DOMESTIC CORPORATE TAX REFORM UNDER PILLAR TWO

The Twelfth IMF-Japan High-Level Tax Conference for Asian Countries

25 October 2022, Tokyo (delivered virtually)

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OECD Report on Tax Incentives and Pillar Two

- Pillar Two will be a **‘game-changer’ for tax incentives**
- This means that countries need to **review and evaluate their incentives**
- **The GloBE Rules will have different impacts** on different jurisdictions, MNEs and incentives
- This report outlines **options for action** for policymakers with a **focus on developing countries**

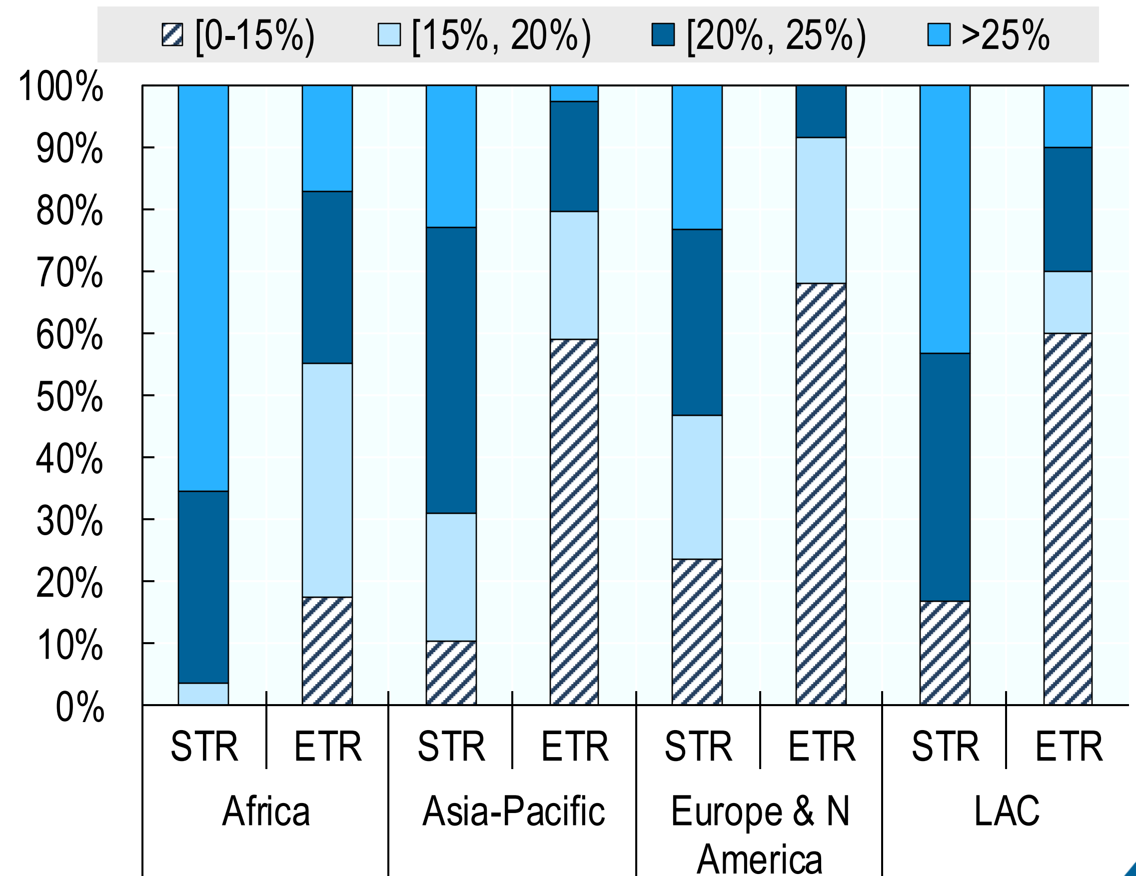
Background

- **Pillar Two will help address profit shifting risks and change the environment for corporate income tax incentives** for countries worldwide
- **Where a tax incentive reduces a firm's effective tax rate (ETR) below** the effective minimum rate of **15%**, **top-up tax will be due on the balance** affecting the tax benefits firms derive from the tax incentive
- In a post-Pillar Two environment, countries may wish to review the nature of the **tax incentives (TIs)** offered and to **evaluate their uptake and impact on the firms' tax liabilities**
- **Tax incentive reform and Qualified Domestic Minimum Top-up Taxes (QDMTs) can support countries in benefitting from Pillar Two**
- **Significant revenues are at stake** even for jurisdictions that have high statutory rates and those that are, on average, high-tax (ETR>15%)

Differences between statutory and effective rates?

- **Revenue forgone can be substantial** although less visible (Redonda et al., 2022)
- **Differences between statutory and effective tax rates can result from profit shifting**
- **Widespread use of tax incentives** is also one of the reasons ETRs are often considerably lower than statutory tax rates

Average tax rates of foreign affiliates of MNEs with revenues over EUR 750m, 2018



Source: OECD Country-by-Country Report data

Widespread use of tax incentives among developing and emerging economies

Tax exemptions, reduced rates and accelerated depreciation are the most commonly used instruments among developing economies

Low income
Lower middle income
Upper middle income

100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%

CIT exemption
Reduced CIT rate
Tax allowance (acceleration)
Tax allowance (enhancement)
Tax credit

Source: OECD Investment Tax Incentives database, July 20 version, based on information for 48 countries (9 low income, 26 lower middle income and 13 upper middle-income countries) and 387 entries of CIT incentives available on 1 January 2021.

Pillar Two

Overview

GloBE rules

- Domestic law provision
- Common approach
- Based on Financial Accounts
- 15% effective tax rate test
- Applies on a jurisdictional basis
- EUR 750 million threshold
- Substance-based income exclusion

Subject to tax rule

- Treaty provision
- At request of developing countries
- Base eroding payments
- 9% Adjusted nominal tax rate test
- Applies on a transactional basis
- Covered taxes for GloBE purposes

Multiple factors define the way jurisdictions, entities and tax incentives may be affected

Jurisdiction Level	Entity Level	Incentive Level
- **Baseline CIT systems** - **Other international provisions** (e.g. CFC rules)	- Whether entities are **part of an in-scope group** - The nature of **the entities' activities**: substance and income mix in the jurisdiction	- **Eligibility conditions** - **Scope** of the incentives (narrowly or broadly targeted) - **Tax instrument design** interacts with GloBE Rules

Interactions are complex as they are jurisdiction-, MNE- and incentive-specific:

There is no "one-size-fits-all" conclusion

Impact of GloBE will differ by incentive design

More likely affected	Less likely affected	Unlikely affected
• **Full exemptions** (e.g. tax holidays) • Reduced tax rates or partial exemptions • Tax allowances • Tax credits	• Accelerated depreciation for short-lived intangibles • Immediate expensing • Qualified Refundable Tax Credits	• Accelerated depreciation for tangible assets

- **Other design factors matter for the impact of the GloBE Rules**
- **Expenditure-based tax incentives** will be more likely to benefit from the substance-based income exclusion (SBIE)

GUIDANCE FOR POLICY MAKERS

Time to revisit and reconsider tax incentives

- **The benefits of using certain tax incentives may change due to the GloBE Rules**
  - No ‘one-size-fits-all’ conclusion
- **Pillar Two should provide impetus for tax reform**
  - Failing to act could mean that countries forego vital tax revenues that will be collected by other countries anyway and could leave them with tax incentives that are ineffective
- **Options will vary by jurisdiction**
  - Reform should be based on jurisdiction-specific analysis, identifying and assessing the tax incentives most likely to be impacted by the GloBE Rules
  - Adopting a “whole-of-government” approach will be important

Importance of considering tax incentive design

- **Narrowly-targeted incentives** (to certain categories of income or expenditure) may be less affected, as may incentives with ceilings or caps
- **Income-based incentives** may be more strongly affected than expenditure-based incentives, particularly for very profitable investments
- **Expenditure-based tax incentives** targeted to payroll or tangible assets may be more protected by the SBIE
- **Incentives based on timing differences** are less likely to be affected, e.g. expensing or accelerated depreciation (for certain assets) or **extended loss carry-over**
- **Qualified refundable tax credits** may be less affected. However, jurisdictions should consider the revenue consequences of refundable tax incentives

Practical guidance for countries

1. **Assess** whether the jurisdiction is at **high, medium of low-risk** of being affected by the GloBE Rules.
2. **Analyse** the impact of the **GloBE Rules on tax incentives** offered
3. **Measure the uptake of tax incentives** and **revenue forgone**
4. **Rank tax incentives based on the risk of top-up taxes** being paid and revenue forgone to establish reform priorities
5. **Study the impact** of existing **bilateral investment treaties investment agreements** and any fiscal stabilisation arrangements
6. **Evaluate** the **efficiency and effectiveness** of **tax incentives** post-GloBE

Possible short-term responses

- **Care should be exercised** in implementing new incentives or when considering entering into new investment agreements or contracts
- **Qualified Domestic Minimum Top-Up Tax (QDMT)** will be an important option for many countries, but it will unlikely be a substitute for a thorough country-specific re-evaluation of tax incentives
- **Pillar Two Revenues** can support DRM and improve investment climate
  - Revenues will support domestic resource mobilisation (DRM)
  - Additional revenues could be invested in ways that support a more attractive investment environment (e.g. investments in skills development and infrastructure)
- **The OECD stands ready to provide technical assistance to developing and emerging economies as they implement Pillar Two and review their tax incentives**