

International Tax Forum: Impact of the Pillar Two project on Corporate Tax Incentives

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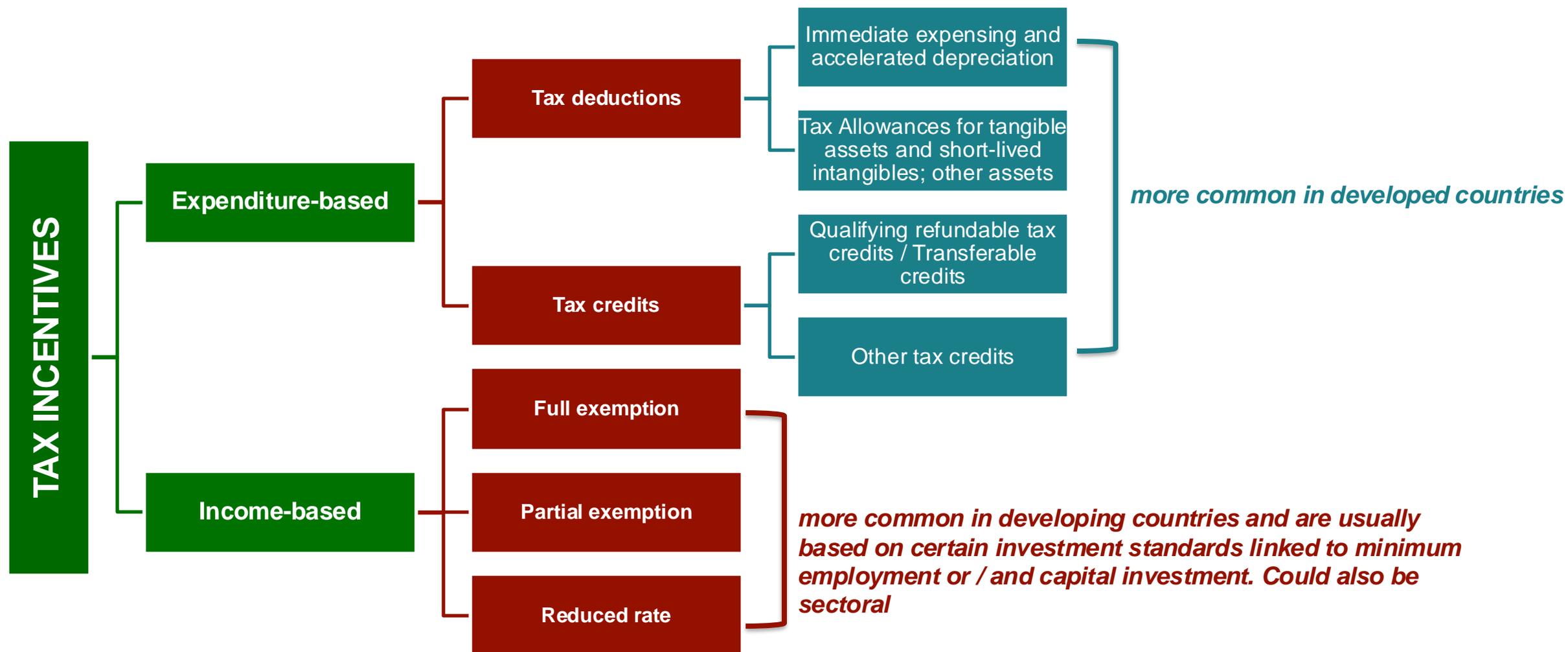
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Agenda

- 1 Overview of different types of tax incentives
- 2 Impact of STTR calculations on tax incentives
- 3 Impact of Pillar Two scope on tax incentives
- 4 Impact of Pillar Two ETR calculation mechanism on tax incentives
- 5 Summary

Overview of different types of tax incentives



Pillar Two Overall Package

1
Subject-to-tax
Rule
(STTR)



2
Qualified Domestic
Minimum Top-up
Tax
(QDMTT)



3
Qualified Income
Inclusion Rule (IIR)



4
Qualified
Undertaxed Profit
Rule
(UTPR)

Qualified Rules

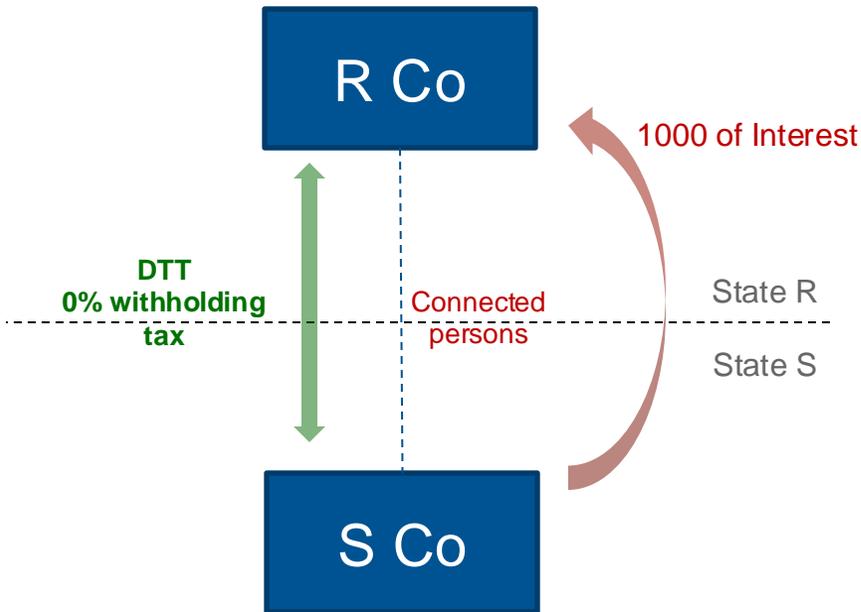
- Subject to the peer review process, conducted by the IF to ensure consistent application and coordinated rule enforcement.
- Domestic legislation that fails to meet peer review requirements will not be recognised under the rules of other jurisdictions.

Rule order

Impact of the STTR on Tax Incentives

Tax rate determination: Para 5

- Normal Corporate Tax rate is 20%. However, interest income is taxed at 5%



Case study

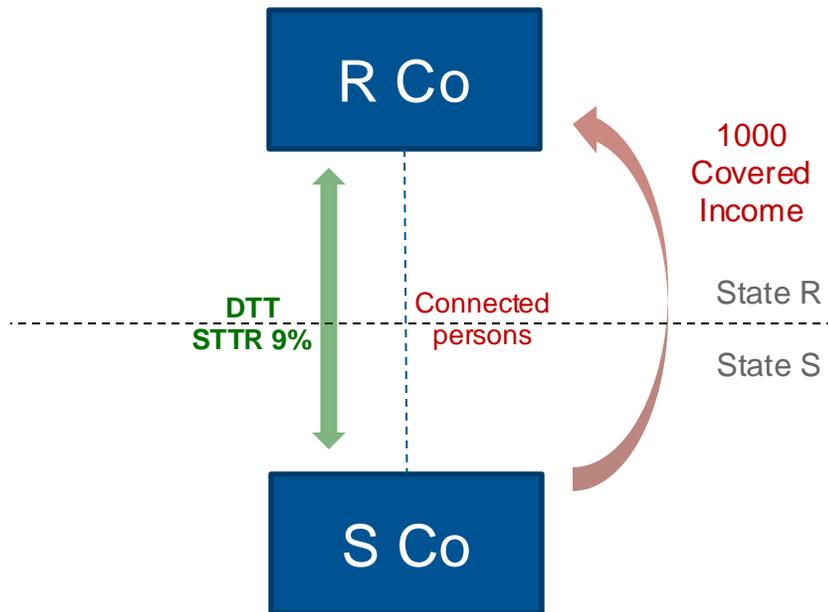
- S Co, a company resident of State S, pays 1000 of interest to R Co resident in State R. In State R, the corporate tax rate is 20%. However, interest income is subject to a preferential rate of 5%.
- The Treaty does not permit, Country S to impose withholding taxes on interest. The Treaty also includes an STTR with a 9% rate.
- Question: How does the STTR apply?

Solution

- The specified rate is $9\% - 5\% = 4\%$.
- State S can tax 1000 of income at the specified rate of 4%

One example: Preferential Adjustments

- CIT 20%
- Preferential regime: 80% exemption of qualifying income



Case study

- R Co, resident in State R receives 1000 of covered income from S Co, resident in State S.
- R Co and S Co are connected entities.
- Statutory Corporate Tax Rate in State R is 20%, However, preferential regime exempts of 80% of the income from taxation.
- Question: How does the STTR apply?

Solution

- Portion of the income subject to tax in State R: $100\% - 80\% = 20\%$
- Adjusted nominal rate: $20\% * 20\% = 4\%$
- Adjusted nominal rate below 9%, therefore STTR applies.
- **The specified tax rate is therefore $9\% - 4\% = 5\%$**

STTR and its impact on tax incentives

Income-Based Incentives

- Income-based incentives are impacted by the STTR when the taxpayers' covered income (which is mostly mobile) benefits from **preferential rates, full or partial exemptions, notional deductions linked to covered income, or tax credits linked to covered income** .

Expenditure-Based Incentives

- The STTR does not target tax incentives that are linked to expenditure incurred by the taxpayer.
- Expenditure-based incentives such as tax credits for R&D, ESG and so on fall outside the scope of the STTR.
- However, some expenditure based incentives (eg. tax allowances) can impact the ETR under the GloBE / QDMTT framework.

Impact of the Pillar Two Scoping rules on tax incentives

Impact of Pillar Two scope on tax incentives

Scope of Pillar Two and Tax Incentives

In Scope MNEs

- Rules to apply MNE Groups that satisfy the EUR 750 million revenue threshold test. The GloBE / QDMTT rules, depending on the type, impact incentives offered to these Groups. This said, such MNEs may benefit from the SBIE carve-out
- Incentives can continue to be offered to excluded entities (e.g. non-profit organisations, investment funds etc) or excluded income (eg. international shipping income, dividends, capital gains and so on)

Out of scope MNEs

- Tax incentives can continue to be provided to such MNEs. However, beware of the STTR

Pillar Two ETR calculation mechanism and its interaction with tax incentives

Impact of Pillar Two ETR calculations on tax incentives

GloBE Rules

Interaction of
ETR and
Top-up Tax
with tax
incentives

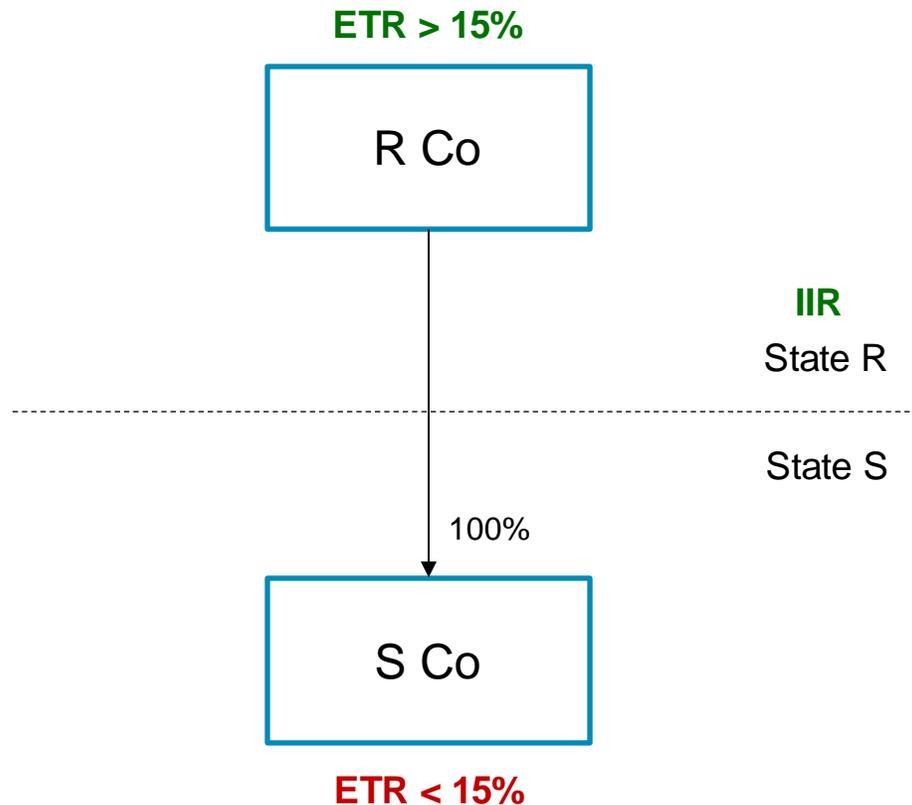
Income based Tax incentives

- As tax incentives does not affect financial accounting income but affects taxes paid, in many cases they are likely to reduce the ETR

Expenditure based Tax incentives

- Deductions which are only allowed for tax law purposes (not deductions for financial accounting purposes) could reduce ETRs. Eg tax allowances
- Deductions on assets which are allowed for tax law purposes and financial accounting purposes but the rates are different such as accelerated depreciation and immediate expensing generally do not trigger additional tax liability under the GloBE Rules (trigger temporary differences which are neutralized in many cases)
- Tax credits which are offered based on expenditure merit attention. A difference needs to be made between good and bad credits. Good credits are added to GloBE income whereas as other credits are reduced from taxes paid

Case study: Income-based incentives



Case study

- MNE Group Parent company R Co is resident in State R
- It owns 100% of S Co resident in State S
- State S offers a tax incentive which is the **full exemption from profits** from taxation for 10 years
- In Year 1, S Co derived 1000 in profit. It incurred payroll costs of 1000 and its carrying value of tangible assets is 500.
- State R has implemented the IIR. State S has not implemented QDMTT

Case study: Income-based incentives

	R Co	S Co
IIR	Yes	
Adjusted GloBE Income	1000	1000
Adjusted Covered Taxes	280	0 (due to full exemption of profits)
GloBE ETR	28%	0
Eligible Tangible Assets		500
Eligible Payroll Costs		1000
QDMTT		No

How much top up tax needs to be paid in Country R with respect to S Co for the year 2024?

Solution

Top-tax linked to State S

- **Step 1: Article 5.1:** Calculate jurisdictional ETR =

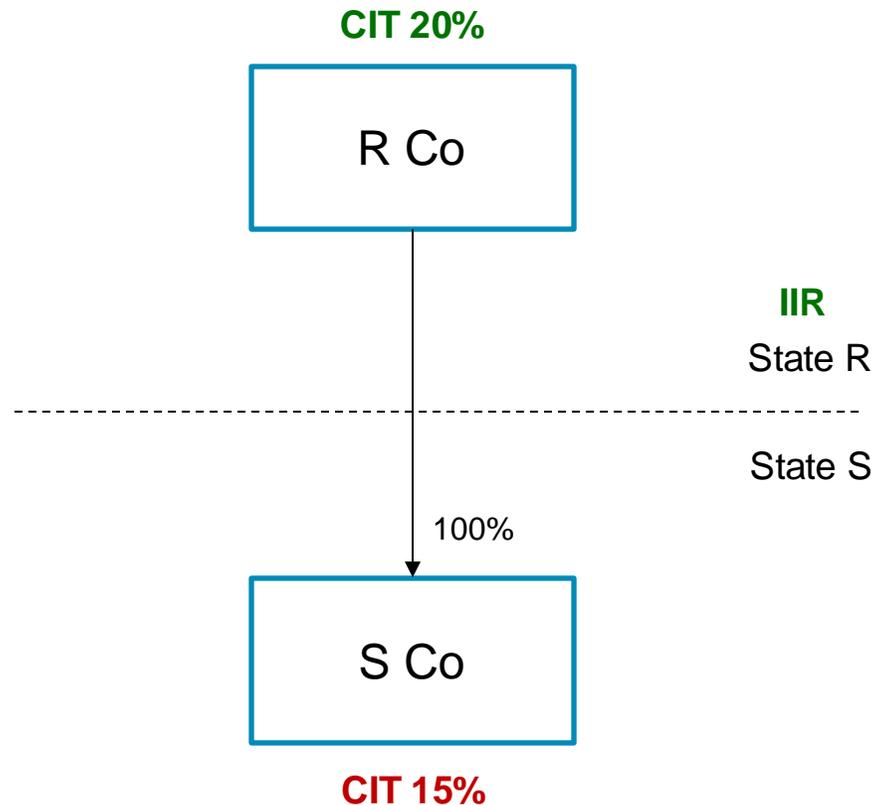
Tax incentive impacts numerator and brings down ETR → $\frac{0}{1000} = 0\%$

- **Step 2: Article 5.2.1:** Calculate Top Up Tax Percentage = 15% - 0% = 15%
- **Step 3: Article 5.2.2:** Calculate Excess Profit = GloBE Net Income – Substance Based Income Exclusion (SBIE)
 - ✓ GloBE Income = 1000
 - ✓ **Article 5.3 read with Article 9.2:** SBIE = 7.8% on Tangible Assets + 9.8% on Payroll Costs = (7.8% x 500) + (9.8% x 1000) = 39 + 98 = 137
 - ✓ **Excess Profit = GloBE Income – SBIE = 1000 - 137 = 863**
- **Step 4: Article 5.2.3:** Calculate Jurisdictional Top-up tax which is = Top Up Tax Percentage x Excess Profit = 15% x 863 = 129.45 (if QDMTT was imposed then this could be reduced further)

	S Co
Net GloBE Income	1000
Adjusted Covered Taxes	0
GloBE ETR	0%
Eligible Tangible Assets	500
Eligible Payroll Costs	1000
QDMTT	No

Step 5: Article 2.1 – IIR: 129.45 of taxes with respect to S Co profits are allocated to State R as R Co owns 100% of the subsidiary. On the other hand, if State S had a QDMTT then the top up tax would be kept at source

Case study: Tax allowance



Case study

- MNE Group Parent company R Co is resident in State R. It owns 100% of S Co resident in State S
- **State S offers an investment tax allowance on tangible assets. The law allows a deduction for tax purposes for specified capital expenditure up to an amount equal to 30% of the value of the asset. The allowance is provided for five years**
- **For both accounting and tax purposes, such assets are also amortised over 5 years on a straight-line basis. The allowance acts as an additional benefit**
- In Year 1, S Co derived 1000 in income and incurred 600 of expenses (including depreciation). It also spent 1000 for the purchase of tangible assets that are eligible for the incentive. This means an additional 300 is claimed as a tax deduction for a period of five years (in addition to local depreciation)
- Tax rate in State S is 15%. State R has implemented the IIR. State S has not implemented QDMTT

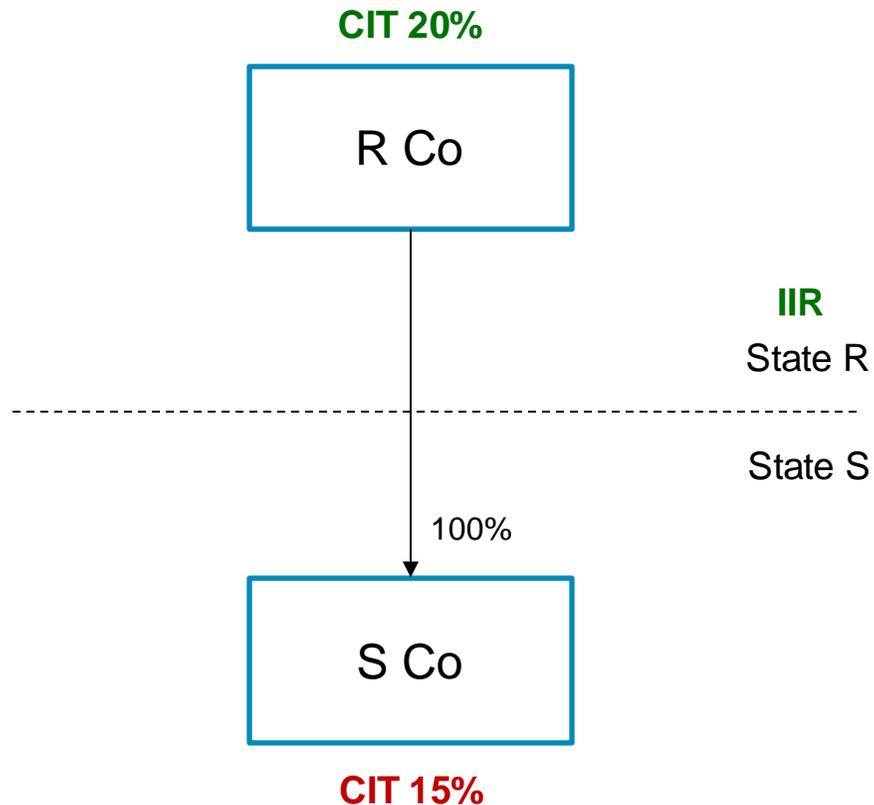
Solution

	Financial Accounting					Taxable income				
Year	1	2	3	4	5	1	2	3	4	5
Income	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000
Expense	600	600	600	600	600	600	600	600	600	600
Profit (B)	400	400	400	400	400	400	400	400	400	400
Tax Allowance*						300	300	300	300	300
Profit after allowance						100	100	100	100	100
Tax rate						15%	15%	15%	15%	15%
Current Tax Paid (A)	15	15	15	15	15	15	15	15	15	15
GloBE Income (B)	400	400	400	400	400					
ETR (A/B)	3.75%	3.75%	3.75%	3.75%	3.75%					

***Tax Allowance is booked as an expense only for taxable income purposes. This reduces the taxes paid and hence the ETR**

Thereafter, top up taxes will need to be determined and allocated

Case study: Immediate expensing



Case study

- R Co is UPE of the MNE Group and it is resident in State R. R Co owns 100% of S Co resident in State S.
- State S offers an expenditure-based tax incentive: immediate expensing of tangible assets for tax law purposes, which under financial accounting rules are depreciated over a period of 5 years.
- State R has implemented the IIR and the tax rate in State R is 20%. The tax rate in State S is 15% and it has not implemented any domestic minimum tax, including QDMTT.
- S Co has spent 1000 to purchase tangible assets that are eligible for the incentive.
- S Co did not have other expenses during the period concerned.

Solution

How immediate expensing impacts the ETR ?

Article 4.1.1 (b):

the Total Deferred Tax Adjustment Amount for a CE is added to the Adjusted Covered Taxes of a CE for a Fiscal Year and this may lead to the increase in Covered Taxes and thus it boosts the ETR

Article 4.4.4 read with 4.4.5 (a):

if deferred tax liability results from deduction of expenses on tangible assets from the tax base, then Covered Taxes may be adjusted for deferred Tax Adjustment Amount without any time limit (an exception to Recapture rule that limits the use of deferred tax liability to increase Covered Taxes up to 5 years)

Year	Financial Accounts					Taxable income				
	1	2	3	4	5	1	2	3	4	5
Income	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000
Expense	200	200	200	200	200	1000	0	0	0	0
Profit	800	800	800	800	800	0	1000	1000	1000	1000
Tax rate						15%	15%	15%	15%	15%
Current Tax Expense (A)	0	150	150	150	150	0	150	150	150	150
Deferred Tax Amount	800	-200	-200	-200	-200					
Deferred tax rate	15%	15%	15%	15%	15%					
Deferred Tax Expense(B)	120	-30	-30	-30	-30					
Covered Taxes (A+B)	120	120	120	120	120					
Globe Income	800	800	800	800	800					
ETR	15%	15%	15%	15%	15%					

This Deferred Tax liability is not allowed as an addition for timing differences that arise from long term IP Assets. E.g. IP Asset is acquired in Year 1 and deducted for tax purposes in year 1 but reversal takes place after 10 years. The recapture rule applies

Recapture Exception Accrual Rule – Examples

Article 4.4.5 (a): cost recovery allowances in respect of tangible assets

- For example, a company that purchases a new piece of machinery may be able to deduct the full cost of the machinery in the year it is purchased, rather than depreciating it over its useful life => a timing difference considered a Recapture Exception Accrual.

Article 4.4.5 (b): the cost of a licence or similar arrangement from the government, such as a lease or concession, for the use of immovable property or the exploitation of natural resources, where this entails significant investment in tangible assets

- For example, a mining company that acquires a mining concession from the government may be required to make significant investments in infrastructure, such as roads and buildings. The cost of these investments could be capitalised and amortized for accounting purposes but deducted immediately for tax purposes. timing difference considered a Recapture Exception Accrual.

Article 4.4.5 (c) research and development expenses

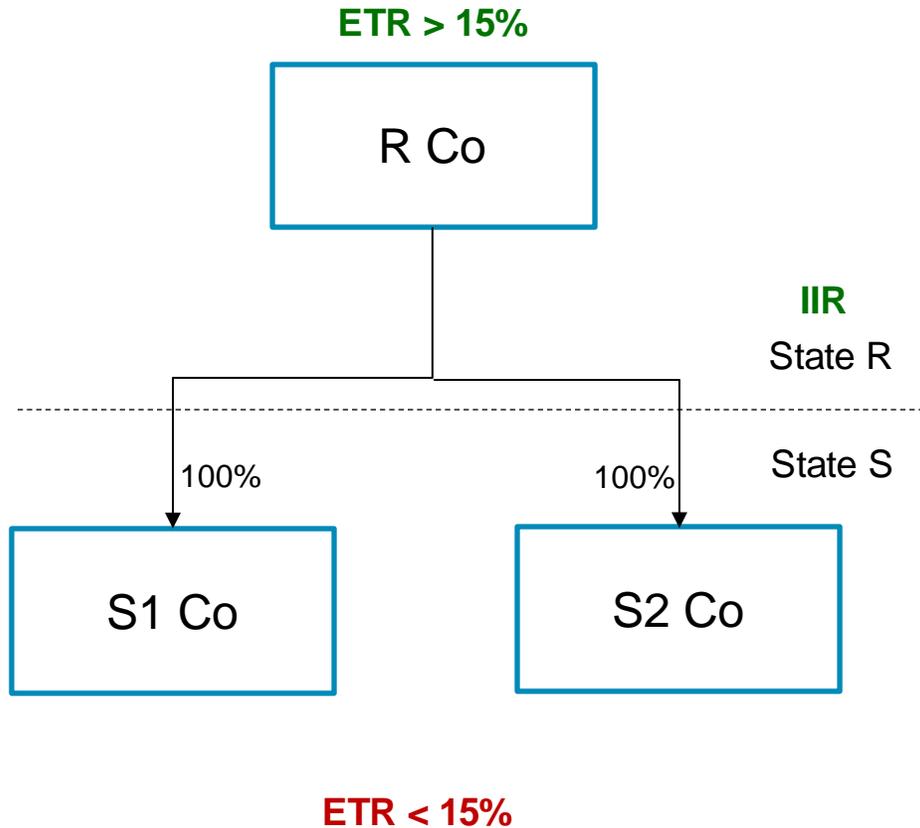
- For example, a pharmaceutical company that develops a new drug may be able to deduct the full cost of the research and development in the year it is incurred, rather than amortizing it over the useful life of the patent => a timing difference considered a Recapture Exception Accrual.

Article 4.4.5 (d) de-commissioning and remediation expenses

- For example, a nuclear power plant operator must set aside funds to cover the cost of decommissioning the plant and remediating the site once it is shut down. These costs may be deductible for tax purposes in the year they are incurred, but they will not be incurred until the plant is shut down. A timing difference between the considered a Recapture Exception Accrual.

Article 4.4.5 (h) Gains from the sale of tangible property located in the same jurisdiction as the CE that are reinvested in tangible property in the same jurisdiction

Case study: Expenditure-based incentives – Tax Credits



Case study

- S1 Co and S2 Co belong to an in-scope MNE group and both operate in State S
- S1 Co is eligible to **good credits** that fulfils conditions of QRTC / MTTC
- S2 Co receives **bad credits** that do not satisfy the definition of QRTC / MTTC
- State S CIT rate is 10%

Case study: Impact on the GloBE ETR: Good vs. Bad Credits

S1 Co

Before credits

- Top-up tax % = 15% - 12,5% = 2,5%
- Top-to tax = 800 * 2,5% = **20**

After good credits

- Top-up tax % = 15% - 11% = 4%
- Top-to tax = 900 * 4% = **36**

S2 Co

Before credits

- Top-up tax % = 15% - 12,5% = 2,5%
- Top-to tax = 800 * 2,5% = **20**

After bad credits

- Top-up tax % = 15% - 0% = 15%
- Top-to tax = 800 * 15% = **120**

	S1 Co / S2 Co	S1 Co (Good)	S2 Co (Bad)
Income	1000	1000	1000
Expenses	200	200	200
Profit before tax	800	800	800
Adjustments to GloBE Income:			
Good credits	0	+ 100	0
Adjusted GloBE Income	800	900	800
Covered Taxes	100	100	100
Adjustments to Covered Taxes			
Bad Credits	0	0	-100
Adjusted Covered Taxes	100	100	0
Standalone ETR*	12.5%	11%	0%

Impact of Pillar Two ETR calculations on tax incentives

Nature of relief	Type of instrument		Tax benefits affected by the GloBE ETR calculation <small>(intensity of the colour indicates intensity of effect)</small>	Effect on GloBE ETR		
				Numerator	Denominator	
Income-based incentives	Full exemption		More likely	↓		
	Partial exemption		More likely	↓		
	Reduced rates		More likely	↓		
Expenditure-based incentives	Tax allowances ³		More likely	↓		
	Immediate expensing and accelerated depreciation		Less likely	Adjusted for timing differences		
	Tax deductions ¹	For tangible assets: machinery, equipment, buildings		Unaffected	No recapturing applies	
		For short-lived intangibles		Less likely	Recapturing may apply	
		Other assets		More likely	Recapturing may apply	
	Tax credits	Qualifying refundable tax credits		Less likely	²	↑
		Other tax credits		More likely	↓	

Source: OECD (2022), *Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules*, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>.

Summary

POST PILLAR TWO BENEFITS

Shipping income incentives: Tonnage tax regimes or Tax Holidays

Participation Exemption Regime / other CIT rules such as restructuring rules: alignment with GloBE to maximize benefits

Converting existing incentives into QRTCs or enacting new QRTC incentives. Alternatively, considering the enactment of MTTC. It could be linked to R&D, using new technologies to address climate change concerns, digital gaming and so on.

Immediate Expensing and Accelerated Depreciation of Tangible Assets and as well as for short term lived intangibles

Subsidies: Competitive programs, which are open to all, and for which applications will need to be made. (EU, Vietnam, Switzerland and so on)

Ongoing work at the OECD: Red Flags with respect to the “Q” in QDMTT and QRTC