The treatment of tax incentives under Pillar Two*

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Abstract

This paper analyses the potential impact of the minimum tax envisaged under the OECD Pillar Two on several common corporate tax incentives. It reaches the conclusion that while the impact is expected to be low to moderate for some common incentives, such as participation exemption regimes and accelerated depreciations, it might be significant for direct cuts from the tax bill, which include tax holidays, intellectual property (IP) box regimes and special economic zones (SEZs). Hence, the response by policymakers must be informed by the specific interaction between the corporate tax incentives under their respective systems and the upcoming international standards on the minimum level of taxation.

Keywords: BEPS, corporate tax law, FDI, international taxation, tax incentives, Pillar Two

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1. Introduction

On 20 December 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit-Shifting (Inclusive Framework on BEPS) released the Global Anti-Base Erosion (GloBE) Model Rules to ensure the 15 per cent global minimum tax agreed under Pillar Two of BEPS 2.0 is consistently adopted (OECD, 2021). The GloBE Model Rules are supplemented by a Commentary which provides tax authorities with guidance on the interpretation and implementation of the rules (OECD, 2022). The current expectation is that the GloBE Rules will begin to be implemented by 2023.

Unlike BEPS 1.0 which was predominantly focused on abusive tax structures leading to tax evasion and avoidance,[1] GloBE has a much broader scope, and is aimed at reducing tax competition between jurisdictions in all (including genuine) cases. To do so, GloBE introduces minimum taxation rules that are supposed to ensure that all corporate profits of large multinational enterprises (MNEs) are subject to a minimum level of taxation, no matter where they are allocated. As such, it is expected that GloBE will impact all forms of tax competition and, therefore, have a profound significance for the corporate tax incentives offered by countries. This paper aims at analysing how the minimum tax envisaged under GloBE will impact a number of common corporate tax incentives.

The minimum tax will be achieved through the implementation of two main rules:

- **Income inclusion rule (IIR):** a domestic rule that will require a taxpayer that is the ultimate parent entity (UPE) of a MNE group to pay a top-up tax on its proportionate share of the income of any low-taxed constituent entity in which it has a direct or indirect ownership interest. Thus, the idea is to tax the income of constituent entities that were subject to tax at an effective tax rate (ETR) below 15 per cent. The IIR will be applied in the jurisdiction of the UPE or an intermediary parent entity (IPE), with the implication being that any constituent entity in any other jurisdiction that has an ETR below 15 per cent will be identified and subject to a top-up tax in the UPE or IPE jurisdiction, irrespective of whether the jurisdiction of the relevant undertaxed constituent entity subscribes to the GloBE Rules or not.
- **Undertaxed payments rule (UTPR):** a domestic rule that will operate by denying deductions or requiring equivalent adjustments to certain low-taxed constituent entities to the extent the undertaxed income has not yet been captured by the IIR (order of priority). A classic example where the UTPR would kick in is when the UPE jurisdiction chooses not to apply the GloBE Rules.

[1] The BEPS 1.0 Actions are available at /www.oecd.org/tax/beps/beps-actions/.

The GloBE Rules are designed to ensure that large MNEs pay a minimum ETR of 15 per cent on the income arising in each jurisdiction in which they operate, through the application of a system of top-up taxes in other jurisdictions (an IIR and/or a UTPR). This top-up tax does not operate like a typical direct tax on income of corporations, but rather *"is closer in design to an international alternative minimum tax, that uses standardized base and tax calculation mechanics to identify pools of low-taxed income within an MNE Group and imposes a co-ordinated tax charge that brings the Group's ETR on that income in each jurisdiction up to the Minimum Rate"* (OECD, 2022, para. 2 [emphasis added]) Therefore, the minimum tax is an alternative mechanism designed to act *in parallel* to existing corporate income tax (CIT) systems, which means that the GloBE Rules do not directly restrict countries from having certain measures that reduce the effective corporate tax liability in their territory.

This can be seen from the fact that neither the Model Rules nor the Commentary explicitly mention that countries are no longer allowed to adopt incentives, or have to change their CIT systems to impose a rate of at least 15 per cent. Instead, if implemented domestically, the GloBE Rules will act in parallel to CIT systems to ensure that MNE groups pay at least 15 per cent tax on excess profit in every jurisdiction in which their constituent entities operate. This means that jurisdictions are still "free" to adopt tax incentives and CIT rates below 15 per cent, but these measures risk being affected by the application of the GloBE Rules in other jurisdictions, as long as the reduced rate applies to excess profits. In the worst-case scenario, the operation of the GloBE Rules might lead to a situation where the revenue forgone due to tax incentives is recaptured in another jurisdiction until a minimum effective rate of 15 per cent is achieved, unless a jurisdiction introduces a domestic minimum top-up tax thereby ensuring that any under-taxation for the purposes of GloBE will be recaptured in the same jurisdiction.

2. General functioning of Pillar Two

2.1. Application of the GloBE Rules

Where an MNE group falls within the scope of the GloBE Model Rules, the UPE will have to calculate its top-up tax liability for each jurisdiction that has an ETR below 15 per cent.

To calculate the ETR, the UPE will first determine the amount of GloBE income or loss of each constituent entity on a jurisdictional consolidated basis. Once the financial accounting net income or loss of each constituent entity is determined, this amount will be adjusted for the permanent or temporary differences that arise between financial accounting results and taxable income results. The GloBE income or loss thus achieved can be referred to as "the GloBE tax base".

As a next step, the amount of taxes that are attributable to the GloBE income or loss is determined by looking at the amounts paid as adjusted covered taxes.[2] These are the (qualifying) taxes that an MNE has paid in relation to its activities in a given jurisdiction.

Having established each constituent entity's GloBE tax base and adjusted Covered Taxes, the jurisdiction's ETR is calculated by dividing the sum of the adjusted covered taxes by the net GloBE income of that jurisdiction (i.e. the positive or negative amount resulting from the difference between the GloBE income of all constituent entities and the GloBE losses of all constituent entities in that jurisdiction):

$$\text{ETR} = \text{Adjusted covered taxes/Net GloBE income}$$

If the ETR is then below 15 per cent, the jurisdiction is a low-tax jurisdiction and a top-up tax percentage has to be calculated, being the difference between the minimum rate and the ETR calculated for that low-tax jurisdiction. For example, if the ETR is 11 per cent, the top-up tax would be 4 per cent. Any top-up tax to be paid abroad might be reduced or eliminated by any qualifying domestic minimum tax.

The top-up tax is levied only on the "excess profit" for a jurisdiction. The excess profit corresponds to the amount of GloBE income for the jurisdiction remaining after applying a "substance-based income exclusion", which is a formulaic carve-out based on payroll and tangible assets aimed to exclude a fixed return for substantive activities within a jurisdiction from the application of the GloBE Rules (OECD, 2022). Generally, the substance carve-out would amount to a fixed return (5 per cent) on payroll and tangible assets costs. This means that any tax incentive, leading to a rate below the minimum, will remain unaffected as long as it applies only to substance intensive activities covered entirely by the carve-out.

[2] According to Article 4.2 in OECD (2021), adjusted covered taxes include, inter alia, income-based taxes, such as taxes recorded in the financial accounts with respect to income or profits of a constituent entity, taxes on distributed and deemed distributed profits, taxes imposed in lieu of a generally applicable corporate income tax, and taxes levied on retained earnings and corporate equity. However, as mentioned in OECD (2022), the definition of covered taxes does not include excise taxes, "indirect taxes, payroll and property taxes, which are not based on a measure of income" (p. 85). Moreover, "[t]ax imposed on gross income or revenue without any deductions (i.e. a tax on turnover) would not be considered an income tax. The design and substantive character of such turnover taxes generally have more similarities to consumption or sales taxes. The definition of Covered Taxes therefore does not include a Tax on a gross amount unless such a Tax is in lieu of an income tax"(p. 92). A tax "in lieu" of income tax might be the withholding tax on gross interest and royalties income by non-residents. However, some turnover taxes such as a number of unilateral taxes on digital turnover imposed by countries seems to remain outside the scope of the definition of "covered taxes". It remains interesting to see how the newly introduced possibility for taxation of the digital economy under the United Nations model at source would affect this distinction. See Article 4.2, paras. 22–27 in OECD (2022).

2.2. Limitations on the GloBE scope

The GloBE Rules provide for certain exclusions from the top-up tax application according to the entities' sector and types of income, and require a minimum amount of revenue for a given MNE group to be in the scope of the rules. These limitations on the scope may also have an impact on potential incentives that can be retained by jurisdictions since some corporate taxpayers remain outside the scope of the rules. It remains unclear, however, if and to what extent high tax jurisdictions can unilaterally expand the scope of the GloBE Rules under their domestic law.

2.2.1. Small and medium-sized enterprises (SMEs)

The GloBE Rules apply to constituent entities of MNE groups that meet a €750 million threshold in the consolidated financial statements of the UPE in at least two of the four preceding fiscal years. This means that, in principle, the application of the top-up tax is limited to MNE groups with annual consolidated revenues of at least €750 million. Importantly, such threshold takes into account the consolidated financial statements of the MNE group, meaning that it is not each constituent entity that has to reach the €750 million threshold, but the whole group, even taking into consideration excluded entities (OECD, 2022).

In addition, a de minimis exclusion may also apply at election of the filing constituent entity to deem the top-up tax as zero if, for that jurisdiction, the average revenue was less than €10 million and the average of GloBE income or loss was less than €1 million in the current and the two preceding fiscal years.

2.2.2. Excluded entities

The GloBE provides for the exclusion of some entities from its rules, referred to as excluded entities. That is, excluded entities are those excluded from the definition of constituent entities and, therefore, are not subject to the GloBE Rules. These include: government entities, international organizations, non-profit organizations, pension funds and investment funds or a real estate investment vehicles that are UPEs of an MNE group.

Important to note that only investment funds and real estate investment vehicles that are UPEs of an MNE group are excluded entities for the purposes of the GloBE. Such exclusion is aimed at protecting their status as tax neutral investment vehicles. Where an investment fund or real estate investment vehicle is not the UPE, it can still be treated as a constituent entity, provided it otherwise meets the consolidation requirements of the Model Rules. However such entities are considered "investment entities" and subject to special rules for calculation of the GloBE ETR under Articles 7.4 to 7.6 in OECD (2022).

2.2.3. Excluded income

Furthermore, there is an exclusion from the GloBE Rules for income derived from international shipping. Thus, if the MNE group has this type of income, each constituent entity's portion of it will be excluded from the computation of its GloBE income or loss. This may result in a reduction in the denominator of the ETR formula, the GloBE tax base, making the ETR higher for that jurisdiction (and therefore reducing the risk of suffering the effects of the top-up tax).

3. Treatment of incentives

As mentioned above, the GloBE Rules do not directly and expressly prohibit jurisdictions to adopt tax incentives or reduced rates within the CIT system. However, based on how the GloBE Rules are intended to operate, their effects might be undermined and risk being impacted by the charging of the top-up tax by the UPE jurisdiction. If that happens, the jurisdiction granting the incentive would eventually give up taxing rights not in exchange for offering more favourable business environment but to the benefit of the tax revenue of the "topping-up" jurisdiction.

Notwithstanding this, the GloBE Rules and the Commentary explicitly determine that some untaxed (or undertaxed) income are not computed as part of the GloBE Income of a constituent entity, and that some types of tax benefits will not reduce the amount of adjusted covered taxes for GloBE purposes. This means that these income streams can be excluded from the denominator of the formula (the net GloBE income), and that these tax benefits will be included in the numerator (adjusted covered taxes), resulting in a higher ETR for the jurisdiction and therefore reducing the risk of application of the top-up tax by the UPE jurisdiction.

In essence, some tax benefits can be upheld by countries because they are not affected by the GloBE Rules, as they do not reduce the ETR for that location. Other types of incentives that have not been expressly mentioned in the Rules, however, do not share the same fate and may be undermined by the top-up tax.

The scope of this contribution is not to deplete the analysis of the impact of the GloBE Rules on each and every tax "incentive" adopted by jurisdictions around the world, but to conceptually understand which incentives will be affected to a lesser extent by the GloBE Rules because their impact on the ETR calculation is somehow neutralized as a result of the operation of these rules and the express mention of them in the Model and its Commentary. Some other incentives that are commonly adopted by countries to attract FDI are also analysed in order to establish whether these will have their effects minimized by the application of the top-up tax.

For this reason, the term “incentive” is used hereinafter in a broad sense, relating to the tax benefits granted by jurisdictions (especially to foreign investors) to attract FDI into their territories. The discussion on the meaning of the term “incentive” is not raised in this article (e.g. whether it means a more favourable tax treatment than the accounting treatment, or than what other countries normally adopt in their tax systems, or than other similar domestic situations, etc.). This is particularly due to the fact that each jurisdiction may define “taxable income” differently and deviations on its meaning would undermine a possible universal definition of the term “incentive”. Therefore, it is not the intention of this contribution to delve into dogmatic discussions about the use of the term “incentives”, as it could not be meaningfully defined in the abstract.

In addition, for the sake of simplicity, the present analysis focus only on CIT-related incentives, since the definition of covered taxes under the GloBE Rules includes basically taxes on corporate income. However, it is relevant to note that there is whole range of other tax incentives in the domestic tax systems of countries that are not affected by the GloBE Rules as they fall outside their scope.[3]

Thus, in light of the limitations set out above, when hereinafter we determine that an incentive is “impacted” by the GloBE Rules, we examine whether its effects would be affected by the top-up tax. This, naturally, presupposes the assumption that the circumstances fall within the scope of the GloBE Rules and that there is an excess profit beyond the standard return under the substance carve-out. Moreover, the analysis naturally presupposes that the application of the incentive leads to an ETR below 15 per cent: nothing in the rules, as they currently stand, suggests that an incentive that reduces the ETR from 25 to 20 per cent would be in any way affected.

3.1. Reduced rate

3.1.1. 0-rated and less than 15 per cent

Countries with zero or less than 15 per cent CIT rates are more likely to have an ETR below 15 per cent. While, a general reduced CIT rate may not be considered an “incentive” per se, unless within the context of competing jurisdictions, an analysis of the impact of the GloBE Rules is necessary for countries with (even general) reduced CIT rates. The GloBE Rules would limit the perceived financial benefits of reduced rates, as a top-up-tax would be chargeable by another jurisdiction in the instance that the ETR in the country offering the reduced CIT falls below 15 per cent.

[3] UNCTAD (2022, chapter III, section C.2). provides further analysis on the variety of tax incentives adopted to attract FDI, also assessing the size of CIT-related incentives in comparison to others.

As described above, the GloBE is an alternative mechanism designed to act in parallel to existing CIT systems and it does not directly restrict countries from adopting zero or reduced rates for CIT purposes. Nevertheless, because the rules require a minimum ETR of 15 per cent on the income in each jurisdiction where an in-scope MNE group operates, the effect produced by systems adopting reduced or zero CIT rates is likely to be affected by the application of the top-up tax. The consequence of the parallel application of the GloBE and the domestic tax systems is that the amount of tax revenue foregone by countries operating a domestic tax system that leads to an ETR below 15 per cent will be collected in another country (the UPE jurisdiction). Therefore, countries will have to rethink how to structure their domestic tax systems.

Importantly, this does not only impact "CIT", as the covered taxes definition under the GloBE Rules is broader. While countries with statutory CIT rates below 15 per cent are more likely to have an ETR below 15 per cent, countries with reduced CIT rates may still avoid the top-up tax if other taxes on corporate income, such as withholding taxes make up for the difference.

However, considering that with no CIT system or with zero or less than 15 per cent CIT rates are more likely to have an ETR below 15 per cent, three policy options may be adopted by these countries to minimize the impact that GloBE will have on their tax systems and avoid having the top-up tax levied in another country, while complying with the spirit and intentions of BEPS 2.0.

First, countries can adopt a CIT system or change the existing ones to impose or increase the (effective) rates to the minimum of 15 per cent. This would avoid the application of the foreign top-up tax under GloBE Rules. However, countries may face administrative and legislative challenges as this could entail an overhaul of the whole CIT system. Moreover, it could also affect the beneficial effects of the reduced rates for circumstances that do not fall within the scope of the GloBE Rules – e.g. SMEs or activities such as manufacturing that are largely covered by the substance carve-out, leading to a higher total tax liability.

Another option would be for source countries to retain the reduced rate in their current CIT systems, but to increase the rate only for in-scope companies. While this would ensure that the top-up tax is not collected at the UPE jurisdiction, it would require restructuring of the source country's CIT systems. A downside of this approach is that it essentially splits the country's corporate taxpayers on an arbitrary basis.

Lastly, countries could choose to retain the reduced rate in their current CIT systems, but to adopt a domestic minimum top-up tax as described under the GloBE Rules, to apply to all MNEs that operate in their territory and fall within the scope of the GloBE Rules. This is because, as explained above, the foreign top-up tax is reduced by any qualified domestic minimum top-up tax (QDMTT) paid.

Under the GloBE Rules, jurisdictions are not required to adopt such Domestic minimum top-up tax, but if they do, such tax will, if implemented correctly, reduce the top-up tax by the UPE jurisdiction to nil (OECD, 2022). Thus, "[f]or example, a Parent Entity with an Ownership Interest in what would otherwise be a [Low-Taxed Constituent Entity] generally will not have any liability under the IIR if that Constituent Entity is subject to a Qualified Domestic Minimum Top-up Tax that imposes the same amount of tax that would otherwise arise under the IIR" (OECD, 2022, p. 212). A QDMTT is defined as "a minimum tax that is included in the domestic law of a jurisdiction and that: (a) determines the Excess Profits of the Constituent Entities located in the jurisdiction (domestic Excess Profits) in a manner that is equivalent to the GloBE Rules; (b) operates to increase domestic tax liability with respect to domestic Excess Profits to the Minimum Rate for the jurisdiction and Constituent Entities for a Fiscal Year; and (c) is implemented and administered in a way that is consistent with the outcomes provided for under the GloBE Rules and the Commentary, provided that such jurisdiction does not provide any benefits that are related to such rules" (OECD, 2021, p. 64).

Therefore, countries should adopt a domestic minimum tax that would operate similarly to the GloBE Rules, ensuring that if the MNEs located in their territory have an ETR below 15 per cent, they would be the countries charging the top-up tax, rather than the UPE jurisdiction. This would create a situation where the two tax systems function in parallel.

3.1.2. More than 15 per cent

Countries with CIT rates above 15 per cent are more likely to have an ETR above the 15 per cent minimum. However, this is not an absolute truth as calculations based on the GloBE Rules may lead to an ETR below the minimum. This is because the GloBE Rules have their own formulas and way of calculating the ETR, not necessarily following the same calculations under the CIT systems worldwide. In addition, even though countries may adopt statutory CIT rates above 15 per cent, the ETR calculation is not solely dependent on the CIT, meaning that any incentive adopted in relation to other taxes on corporate income treated as covered taxes under the GloBE Rules may also impact on the calculation and eventually bring the ETR below 15 per cent. Therefore, jurisdictions can never have absolute certainty that their ETR does not fall below the minimum under the GloBE Rules unless the ETR calculation is performed each and every time.

Thus, implementing a qualified domestic minimum top-up tax for all instances when an MNE falls within the scope of the GloBE Rules may be desirable to avoid, in the event the ETR for an MNE group in its territory is found to be below 15 per cent, the UPE jurisdiction charging the top-up tax (rather than the source jurisdiction). This can be seen as a safety valve against having to constantly recalculate under the GloBE Rules the effects of domestic CIT reforms.

3.2. Deductions

3.2.1. Accelerated depreciation and immediate expensing

Since the GloBE Model Rules rely on financial accounts to arrive at the tax base, they do not consider the domestic tax treatment of depreciation. Tax rules for the deduction of depreciation differ from accounting rules and even more so between countries.[4] This is because the timing rules[5] for when to expense depreciation differ (Goddard and Rogers, 2006). Tax rules offer more favourable options for the depreciation of assets (as opposed to straight-line which spreads the cost evenly over the life of the asset), such as accelerating depreciation or immediately expensing the cost of the assets. Accelerated depreciation rules permit taxpayers to expense the cost of an asset much faster than traditional depreciation methods (Easson, 2001). Immediate expensing permits the deduction of the entire cost of the asset in the year it was purchased. Both incentives lower the taxable profits for the years where they are applied and will give rise to timing differences when compared to the financial accounts. To neutralize this outcome, typically, in the years where the actual taxes paid are lower than the taxes that would have accrued based on the financial accounting method, a deferred tax liability will be created, and this represents a company's higher tax liability in the future.

Accelerated depreciation and immediate expensing are common incentives adopted by countries and will, as a result, more frequently lead to temporary differences (caused by the timing issues) that could cause the ETR to fall below the minimum rate (OECD, 2022). This will result in a liability under the IIR and in "significant and frequent IIR tax paid and ultimately IIR tax credits" (OECD, 2020, para. 220). The GloBE tax liability arising from this temporary difference will then eliminate the intended-benefits of national tax rules (OECD, 2020). This is a significant risk to capital intensive businesses and could lead to over-taxation. This is because, the temporary differences arising from accelerated depreciation and immediate expensing are common around the globe and the Inclusive Framework recognizes that they are tied to substantive activities in a jurisdiction or are differences that are not prone to taxpayer manipulation (OECD, 2022, Article 4, para. 92). Accelerated depreciation and immediate expensing are therefore recognized as low-risk incentives.

[4] This tension between accounting profits and taxing profits has been discussed extensively. See, for example: Brown (2020); Chandler and Edgley (1999); Freedman (1993 and 1995); and Whiting (2006).
[5] For a discussion on this, see Schon (2004).

As a result, there is a need for the temporary differences that will be caused by the computation of the tax base using the GloBE Rules to be taken into account and adjusted for so that they do not distort the calculation of the ETR. To do this, accelerated depreciation and immediate expensing of the tangible property of the constituent entity will be included in the computation of the ETR as deferred taxes. A deferred tax liability is “the amount of income tax payable in future periods in respect of taxable temporary differences” or “tax that is payable in the future”.[6]

To arrive at the deferred tax amount, entities will rely upon the rules applicable in the constituent entity’s tax jurisdiction (OECD, 2020). This is obviously a departure from the policy approach of the GloBE Model Rules which refrain from relying on national rules. The deferred tax adjustment amount for a constituent entity for a fiscal year will equal the deferred tax expense accrued in its financial accounts if the applicable tax rate is below 15 per cent. This amount will be added to the adjusted covered taxes of a constituent entity, which will ultimately, once computed, increase the ETR (OECD, 2022, Article 4, para. 69).

MNEs are directed to the section addressing the computation of adjusted covered taxes where they are required to apply the deferred tax rules contained in Article 4.4. This provision sets out the method for calculating the total deferred tax adjustment amount, it builds on traditional deferred tax accounting principles but includes key adjustments “to protect the integrity of the GloBE Rules” (OECD, 2022, p. 100). It should also be noted that, regarding the application of the UTPR, the denial of a deduction under this Article includes the denial of an allowance for depreciation or amortization (OECD, 2022).

3.2.2. Loss carry-forward

A tax loss occurs where the allowable expenses exceed the taxable income. Tax losses may generally be carried forward to future years as long as the national tax rules permit or until the loss has been completely offset against future tax liability returning the company to a payable position. This is a common form of tax relief for companies that experience losses. A loss carry forward is an asset in the financial statement since it will assist in reducing future tax liabilities. A deferred tax asset will then be created and will be offset against net income arising in the following financial years. The deferred tax asset account may either be reduced each year or may increase if the losses persist.

[6] Association of Chartered Certified Accountants, “Deferred tax”, www.accaglobal.com/in/en/student/exam-support-resources/fundamentals-exams-study-resources/f7/technical-articles/deferred-tax.html (accessed 6 July 2022).

The GloBE Model Rules permit adjustments for the carry forward of losses. Losses are defined as the excess of expenses over income included in the GloBE tax base of the jurisdiction for a year. Losses include qualified pre-regime losses or losses incurred prior to the MNE group falling within the scope of the GloBE Rules (OECD, 2020). The carrying forward of losses will reduce the GloBE tax base in the year they are deducted, as a result, the adjustment of the GloBE tax base has been permitted for losses and other carry-forwards (such as excess tax payments paid in prior periods into a subsequent period) in order to smooth-out any potential volatility arising from the mix of taxes imposed under local law or resulting from timing differences (OECD, 2020). This follows the same rational as the treatment of depreciation and, as a result, a deferred tax accounting approach is also available to companies.

The mechanism to address temporary differences using deferred tax (Article 4.4, highlighted in the section on depreciation) may be applied to the carry forward of losses or the entity may opt for the GloBE loss election (OECD, 2021 and 2022). A constituent entity can make a GloBE loss election for a jurisdiction resulting in the creation of a GloBE loss deferred tax asset in that fiscal year when the loss election is made (OECD, 2021). The GloBE loss deferred tax asset is equal to the net GloBE loss multiplied by the minimum rate. The balance of the GloBE loss deferred tax asset is carried forward to subsequent fiscal years, reduced by the amount of GloBE loss deferred taxasset used in a fiscal year. It must be used in any year where there is net GloBE income.

3.2.3. Refundable tax credits

The negative corporate tax liability (losses) need not be carried forward. Although more rarely, countries might opt to directly refund the negative tax liability by means of a refundable tax credit. For instance, if a onstituent entity has a loss of 1,000 in a given year and the CIT rate is 10 per cent, a jurisdiction might opt to directly refund the 100 of negative tax liability rather than have the loss being carried-forward. The result achieved is essentially the same as if the losses are carried forward (provided that the future holds sufficient profits) but the refundable tax credits provide a manifest cash-flow advantage which could be especially beneficial in stimulating new businesses.

In some instances, refundable tax credits can also be used as a direct incentive where a government commits to cut the tax bill with respect to certain activities (e.g. R&D) and to the extent there is no sufficient tax due to refund the amount of unused credit. While it is in this latter sense that the GloBE envisages refundable tax credits (OECD, 2020), the logic of the rules also holds when it comes to refunding negative corporate tax. The refunding of negative corporate tax is important to explicitly consider as it might be a powerful economic stimulus in times of crisis.[7] The Model Rules differentiate between qualified and non-qualified refundable tax credits. The differentiating criterion between the two is whether the credit is refundable within four years of the moment when the conditions for it are met. Qualified credits are treated as income for the purposes of the GloBE computation of the base (OECD, 2021). Hence, qualified credits are treated similarly to governmental grants. On the other hand, non-qualified refundable tax credits are treated at the level of the tax expenses under Article 4 of the Model Rules, leading to a reduction in the tax expenses (OECD, 2022). In any event, both the qualified and the non-qualified will have an impact on the ETR calculation.

That being said, their effect would not necessarily lead to a top-up tax. It will ultimately depend on the exact constellation of activities (presumably not all eligible for a tax credit incentive) of the MNE, as well as its net GloBE tax result. It must be noted that for the refundable tax credit to apply it would be often the case that there might be a negative tax result. Moreover, even if due to differences in calculating the base or because the credit applies for a specific activity (e.g. R&D), the GloBE net result is positive, one could expect that refundable tax credits would not be entirely re-collected as taxes since the tax due is a percentage of the overall income with a net effect of reduced overall taxation also below 15 per cent.[8]

3.2.4. Deductions for qualified expenses

Deductions for qualified expenses refer to the allowable expenses that businesses are permitted to deduct for tax purposes:

> The financial accounts of the [constituent] entity are used to determine the entity's profit (or loss) before tax. Profit (or loss) before tax is the preferred profit measure under the GloBE rules for several reasons. First, it takes into account the actual costs of doing business, including all operating and non-operating expenses. Second, it is the most comparable financial accounting measure to taxable income, but, critically, it is computed without regard to special local tax exclusions, deductions and tax accounting conventions that would undermine the policy objectives of the GloBE rules. Therefore, using profit (or loss) before tax as a measure of profit for computing the GloBE tax base should limit the risk of the GloBE tax base diverging significantly from the tax base of the MNE Group under local corporate income tax rules, where such a divergence would be inconsistent with the policy objectives of the GloBE rules (OECD, 2020, para. 159).

[7] Wofgang Schön has been a prominent proponent of this idea: See "Tax law under heavy weather", Max Planck Institute for Tax Law and Public Finance, September 2020, www.tax.mpg.de/en/news.
[8] See in this sense also UNCTAD (2022, p. 147).

To address the treatment of deductible qualified expenses, the Inclusive Framework recognizes that it is "implicit in the decision to use financial accounts as the starting point for determining the GloBE tax base that certain permanent differences will arise between that local tax base and the GloBE tax base" (OECD, 2020, para. 177). These permanent differences are expected and "it would not be possible or desirable, from either a policy or a design perspective, to develop a comprehensive set of adjustments that will bring the GloBE tax base fully into line with the tax base calculation rules of all Inclusive Framework members" (OECD, 2020, para. 177).[9] However, some adjustments are still possible and appropriate and to determine whether they will acceptable an evaluation of the materiality and commonality of a permanent difference will be required. Ultimately, an adjustment should only be made to "exclude material items that are commonly excluded from the tax base of Inclusive Framework jurisdictions" (OECD, 2020, para. 178). But these allowable adjustments should be kept to a minimum to reduce complexity, these adjustments include net tax expenses, excluded dividends and excluded equity gains or losses amongst others.

3.3. Exemptions

3.3.1. Tax holidays and other specific exemptions (location/sector/entity)

In order to attract investments to their territory, it is a common practice for countries to resort to tax incentives, such as tax holiday schemes and other specific exemption regimes. In general terms, tax holiday is a government incentive programme offering a temporary reduction or elimination of taxes. Specific exemption regimes include, for example, those that fully or partially exempt from the tax base income arising from certain sectors of the economy, types of entities or locations.

While the GloBE Rules do not explicitly prohibit countries from adopting these exemptions, CIT-related incentives directed at businesses are likely to be affected. This is because, the GloBE Rules will have an impact on income-based taxes and, therefore, certain exemptions and tax holiday schemes aimed at temporarily "eliminating" income taxes will largely be affected by the charging of the top-up tax in the UPE jurisdiction.

Naturally, if such measures target out of scope companies, or they do not lead to a reduction of the ETR below 15 per cent, they will remain unaffected provided that the UPE jurisdiction is not applying lower thresholds under its domestic implementation of the GloBE Rules.

[9] Whereas temporary differences are eventually reversed, permanent differences will never be eliminated. Some examples of permanent differences are penalties and fines which are recorded for accounting purposes but cannot be deducted for tax reporting purposes.

3.3.2. Participation exemption regimes

In many jurisdictions, dividends are excluded, in whole or in part, from the taxable income of a corporate shareholder, through a mechanism often referred to as participation exemption. These regimes are reliefs usually granted under domestic law in recognition of the fact that the dividend is paid out of profits that have already been subject to tax at the level of the distributing company. Taxing these dividends under the GloBE would thus give rise to the risk of over taxation (OECD, 2020, para. 181).

The rules allow certain types of dividends to be excluded from the GloBE Income (the denominator of the ETR fraction), which means that the untaxed dividends will not be computed in the ETR calculation. However, there are some limitations for this exclusion. An exception is found for dividends received from short-term portfolio shareholding, i.e. below 10 per cent and helf for less than one year. In any event, domestic participation exemption regimes will impose similar conditions for their application.

3.3.3. Exemptions for excluded equity and asymmetric foreign currency gains or losses

The rules provide for other adjustments in the GloBE tax base computation to address permanent differences between the treatment of some items under financial and tax accounting standards, which may have an impact on exemptions adopted worldwide.

Many jurisdictions fully or partially exempt from the tax base gains and losses arising from the disposition of ownership interests. Usually, these gains or losses are included in the financial accounting income of the seller but excluded from its taxable income. If this difference is not adjusted in the GloBE income or loss computation, "gains on sales of Ownership Interests will result in a lower GloBE ETR for the seller (and potential tax liability under the GloBE Rules). Losses, on the other hand, will result in a higher GloBE ETR for the seller (and potentially shield other income from GloBE tax liability)" (OECD, 2022, p. 54). The rules exclude gains and losses from dispositions of ownership interests from the seller's GloBE income or loss computation, as long as these are not from the disposition of a portfolio shareholding (below 10 per cent shareholding). Thus, exemptions granted to dispositions of ownership interests, other than a portfolio shareholding, may not be affected by the application of the rules.

However, exemptions granted for foreign currency exchange gains or losses (FXGL) that arise due to differences between the functional currency for accounting purposes and the one used for local tax purposes, may be at risk, since the GloBE Rules do not make any adjustments for FXGL when the tax and the accounting functional currencies are the same (OECD 2022, para. 67). Thus, if FXGL are exempt under domestic tax rules in this situation, there will be a permanent difference that will affect the ETR of the jurisdiction, where such exemptions are likely to be impacted by the GloBE application. Nevertheless, if the functional currencies used for accounting and tax differ, different types of adjustments are made by the GloBE Rules to avoid distortions that could arise.[10]

3.4. Other income taxes-related incentives

3.4.1. Imputation regimes

These regimes are intended to protect resident shareholders from economic double taxation, as they allow either the company or the shareholder to claim a full or partial credit or refund of the CIT previously paid by another company when its profit is subsequently distributed as dividends.

According to the Blueprint, CIT paid under an imputation system seeking to prevent economic double taxation at the resident shareholder level should be treated as a covered tax. Thus, only to the extent that such shareholder is subject to tax (OECD, 2020, para. 138).

In this context, the GloBE Rules differentiate between qualified imputation tax and disqualified refundable imputation tax regimes. qualified imputation tax regimes relate to those regimes that allow a refund of taxes to be paid in respect of distributions made to a resident shareholder that is generally subject to tax, or which is an excluded entity. Under these regimes, the tax refunded will not be treated as a reduction in covered taxes (the numerator of the ETR fraction), resulting in a higher ETR for the jurisdiction and thus reduce the risk of application of the top-up tax. Thus, qualified imputation tax regimes may not be affected by the GloBE Rules and can be upheld by countries.

Disqualified refundable imputation tax regimes, on the other hand, relate to regimes that allow a refund of taxes previously paid by the company when the income is subsequently distributed as dividends even where the shareholder is not subject to tax on the dividend. In such a case, disqualified refundable imputation taxes that are paid or accrued and included as an expense in the financial accounting net income or loss do not qualify as a covered tax and must be added back in the GloBE tax base. This will represent an increase to GloBE income, ultimately reducing the ETR (OECD, 2022).

[10] For the potential scenarios, see Article 3.2, paras. 68–74 in OECD (2022).

3.4.2. Withholding tax incentives

Withholding tax (WHT) is a tax that source countries levy on various forms of income paid to residents or foreigners including dividends, interest, professional fees, management services and more. The foreign companies subject to WHT may or may not have a permanent establishment in the source country. Some countries provide for favourable WHT treatment to foreign investors by eliminating WHT on outbound passive payments, such as on dividends (or liquidation payments), interest and/or royalties. The GloBE Rules include all types of passive inbound income in the computation of the tax base: dividends, interest and royalties, except for participation exemption regimes as discussed above.

The WHT paid in the source state would be included in the computation of the covered taxes for the purposes of calculating the ETR – see Article 4.2.1. (c) of the Model Rules.[11] The effect of this will be that the inclusion of the passive income will increase the tax base, whilst the availability of WHT incentives will fail to increase the covered taxes. This will result in a lower ETR and means that WHT incentives could reduce the ETR of a constituent entity to below the minimum rate, and lead to either the resident jurisdiction of the recipient or the UPE charging a top-up tax. This will be particularly concerning where the passive income enjoys both a WHT incentive and low or no CIT in the jurisdiction where the outbound payment is received.

Therefore, source jurisdictions might wish to levy a WHT for the difference in each and every case where, due to the WHT incentive and the level of taxation in the residence state of the item of income, the overall taxation of such item is below 15 per cent. For example, a source jurisdiction might wish to levy at least 5 per cent WHT on royalties if the recipient entity is at a profit and enjoys an IP box regime where IP income is taxed at a 10 per cent rate. If in such a scenario the source jurisdiction refrains from levying WHT, the difference up to 15 per cent might be anyway taxed under the GloBE Rules, only in another jurisdiction. The above comes to say that source countries could revisit their beneficial WHT regimes and make them conditional upon a minimum tax of 15 per cent in the country of residence for the specific item of income.

Moreover, WHT benefits might be maintained with equal efficiency if a source country applies the WHT refund mechanism and ascertains for its application that the overall GloBE ETR in the country of residence of the recipient for the relevant period is above 15 per cent (rather than the simplified per-item of income approach) or that there is no GloBE excess profit (because the MNE is in a loss position in

[11] See also OECD (2022, Article 4, para. 31): "This test […] would generally include *withholding taxes on interest, rents and royalties, and other taxes on other categories of gross payments* such as insurance premiums, provided such taxes are imposed in substitution for a generally applicable income tax" [emphasis added].

the given jurisdiction of residence or due to the substance-carve out). Hence, a certain flexibility as regards reduced WHT rates is in order. While such flexibility is possible under domestic law, double tax treaties might introduce restrictions to countries' possibility to levy variable WHT depending on the tax treatment of the corresponding income in the residence state.

3.4.3. Subject to Tax Rule (STTR)

The STTR is a standalone rule, designed to complement the IIR and UTPR, which will be included in tax treaties. It applies to payments between the residents of two contracting states that are connected persons and specifically targets intragroup payments that shift profits from source jurisdictions to low or no tax locations. In particular, the STTR "is based on the rationale that a source jurisdiction that has ceded taxing rights in the context of an income tax treaty should be able to apply a top up tax to the agreed minimum rate where, as a result of BEPS structures relating to intragroup payments, the income that benefits from treaty protection is not taxed or is taxed at below the minimum rate in the other contracting jurisdictions" (OECD, 2020, para. 567). The STTR addresses this by allowing the source state to impose additional taxation on certain covered payments up to a nominal rate of 9 per cent. This rule will not apply to payments made to or by individuals (OECD, 2020).

The STTR is essentially a rule that makes a double-tax-treaty benefit (e.g. reduced WHT rate) conditional upon taxation of the corresponding income in the country of residence. For example, while the OECD Model convention precludes the source country from levying WHT on royalty payments, by including an STTR, this surrender of taxing rights would be conditional upon effective taxation in the state of residence of up to 9 per cent. Covered payments include: (i) interest; (ii) royalties; (iii) other payments for mobile factors, such as capital, assets or risks owned or assumed by the person entitled to the payment, such as franchise fees or other payment for intangibles in combination with services; (iv) insurance premium; (v) guarantees, brokerage or financing fees; (vi) rent or any other payment for the use of or the right to use moveable property; and (vii) payments in consideration for the supply of intermediary services.

The STTR is intended to assist source states to protect their tax bases, and, to ensure it is focused on BEPS structures, a materiality threshold will be applied based on either the size of the MNE group, the value of the covered payment or the ratio of the covered payments to total expenditure (OECD, 2020).

3.4.4. IP box regimes

The IP box regime tax incentive relates to favourable tax treatment of income derived from intellectual property rights (e.g. patents). Such IP box regimes would be compatible with BEPS Action 5, provided that they are substance-based: i.e. the R&D activities that lead to income from IP rights must be performed in the jurisdiction that grants the incentive (e.g. “non-harmful IP box regime”).

However, the GloBE Rules do not differentiate between IP box regimes depending on whether they are BEPS Action 5 compatible or not. This in essence means that if an IP box regime results in an overall ETR below 15 per cent as computed under the GloBE Rules in the given jurisdiction, the effect of the incentive would be impacted also for non-harmful regimes. The effect would depend on the exact activities that an MNE is performing in the given jurisdiction – e.g. the effects would be “diluted” if there are substantial other business activities that generate income not entitled to the beneficial IP rate. In the latter case, even if the IP incentive applies with a rate below 15 per cent, the total ETR of the MNE in that jurisdiction might be above 15 per cent.

A further rule that might have an impact on the effects of GloBE to BEPS Action 5 compatible IP box regimes is the substance-based income exclusion. Non-harmful IP box regimes presuppose actual R&D activity to take place in the jurisdiction offering them. The substance-based GloBE carve-out excludes from the net GloBE profit a standard 5 per cent return on eligible payroll costs and tangible assets, such as property, plant and equipment. If the substance based income exclusion, exceeds the net GloBE income, there would be no excess profit subject to a top-up tax. Thus, a BEPS Action 5 compatible IP box regime might be further shielded from the GloBE Rules if the R&D behind it is heavily dependent on cost intensive staff and tangible assets.

What the above means is that in principle GloBE Rules can have an impact on IP box regimes. However, the intensity of this impact would be dependent upon a number of factors, such as tax rates, exact constellation of activities performed by the MNE in the jurisdiction at hand, as well as the related staff and tangible assets costs related to the R&D activity. Hence, the GloBE Rules are not expected to entirely cancel out but rather to reduce the impact of IP box tax incentives. Unlike WHT, however, it is the jurisdiction that offers the incentive that would eventually collect the top-up tax if such is due assuming it applies a domestic top-up tax. In this sense, it appears sensible that IP box regimes are retained in parallel to the GloBE Rules, as long as a country maintains a qualified domestic top-up tax regime.

3.4.5. Distribution based corporate income tax systems

The Inclusive Framework recognizes that some members have income tax regimes that impose corporate income tax when the income is distributed to the shareholders of a company rather than when it is earned. Although the tax rates applicable to these distribution-based regimes maybe equal to or above the GloBE minimum tax rate, "absent a distribution [...] the income is not subject to the distribution tax in the year it is earned and included in the financial accounts" (OECD, 2020, para. 226). As a result, under the GloBE Rules, the covered tax expense for the year that the income was earned would fall below the minimum tax rate. The GloBE Rules do not permit an indefinite deferral but introduces a deemed distribution tax, which enables an entity to "increase its covered taxes for the year up to the minimum tax liability for purposes of the GloBE ETR computation in the jurisdiction, but requires the corporation to recapture the increase to the extent an equal amount of distribution tax is not paid within a reasonable period of time, e.g. 2–4 years" (OECD, 2020, para. 228).

4. Concluding remarks

This paper demonstrates that while the GloBE Rules do not explicitly prohibit countries from maintaining a system of tax incentives, they might have an impact on the lower tax benefits arising from the use of incentives and lead to the need for countries to rethink their incentives policy. Moreover, it seems largely irrelevant whether a jurisdiction is part of the Inclusive Framework or has endorsed Pillar Two to be affected by its rules. This is because the rules are designed in such a way that, as long as the capital-exporting countries implement them, any under-taxation (below 15 per cent ETR on consolidated jurisdictional basis) would eventually be recaptured, the only remaining question being *where*. If the IIR or the UTPR apply, this would be at the level of another jurisdiction, leaving the country offering the incentive in a situation where it foregoes tax revenue to the benefit of another country. If the qualified domestic top-up tax applies, this would be the same jurisdiction offering the incentive.

In practical terms, the GloBE Rules have a very different impact on different incentives. There is the "green" zone where, although providing a tax benefit, the rules pursue a higher goal recognized by the OECD and the international community, such as prevention of double taxation (participation exemption), dealing with timing differences (accelerated depreciations), or determining ability-to-pay by recognizing certain expenses in deviation from the financial accounts. Such domestic rules would remain largely unaffected by the GloBE Rules.

At the other end of the spectrum is the "red" zone where the corporate tax reduction is generalized and serves no purpose other than to provide a favourable tax regime.

The reduction might be intrinsic for the system (e.g. because no CIT exists at all), time-related (tax holidays), geographically located (SEZs), etc. To the extent such systems apply to all entities of an MNE in a given jurisdiction and lead to an ETR below 15 per cent, they would always be affected by the Pillar Two Rules for in-scope situations and excess profits with the resulting tax policy dilemma for the jurisdictions that offer them.

Finally, there is the "yellow" zone in between, where only certain items of income are affected. These would include mostly passive income, such as interest or income from royalties and IP box regimes. The yellow zone is interesting because one can hardly determine a priori what would be the effect of Pillar Two in the abstract since this effect would depend on the specific circumstances of each taxpayer, the constellation of its activities, as well as its substance and the profit-margins it operates at. Moreover, since these types of income are mainly "passive" and therefore the taxing rights between residence and source countries are mostly shared, any under-taxation can be compensated not only at the level of the residence state but also by the source state.

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