provide common interpretation and tax administration under the Pillar Two rules. The OECD has also published examples or illustrations of how to apply the IIR, UTPR, STTR and other related approaches and mechanisms.

Proposal

The appropriate tools for preparing a suitable tax policy following the global tax reform suggested by Pillar Two are crucial. Countries may need to adjust their domestic tax laws and income tax regimes to ensure that MNEs will not be subjected to top-up taxation elsewhere. Still, they need to reconsider the tax incentives provided by the current tax regime. The effectiveness of tax incentives is potentially affected by the neutralising effect of tax incentives under Pillar Two. For example, for developing countries offering tax incentives, if the starting effective tax rate was 18.5 percent, then reduced to 9.25 percent by an incentive, the global minimum tax could apply to raise the effective tax rate to 15 percent, neutralising the benefit provided by the incentive. While implementing the global minimum tax should not directly impact domestic tax law, it is expected that several jurisdictions would respond to the tax by amending their own laws. Accordingly, it is likely that jurisdictions would terminate certain incentives or that jurisdictions would enact their own domestic minimum taxes that could override incentives. Nevertheless, Pillar Two rules can also be viewed as a way for developing countries to avoid adopting excessive tax incentives for MNEs, as these countries frequently have a weak bargaining position with regard to investing MNEs, which can lead to them offering extremely low tax rates to MNEs (OECD, 2020).

To find the best strategies for implementing the incentives under Pillar Two rules, developing countries must examine their existing tax-incentive policies to measure the incentive's benefit and the potential top-up taxes if Pillar Two is implemented. The following are the proposal for data tracking of the countries' tax incentives: First, countries should rely on reliable data to conduct the assessment, which can start from policy assessment through tax-expenditure reports, as has been done in certain countries, both developed and developing countries². Second, the developing countries can also maximise the utilisation of country-by-country reporting (CbCR) and exchange of information (EoI) to assess the effectiveness of their tax incentives and calculate the potential top-up taxes. To provide transparent CbCR, implementing CbCR and EoI needs standardisation among countries. This proposal aligns with the G20 Communique of implementing globally agreed tax-transparency standards.

On the implementation of Pillar Two, we propose, third, a global consensus that the model rules for Pillar Two will not be implemented retrospectively. For example, if a company has received five years of tax holiday incentives starting from 2020, the government needs to

² For example, Indonesia has issued a tax-expenditure report since 2018, the only country in ASEAN that has adopted this regular policy assessment, and its publication is also open to public.

ensure that the MNEs will enjoy the tax holiday scheme until 2025. Meanwhile, for a company gaining a tax holiday starting in 2023 while the projected profits are starting in 2028 and afterward, the jurisdictions will experience tax forgone because the ETR of the company is still zero percent. Thus, there will be a 15 percent tax income that another jurisdiction will enjoy. However, because of the substance-based income exclusion, the amount of tax foregone will be less than 15 percent. In the latest OECD publication, there will be a carve-out mechanism in the transition period during 2023-2033 to allow the company to deduct its excess income with the carve-out portion for tangible assets and payroll or employee costs. The tangible asset portion begins at 8 percent and the payroll portion at 10 percent; the percentage of carve-out will steadily decline until it reaches a 5 percent carve-out portion for both aspects in 2033. This carve-out approach might help jurisdictions minimise the top-up tax computation in another jurisdiction (tax forgone) while keeping the tax-incentive scheme in place. This substance-based income exclusion is one of the features that could minimise such tax forgone from Pillar Two implementation.

Fourth, countries with high reliance on tax incentives need to consider adjusting their policies and start to phase-out excessive incentives. To support the attractiveness of investment, the countries may need to alternatively change the tax incentives to other less distortive forms, such as shifting into expenditure-based tax incentives instead of profit-based tax incentives. The government may also modify the scheme for research and development incentives to meet criteria based on eligible employees and assets. KPMG (2021) has suggested payroll incentives or a reduction of regulatory burdens as alternative non-tax incentives to attract foreign investment in the Asia-Pacific region.

Furthermore, the OECD (2020) stated that governments will continue to be able to use various tax and non-tax incentives to support the attractiveness of their countries for foreign investment. However, some jurisdictions may be able to adjust their policies beyond simple tax-cost considerations. More limited and cost-effective use of investment tax incentives, for example, could boost domestic resource mobilisation in developing countries. Both responses would have a positive impact on international capital allocation.

The developing countries might also consider eliminating ineffective tax incentives. However, the suggestion needs to address challenges in implementing it, especially for developing countries with non-discrimination articles in their tax laws, such as Indonesia. Such jurisdictions would not be able to reduce or eliminate tax incentives only for certain companies located in their jurisdictions. Moreover, the timetable of Pillar Two implementation is very tight, limiting countries' ability to thoroughly analyse all tax incentives. To minimise the risk of tax forgone when providing tax incentives, developing countries might consider implementing a minimum domestic tax, which eliminates the zero percent tax incentives for all companies.

Fifth, a coordinated and harmonised incentive strategy at the regional level (e.g., ASEAN, Asia-Pacific, Latin America) is critically needed to avoid potential looming competition among developing countries that rely on tax incentives to attract foreign investment. The proposal might be boosted by the G20's existing policy, as stated in the G20 Communiqué, to support global and regional efforts, especially those in the Asia-Pacific region. This requires an effort from all countries globally for better international tax regulation and will need to deal with the limited time to implement Pillar Two effectively. To provide tax incentives compatible with other countries, developing countries need to come to a common understanding in regulating their taxation systems under Pillar Two, particularly regarding the tax incentives.

Lastly, capacity building and technical support from a robust organisation, such as the G20, is needed to help developing countries. This proposal aligns with the G20 Communiqué published in February 2022, which has stated that tailored technical assistance and capacity building are available for developing countries to help them with the technical details of the Pillar Two implementation. All jurisdictions critically need technical support because of the tight implementation timetable of Pillar Two, which is set to start in 2023. Some jurisdictions have stated their concerns regarding the tight timeline. According to the New Draft Council Directive by the EU Council (2022), finance ministers of EU member states have planned³ to extend the time limit for the transposition by the member states to 31st December 2023, which implies that implementation of Pillar Two will start on or after 31st December 2023⁴. The timeline is very compressed for countries to perform the impact modelling and/or sensitivity analysis of Pillar Two's potential effect on the existing tax incentives. The pressures to quickly adopt the measures are even higher for developing countries, which have limited capacity to upgrade the resources in re-assessing and adjusting the tax incentives under the Pillar Two approach. All in all, the common understanding of the model rules will help to secure a global level playing field across countries.

³ The EU Finance Ministers failed again to reach political agreement on the Draft Council Directive of the Pillar Two implementation on the latest ECOFIN meeting on 17th June 2022

⁴ Exception for the UTPR which would apply for fiscal years starting on or after 31 December 2024

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Appendix

In the G20 Communique of G20 Finance Ministers and Central Bank Governors Meeting on 17-18 February 2022, G20 countries commit to develop the model rules and multilateral instruments according to the Pillar Two's timetable to ensure that the new rules will come into effect in global level in 2023. G20 countries welcome the technical design of the Global anti-base erosion Model Rules for Pillar 2 adopted by the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) and call for their finalisation and consistent implementation at a global level as a common approach. G20 Communique also stated that developing countries would be able to access tailored technical assistance to help them with all areas of implementation. G20 members support global and regional efforts, especially those in the Asia-Pacific region, to promote domestic resource mobilisation in developing countries through technical assistance and capacity building. They welcome the G20 Ministerial Symposium to explore these concerns. The G20 acknowledges the OECD/G20 Inclusive Framework on BEPS report on Tax Policy and Gender Equality and the progress made in implementing globally agreed tax transparency standards.

Further, the authors want to acknowledge that all the analysis made in this policy brief is based on the data and information gathered from the latest OECD Publication on December 20th, 2021. The authors propose revisiting this policy brief once a detailed model rule of Pillar Two regulation finalises in order to assess the possible impact correctly.