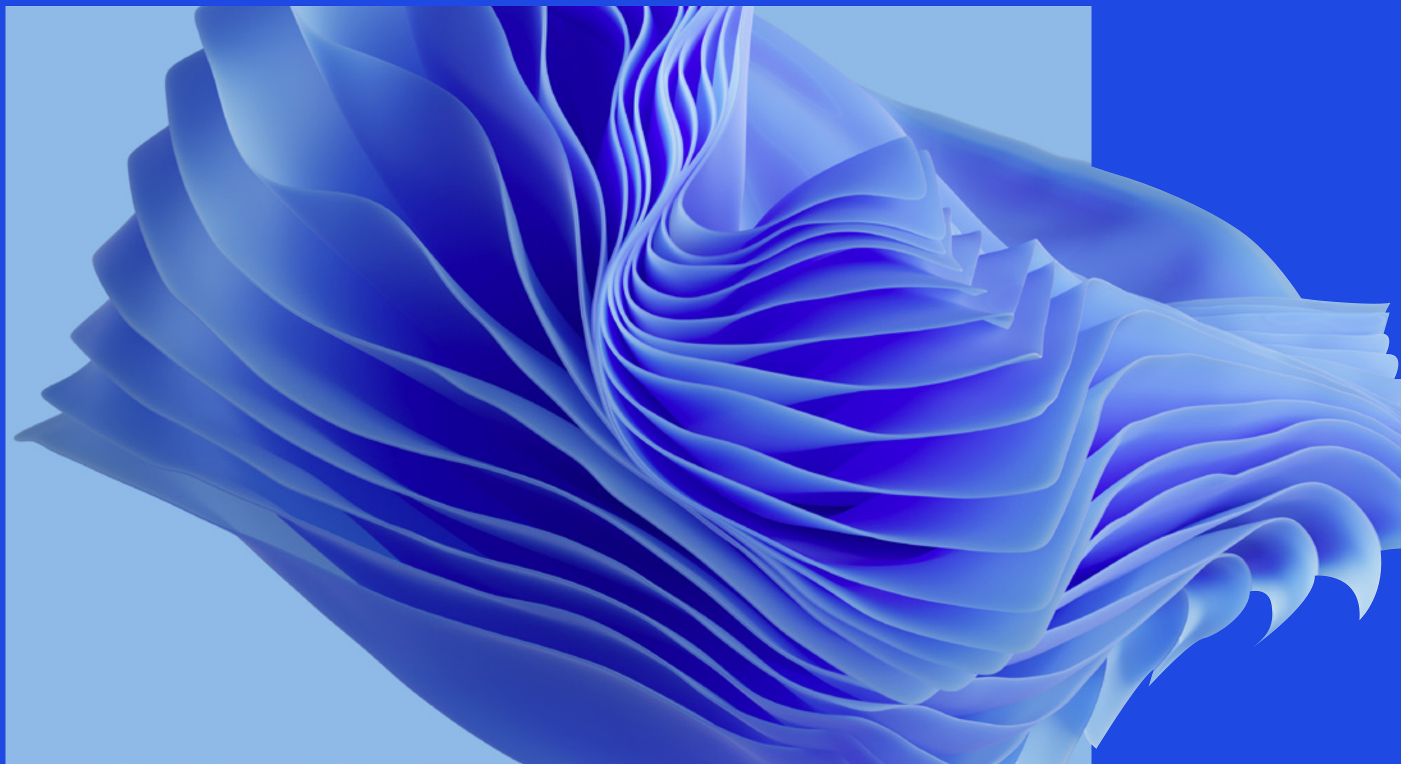
Tax Incentives Revisited

Initial observations of OECD report on tax incentives and the global minimum tax



On 6 October 2022, the Organisation for Economic Co-operation and Development (OECD) released a report entitled Tax Incentives and the Global Minimum Corporate Tax on the interaction between the global minimum corporate tax and tax incentives. This report was undertaken at the request of Indonesia as host of the G20 Summit in November.

The main thrust of the nearly 80-page report is that now is the time for jurisdictions to assess their current tax incentives in preparation for the arrival of Pillar 2. This includes stabilization clauses in contracts which may arise from investment agreements.

The report points out that taxpayers will be impacted differently when considering the interaction between the Global Anti-Base Erosion Model (GloBE) rules and incentives, noting that:

- Many firms will be under the €750 million threshold;
- The Substance-Based Income Exclusion (SBIE) will mean those firms with greater substance in a jurisdiction will be less affected; and
- Targeted incentives are likely to be impacted less than broad ones, all else being equal.

Leveraging from work previously undertaken by the OECD, it is asserted that expenditure-based tax incentives are more effective than income-based incentives. This is particularly the case for those based on payroll and tangible assets. On tangible assets, it is noted that the GloBE rules do not impact incentives based on faster recovery of the cost of tangible assets or immediate expensing given the treatment of timing differences. It is also said that refundable tax credits (often R&D incentives) are treated in a similar manner to cash grants and therefore note adversely impacted.

Use of tax incentives around the world

The report notes the proliferation of new tax incentives throughout the globe to attract economic activity in recent times: the number of jurisdictions in the OECD offering support for innovation-related income is five times greater in 2021 than it was in 2000. It is also noted that many multinational enterprises (MNEs) have companies with effective tax rates (ETRs) below 15 percent due to tax incentives, even though they may be located in jurisdictions with high headline rates.

It is observed that broadly targeted tax incentives are prominently used among developing countries. The popularity of broad tax incentives for developing countries is partly attributed to the fact that they are non-discretionary and the government does not have to pick winners or evaluate on a case-by- case basis. It is also said that excessive reliance on tax incentives can be counter-productive where capacity is low and may encourage channeling income rather than activities.

The review also refers to the use of contractual arrangements between governments and firms which can act as an impediment to updating policies. Many older investment treaties do not exclude tax from their purview.

By contrast, developed countries tend to rely on more on expenditure-based incentives, such as accelerated depreciation and investment tax credits, which are perceived to be more effective.

Key elements of the GloBE rules that impact tax incentives

The report applies a three-tiered framework to consider the interaction between the GloBE rules and tax incentives.

The first is the **jurisdiction** level, where the tax rate and tax base are important, including the incidence of any base narrowing provisions. Controlled foreign company (CFC) rules in other jurisdictions may also have an impact. Importantly, even if some income is taxed at below 15 percent due to incentives, with other income and jurisdictional blending, this may not have an impact, such as triggering top-up tax.

The second is the **entity** level. Here the report notes that there is a greater likelihood of top-up tax where the economic substance in the jurisdiction is low. Standalone entities that are not part of an MNE group with revenue exceeding €750 million are not impacted.

The third level is the **tax incentive** level. If a tax incentive has substance requirements that are based on the level of payroll and tangibles, the impact could be low due to the SBIE or reflects a timing difference on tangible property or falls within the concept of a refundable tax credit, the impact may be minimal or there may be no impact at all.

© 2023 KPMG Tax Services, a Belgian CVBA/SCRL and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

GloBE and tax incentive design

The report uses the concept of Effective Average Tax Rate (EATR) to evaluate the impact of different incentives over the lifetime of an investment. The EATR compares the tax burden, including top-up taxes, over the lifetime of a profitable investment. The report uses stylized examples to highlight the impact of GloBE on tax incentives. Consideration is also given to different sectorial impacts.

This EATR analysis supports the following propositions:

- Tax incentives are more likely to give rise to top-up tax where they are treated as a reduction in covered taxes under the GloBE rules. These include reduced corporate tax rates or investment tax allowances or credits that permanently reduce taxable income.
- Tax incentives that defer tax payments into the future are more unlikely to generate top-up tax. For tangible assets, immediate expensing or accelerated depreciation should be unaffected by the GloBE rules; however, for intangible assets where temporary differences last longer than 5 years, the GloBE rules may have an impact. This is because there is a recapture rule which effectively 'regularizes' top-up taxes over a period if the timing benefit is not reversed within 5 years.
- The SBIE also plays a key role where an incentive is based on payroll and tangible assets. This can be framed by saying tax incentives based on economic substance — payroll and tangible assets or labor and capital costs — will have a greater impact than those that are not based on substance. It is also true to say that as a result of the SBIE, firms with higher levels of tangible assets and payroll could be less impacted by the GloBE rules.

The report calls for governments to review their current incentives and carefully consider the policy options in regard to the impact of the GloBE rules to ensure they remain fit for purpose. To this end, the OECD intends to launch pilot programmes in the fourth quarter of 2022 to assist developing counties in assessing the impact of the GloBE rules and how they interact with domestic tax policies. The aim of these pilot programmes is to ensure developing countries can collect taxes from MNEs operating in their jurisdiction without sacrificing their ability to attract foreign investment.

Businesses should consider

Although the report is focused on what governments should do, in our view, now is the time for businesses to consider the incentives they are experiencing and whether they are effective in a post-Pillar 2 world. In many cases, we believe it will be appropriate and beneficial for businesses to communicate with governments to help ensure the future design of incentives is beneficial for all parties in a changed world.

© 2023 KPMG Tax Services, a Belgian CVBA/SCRL and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Contact

Koen Van Ende
Partner
KPMG in Belgium

M: +32 (0)2 708 36 72
E: kvanende@kpmg.com

Kris Lievens
Partner
KPMG in Belgium

M: +32 (0)2 708 47 61
E: klievens@kpmg.com

kpmg.com/be

kpmg.com/be/social

© 2023 KPMG Tax Services, a Belgian CVBA/SCRL and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.