Kluwer International Tax Blog

Pillar 2 and alternatives for attracting (as well as keeping) foreign investments

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The Pillar 2 initiative (GloBE and QDMTT) has been seen as the end of using low effective corporate income tax rates (either by virtue of low nominal corporate income tax rates and/or through the use of tax incentives) as a means to attract foreign investors. Sacrifices made by the host country in terms of lower tax revenues are made meaningless by Pillar 2 mechanisms which allow other jurisdictions to collect top-up taxes on the same profits. For many countries (and even whole regions) in the world today Pillar 2 undermines the very foundations of their economic development policy. In other words, in a Pillar 2 environment states which relied on low effective corporate income tax rates to attract capital from abroad now have to come up with alternatives in order to achieve the same goal. There has been notable debate in academic and policy circles on whether or not Pillar 2 is a good solution for developing countries, but it is safe to say that this ship has sailed – Pillar 2 rules have been adopted by the world's most powerful economies (eg, several influential common law states, countries in the European Union, etc.) and can no longer be avoided.

The preliminary question which must be addressed is should alternatives to low effective corporate income tax rates even be sought. I.e. should countries stop providing fiscal incentives in any form to corporations in order to attract and stimulate investment. While this may be an interesting theoretical topic for debate it would be safe to assume that countries will continue to attempt to make themselves as attractive as possible as a destination for global capital. Furthermore, Pillar 2 will most certainly not prevent global multinationals from seeking the most beneficial conditions to locate their business. Thus, incentives are here to stay, its just a matter of what form will they take.

Governments which so far relied on low effective corporate income tax rates as a means to attract foreign investors today have several dilemmas.

Firstly, they have to decide if their corporate income tax systems should be divided into two subsections – one for those entities which do, and one for those which do not fall under the scope of Pillar 2 rules. In other words, should our tax systems be based on the 750 Million EUR global revenue divide, where those who would be under this threshold could continue to enjoy all the benefits of the *ancien regime* in terms of lower nominal tax rates and/or incentives resulting in lower effective tax rates. This approach may be quite tempting as in many jurisdictions, particularly in developing countries, it is the domestic businesses that would not meet the Pillar 2

criteria. Alas, most of such jurisdictions cannot rely purely on domestic sources to drive their growth and are still at an impasse as what to do to attract foreign capital once the measures they have been accustomed to become obsolete.

Secondly, countries may choose to keep their existing tax systems, but introduce a QDMTT mechanism so that those profits which would be taxable in other jurisdictions due to the application of Pillar 2 rules (GloBE rules) are taxed by them.

It should be noted that the choice between the two previously described approaches is not a completely free one in terms of potential legal constraints and that is not just pure econometrics that should decide on which one to implement. E.g. notable non-discrimination issues arise in terms of both of the outlined choices and their potential infringement of the provisions of double taxation treaties (e.g. prohibited capital ownership discrimination provided under Art 24(5) of the OECD Model Tax Convention), bilateral investment protection treaties (e.g. infringement of the fair and equitable treatment, most favored nation treatment in case of those bilateral investment protection treaties which do not contain an applicable tax carveout), as well as other international agreements the respective country is party to. Furthermore, the application of the UTPR mechanisms may also lead to the violation of (tax and non-tax) international treaty obligations. All of these must be researched thoroughly before making the final policy choice.

Thirdly, there is the rather sophisticated route of designing qualified refundable tax credits. In other words, Pillar 2 enables countries to keep some forms of tax incentives, although somewhat limiting their effectiveness (in terms of their ability to lower the effective corporate tax rate). Unfortunately, this approach is burdened with uncertainty. Namely, the acceptability and the corresponding success of the design will have to be ultimately ascertained by other jurisdictions and not the one which has been responsible for the design itself. While this is not an unheard-of situation (e.g. countries which host US investments will often try to make sure that their taxes are creditable for US foreign tax credit purposes, wherein we have the same principle issue – the ultimate success of the design of the respective tax will be determined by the approach of another country's tax authority), Pillar 2 rules are still quite novel and broad consensus is yet to be found on many issues.

Governments may choose to completely give up on providing incentives through corporate income taxation which leads them to two potential policy options.

One is to dwell more deeply into the possibilities for providing tax incentives within the ambit of other tax forms. E.g. let us assume that a jurisdiction managed to attract headquarters of global multinationals by providing them, in addition to the rule of law, political and financial stability and developed infrastructure, with a competitive corporate tax environment. If such a country can no longer provide low corporate income tax rates it may introduce generous incentives for the income generated by top level management in order to maintain its competitive edge. Although so far much less the object of scrutiny within international taxation developments, such incentives are not beyond reproach and may cause notable political (e.g. such as the most recent ones in Germany in relation to the proposals for tax incentives for inbound high-skilled immigrants) as well as broader social issues (the growth in the cost of housing, the gentrification of certain communities, etc.).

The second one is turning to direct subsidies as the primary tool for attracting foreign investment, a policy choice already adopted by some jurisdictions in combination with the introduction of a QDMTT, most notably Vietnam.

Providing direct subsidies to large multinationals opens up numerous issues. Namely, retaining the low effective corporate income tax rate without introducing a QDMTT essentially leads to the increase in the public revenue of the state of the parent entity. In other words, by giving up a part of your taxation rights (by virtue of a low effective corporate income tax rate) you are just increasing the taxation revenue of another country without any benefit for the taxpayer who's profits cannot escape the minimum level of tax (it's just a matter of which jurisdiction will tax them). On the other hand, in reverting to a direct subsidy mechanism you will be ***seen*** as not only financially supporting a multinational group (which may be far more politically unpopular than providing a sophisticated tax incentive i.e. a qualified refundable tax credit), but due to the fact that the subsidy will be treated as income under IAS 20 you may also be *subsidizing* the budget of another state the tune of 15% of the subsidy.

However, if we are able to avoid the hurdles of a political debate (which are often burdened by populist rhetoric), the effect of a direct subsidy is in essence the same as that of a qualified refundable tax credit.

The direct subsidy policy choice is burdened by similar concerns that other Pillar 2 compliant incentives are subject to. The primary danger lies in the subsidy being seen as a direct quid pro quo for the jurisdiction introducing a QDMTT into its tax legislation, which may trigger the application of the no benefits requirement (NBR) found in Pillar 2 rules which have already been discussed on this blog (see: https://kluwertaxblog.com/2023/09/18/fiscal-subsidies-aspirers-beware-of-the-no-benefit-requirement-in-pillar-two/).

Namely, for a QDMTT to be a "qualified" minimum tax, the jurisdiction implementing it must not *provide any benefits which are related to such rules.* In other words, a simple introduction of a direct subsidy mechanism to mitigate the effects of Pillar 2 application (in essence the introduction of the QDMTT) may lead to the QDMTT losing its qualified status However, the existence of broad direct subsidy programs in many jurisdictions in the world (e.g. the EU Green and Digital Transformation Deal and similar US initiatives) gives good reason to assume that a subsidy program which can also mitigate the effects of introducing a QDMTT may be implemented successfully, wherein revenues collected by virtue of the QDMTT may provide funding for the subsidy mechanism, although it would not be advisable to establish an express link between the two. The same logic may be applied to the conditioning of granting the subsidy on the beneficiary being subject to a QDMTT. On the other hand, it is evident that certain criterion which have no direct link to the QDMTT or Pillar 2 for that matter, may lead us very close to the same result we would achieve if we were to condition the granting of a subsidy on one being subject to a QDMTT. Actually, the way in which a QDMTT is implemented may guide the definition of the criteria for being eligible for a subsidy. E.g. if all entities who are part of groups whose consolidated revenues are above 750 Million EUR are subjected to QDMTT, and not just those who in addition to meeting this condition are subject to Pillar 2 rules at the level of their headquarters, this would provide broader space to the designers of the subsidy mechanism. In other words, if only those taxpayers whose headquarters or affiliates are subjected to an IIR or an UTPR mechanism would be liable to the QDMTT, this would mean that other taxpayers belonging to comparable groups or even large domestic companies/groups would not have to pay additional tax on their profits. If we were to provide a subsidy only to those companies subject to the QDMTT it would be quite difficult to argue that the primary purpose of the subsidy is to alleviate the burden of additional taxation. If, however all taxpayers, foreign and domestic, who belong to groups whose consolidated revenues are above the Pillar 2 threshold are subjected to an additional

layer of tax, regardless of whether or not their headquarters or affiliates are subjected to an IIR or an UTPR mechanism, and the respective jurisdiction starts providing subsidies to all of these entities based on objective criteria which can be met only by large multinational or domestic groups, the link between the subsidy and the QDMTT is much harder to establish making the risk from the application of the NBR anti-avoidance rules considerably lower.

Once the problem of the NBR anti-avoidance rules is overcome, for most countries in the world the constraints for designing the direct subsidy mechanism are quite limited. Provided the country is not a member of the EU, or does not have in its domestic legislation rules which would mirror the EU state aid rules (e.g. EU accession countries), the main concerns to be taken into account are related to WTO law and international trade agreements to which a country is a party to. However, the provisions of the WTO Agreement of Subsidies and Countervailing Measures, as well as most international trade agreements provide quite a wide space for designing subsidy mechanism, wherein the primary criterion for the application of Pillar 2 rules (the size of the multinational group in terms of consolidated revenue) may not be of relevance. This is a matter that will be explored in our next blog.

While the work on alternatives to the tax incentives made obsolete by virtue of the introduction of Pillar 2 rules is in its initial stages it is imperative to notice that we no longer have the luxury of remaining within the ambit of just tax legislation. The quest to attract capital while meeting the Pillar 2 requirements may easily lead to the infringement of other international obligations, those emanating from e.g. bilateral investment treaties, international trade agreements and even WTO law. It is against all of these legal sources, and not only the Pillar 2 ones, that potential measures must be tested prior to their introduction as these additional legal sources may have also effective litigation forums, the consequences of whose decisions may be quite grave.

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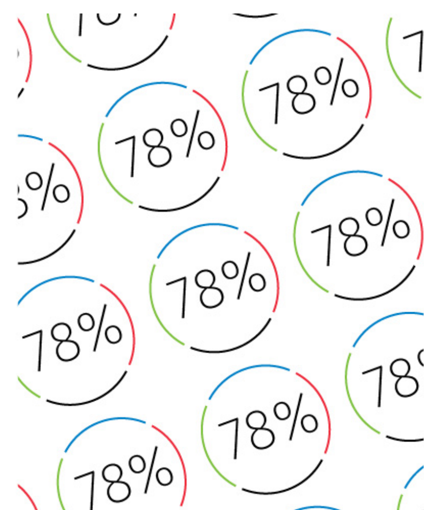

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This entry was posted on Wednesday, August 14th, 2024 at 6:25 pm and is filed under GloBE, OECD, Pillar II, QDMTT
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