Pillar 2: Tax Competition in Low-Income Countries and the SBIE

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The very notion of a globally agreed minimum level of tax on international corporate income must be viewed as an amazing breakthrough. Surely no knowledgeable observers a decade or more ago could have predicted this—nor that 100 countries beyond the OECD and G20 would be participating in the process, whatever its flaws. And if the economically globalized world does wish to continue to tax capital income—at least until there is a means of achieving this entirely at the level of individual owners—then some such agreement has been proven necessary. The incentives of MNEs to minimize their taxes, of individual small jurisdictions to establish business models based upon facilitating that minimization, and—it must be said—of the major advanced economies to create a system that permits this, are simply too strong to overcome without some mutually coercive mechanism.

Pillar 2 of the OECD's global tax reform proposal will have significant direct and indirect impacts for low income developing countries (LICs), although the two Pillars were not instigated by nor largely designed around LICs. [1] Most interesting and problematic is the question as to how the Global Anti-Base Erosion (GloBE) rules for a proposed global minimum effective tax will affect tax competition behavior in LICs, and how LICs should respond when a critical mass of higher income economies adopt the new structure—as now appears likely.[2] This paper addresses that issue.

The paper is structured as follows. Section 1 describes salient aspects of the current situation in regard to the tax systems, particularly the corporate income tax (CIT), in LICs. Section 2 describes Pillar 2: its purported goals and its structure. Section 3 reports briefly on recent projected revenue impacts and impacts on foreign direct investment in LICs, as assessed by the

[1] The focus of this paper is on low-income source countries, and not upon low- or no- tax jurisdictions that frequently serve as tax planning hubs. The dilemmas posed for the latter by Pillar 2 are even starker, but very different.

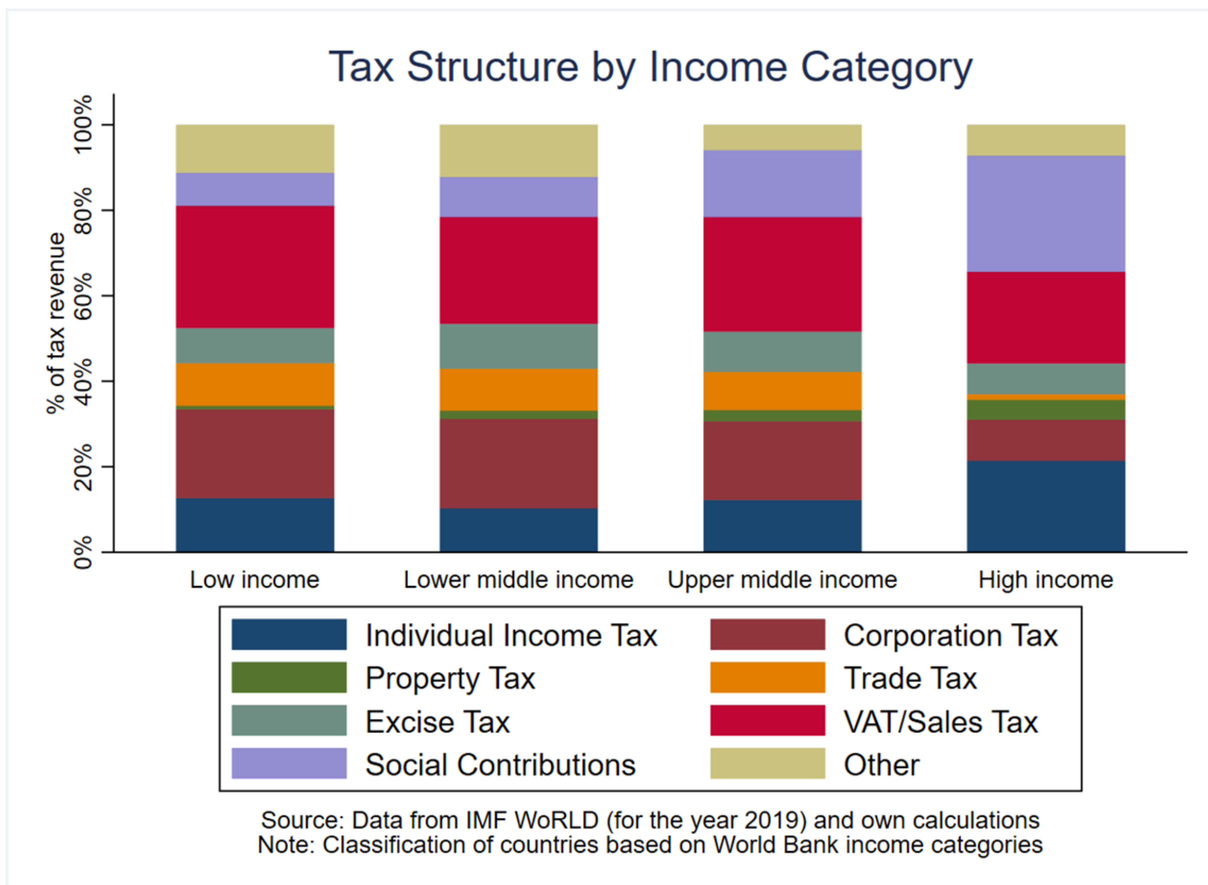
[2] Public consultations, some already with draft legislation, have been launched in the UK, Canada, Korea, New Zealand, Switzerland, Mauritius and Malaysia. The EU has drafted a Directive for implementation of the OECD GloBE rules, aiming for 2024 implementation; 26 of 27 member states have agreed the Directive. *Reported in "The Global Minimum Tax: From Agreement to Implementation*," *World Bank, September 2022.* With Hungary holding out, some member states—notably, France, Germany, Italy, Spain and the Netherlands—have stated that they want to push ahead unilaterally, and there has been discussion of shifting away from unanimity on this point. As of December 1 it appears that the opposition from Hungary is likely to be overcome. The recent attempt in the US to bring its own international minimum tax rules (GILTI) closer into line with the GloBE rules has for the present failed, but the US was the prime mover of such a tax (in 2017) and remains the only current host of a similar tax; how the GILTI will in the end be treated by the Inclusive Framework thus remains to be seen.

IMF, the EU Tax Observatory, and UNCTAD. Section 4 discusses whether, and if, Pillar 2 could be improved in regard to tax competition. Section 5 concludes.

Section 1: LICs, tax structures, and the CIT

The focal point of Figure 1 is the relative importance of the corporate income tax (CIT) for LICs as compared to advanced economies. Most importantly in the context of a global minimum effective tax, CIT is a far more significant part of overall taxation in LICs, although of course smaller in absolute terms, than in advanced economies. LICs derive less of their total government revenue from personal income taxes (PIT) and social contributions (ie, social security levies) than do advanced economies; the same is true of real property taxes. Conversely, VAT—a broad based consumption tax—is responsible for a larger portion of LIC total revenue, as are trade taxes, with the latter having been largely eliminated as a significant revenue source in advanced economies.

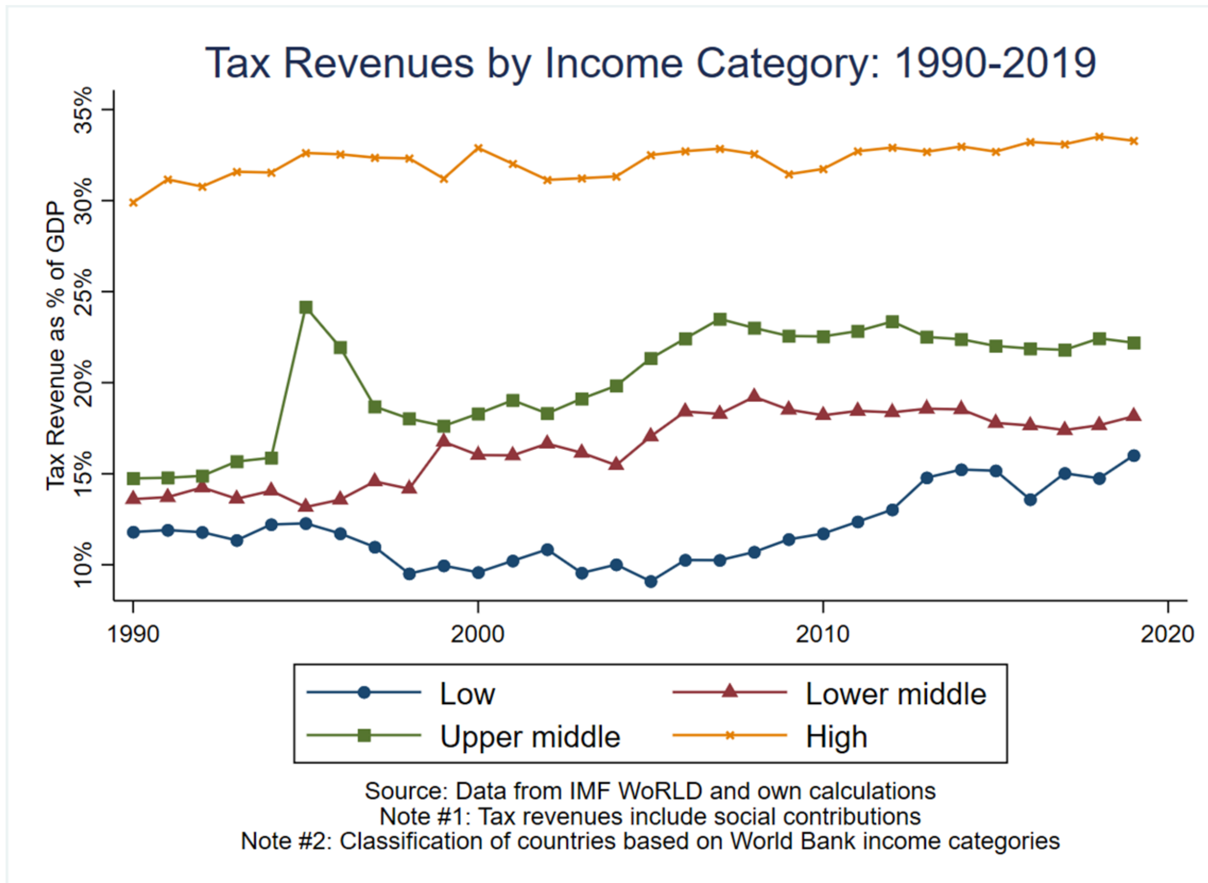
Figure 1. Tax Structure by Country Income Groupings



Also notable from the point of view of a CIT minimum tax, LICs raise far less revenue overall as a proportion of the economy than do higher income countries—despite their evident need for substantial additional government revenue to finance contributions to growth. As seen in

Figure 2, on average the tax to GDP ratio for LICs is considerably less than half that in high income economies. An imposition of a real minimum level of corporate income tax, if accruing to them, would be relatively more significant for LICs.

Figure 2. Revenue Ratios over Time across Country Income Groupings



We turn now to tax competition issues. Statutory corporate tax rates have been declining everywhere for the last 40 years. This is true for LICs as well as advanced countries, as shown in Figure 3. As also seen there, however, African countries—a substantial proportion of the world's lowest income countries—although experiencing declining CIT rates, still have the world's highest statutory average rates, ranging now for sub-Saharan Africa (SSA) between 25 and 30 percent. [3]

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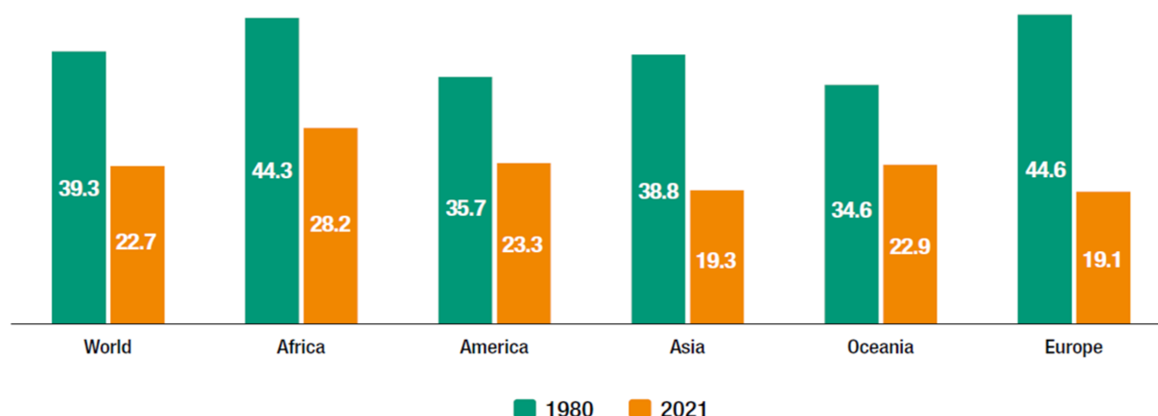
[3] Why CIT revenues everywhere have not fallen more as a result of this rate competition is an interesting question—the "rate/revenue puzzle". One answer is found in evidence from advanced countries that the proportion of corporate profits in GDP has increased.Nicodème, Gaëtan, Antonella Caiumi, and Ina Majewski, 2018. "What Happened to CIT Collection? Solving the Rates-Revenues Puzzle." CESifo Working Paper No. 7412. CESifo, Munich; *Fuest* and coauthors (NJT) find for 33 OECD countries that pretax corporate profits increased by 8.6 percentage points in overall value added (while labor's share declined). The share of intangibles relative to depreciable assets increased

Figure 3. Declining Statutory CIT Rates



Source: UNCTAD, based on Tax Foundation.

Expansion of tax *bases* would have this effect too—through the elimination of tax exemptions and incentives, for example. But such base broadening does not seem to have happened in SSA—perhaps the contrary, as seen in Figure 4. [4]

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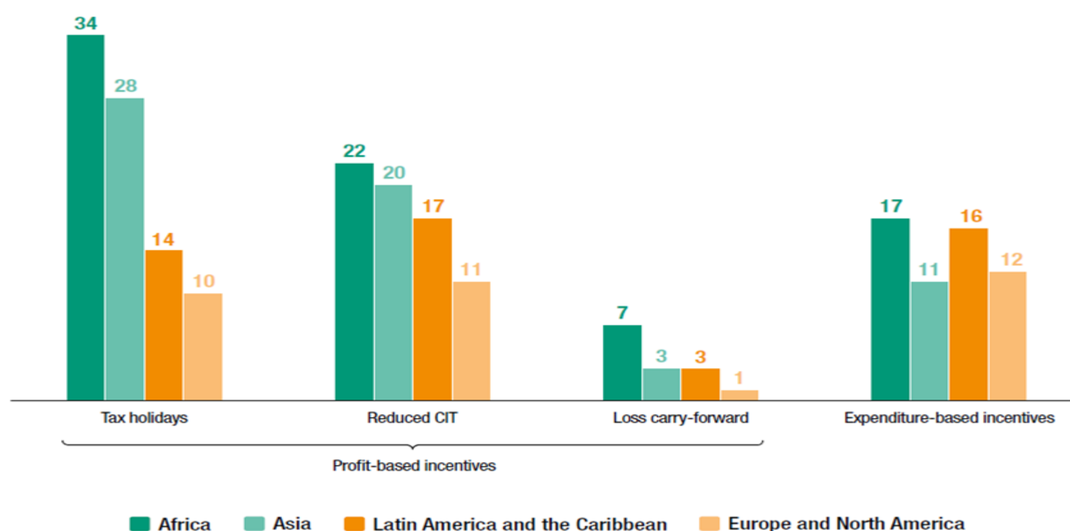
the tax base, too. But the study also finds, not surprisingly, that firms with a higher share of intangible assets pay lower taxes, due to facilitation of profit shifting.

[4] OECD (Oct. 2022) notes that nearly 45 percent of LICs introduced new incentives or made others more generous between 2009 and 2015, while less than half that proportion removed any tax incentives. More than 40 percent of LICs globally offered tax holidays as one form of incentive, with the proportion in SSA countries being even somewhat higher. An earlier study—now somewhat old-- by Keen and Mansour using 2005 data found that in 1980 fewer than half of SSA countries had tax holidays; in 2005 80 percent did. In 1980 only one had an official "free zone"; by 2005, 18 did. Another more recent survey of 30 SSA countries by James found that 60 percent of the studied countries had tax holidays and exemptions, and nearly 60 percent had free zones.

Figure 4. Tax Incentive Types by Region



Most LICs are source-only countries. That is, they are the recipients of foreign direct investment (FDI) and the site of production, and they do not themselves export capital. And they are very much in competition to attract such FDI—as implied by Figures 3 and 4, through the grant of various tax incentives and exemptions especially in regard to the CIT, rather than through reductions in their statutory tax rates. While SSA countries, for example, all retain statutory CIT rates well in excess of the proposed GloBE minimum effective rate of 15 percent, discussed in Section 2 below, these incentives frequently bring the effective rate on specific investments and foreign investors to well below 15 percent, and in the case of tax holidays, to zero.
LICs will have to determine their own goals in light of Pillar 2. While it might appear that Pillar 2 in regard to LIC source countries constitutes a form of paternalism—protecting the countries from their own low effective taxes on MNEs—that was an artifact, not the fundamental point. The main point was for advanced countries to impose some higher tax on their own MNEs, who had come to be viewed as escaping their "fair share" of global taxes by means of artificially shifting profits to low tax jurisdictions.

But do LICs want to continue to compete using the tax system to the extent possible, to step back from that competition, or to take some intermediate course? Pillar 2 does not itself change a country's desired position on the competition spectrum—it merely affects how, and to what extent, that position can still be obtained. Many organizations—the IMF, the World Bank, the OECD, UNCTAD—are now urging LICs to take this opportunity to assess the costs and benefits of their tax incentives and competition strategies. But this advice has been given for decades: it is not at all clear that LICs in general want to, or feel they can, heed it.

Section 2: Pillar 2, Its Structure and Its Goals

Pillar 2 is one part of a two-part proposal originally aimed at addressing the implications of the "digital economy." That term has been used to mean the tax challenges created by the increased use of intangible assets in production, along with the decreased need for multinational enterprises (MNEs) to have a physical presence to create profits in any given jurisdiction. Both Pillars have, however, now extended their theoretical reach well beyond the confines of the ill-defined notion of "digital" companies or sectors. [5] [6] The Pillars were both agreed among 137 of the 141 members of the Inclusive Framework in October, 2021. [7] Pillar 2 reflects a "common approach," meaning that it is not mandatory to implement these rules, but by agreeing countries must accept adoption and application by others. If ultimately successfully enacted by individual countries, both Pillars would represent extraordinary transformations of the traditional international corporate tax architecture—going far beyond the loophole-closing of the original OECD Base Erosion and Profit Shifting ("BEPS") project that was agreed to in 2015. That project explicitly did not address either the allocation of profits or global minimum taxation.

Pillar 2 has two aspects: the GloBE minimum tax, and the feature known as the Subject to Tax Rule (STTR), which deals with bi-lateral tax treaty withholding rates. The detailed structure of the most focal aspect of Pillar 2—the world's first global minimum tax on international profits, the GloBE—was agreed on December 22, 2021, among almost all representatives of the 141 member countries of the G20/OECD Inclusive Framework. [8] On March 14, 2022, an additional 225 pages of explanatory commentary, along with dozens of pages of examples, was published by the OECD staff. [9] [10]

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[5] Both Pillars are limited in their scope—though differently—based upon the size of the MNEs to which they would apply, and in the case of Pillar 1, with the exclusion of certain economic sectors; the idea of application to a "digital sector," though, has been abandoned.

[6] Pillar 1 aims at a reallocation of a (small) part of taxable profits of the world's largest MNEs outside the parameters of the traditional tax architecture, to countries where customers are located rather than only to the location of production. This paper does not address Pillar 1 and its implications, significant as they are.

[7] Nigeria, Kenya, Sri Lanka and Pakistan have not agreed.

[8] *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the- economy-global-anti-base-erosion-model-rules-pillar-two.htm. (hereinafter the Model Rules). This followed from the October 2020 "Blueprint" endorsed by the G7 and the G20 countries in the summer of 2021, OECD (2020), Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/abb4c3d1-en.

[9] OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the- digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf. Hereinafter, the Commentary.

[10] The other aspect of Pillar 2, the STTR, is discussed in appendix 2; unlike the GloBE, it has not yet been the subject of any elaboration by the OECD and the Inclusive Framework beyond that which was included in the October 2020 Blueprints, with only a slight expansion in October 2021.

Though the subject of near-obsession and endless Talmudic analysis for the past two years by international tax lawyers, accountants and public finance economists, the rhetoric around Pillar 2 in the more popular press is confusing for the part of the greater public who may actually be interested. Its description as a "global minimum [corporate income] tax" would lead one to think that indeed, that is what it is: an agreement that all signatories will impose a certain rate of taxation on corporate profits falling within their remits. And that would have a very different impact on LICs than the reality of Pillar 2 is likely to do.

The language describing Pillar 2's purpose has varied over evolving versions from the Inclusive Framework, and in OECD explanatory documents and draft rules. Earlier formulations included phrases such as "put a floor under tax competition," and have alternatively (or in addition) referred explicitly to a purpose of raising revenue. The current language tends to state the purpose as ensuring that MNE profits are taxed somewhere in the world at some minimum effective tax rate—set now at 15 percent. These are not in theory mutually exclusive—but they do put the emphasis in different places, with the last version probably being closest to the popular conception of imposing some minimum tax on MNEs. MNEs have been viewed (correctly) as frequently failing to pay anything like an overall tax at the nominal rates of CIT in the countries where they actually operate or where they are typically headquartered. The original BEPS loophole-closing action items mainly aimed at this issue, though in a less sweeping way than the GloBE rules. The question is whether and to what extent the currently proposed GloBE rules will achieve the plain meaning of any of these three related purposes.

The answer to the first of those questions is that, in fact, the GloBE as presently proposed does not try to achieve those plain meanings. Rather, in effect it is aimed at combatting the reduction in global effective CIT rates for MNEs as achieved through artificial profit shifting, from either source countries or headquarters/residence countries, to low or no tax jurisdictions which become the legal situs of the shifted tax base. Further, these rules do not apply to all corporate profits. There is a very high threshold of global annual turnover (Euro 750 million) defining in-scope MNE groups. In itself that threshold can be an important consideration for many small and lowest income LICs. [11] More notable as a structural matter, though, is the fact that all taxable profits are not in-scope: only so-called "excess profits" are subject to the 15 percent minimum effective tax rate, and indeed given other subsidiary features not all of those need be covered. This is the main subject of Section 4 below. The complexity of these proposed rules means that much tax planning (some would say tax avoidance) will go on within this new framework—and indeed already is.

[11] Some countries in SSA may not host investment from members of MNE groups that are in-scope, but many will have at least one such investor and most may hope to do so in the future. Notably, countries with mining and petroleum investments, as well as those with foreign owned telecom investments, may find that those investors do belong to MNE groups that fall within scope for Pillar 2.

How Pillar 2 works [12]

In brief: "profits" are calculated for a worldwide unified MNE using a modified financial accounting standard, rather than the jurisdictionally unique CIT bases on which the international corporate tax architecture now rests. This itself poses substantial issues, which are not the subject of this paper. But without at least some degree of uniformity in the tax bases across countries, an effective minimum rate could not be calculated. Then, a "top-up" tax is calculated for each jurisdiction that hosts a constituent entity (CE) of the MNE, consolidating across CEs only within a jurisdiction to determine the effective rate—"covered taxes" divided by the financial accounting base—in that jurisdiction. Should that rate be less than 15 percent, a "top-up" tax is imposed somewhere in the world, calculated as that rate times the total "excess profits" on a jurisdiction-by-jurisdiction basis.

"Excess profits" – the actual base for the top-up tax—constitute the modified financial accounting profit less a carve out for a deemed return on "real" investment. This is the substance-based income exclusion (SBIE). [13] The existence of this carve out in the proposed model rules makes plain that the goal is not to impose a minimum tax on all international corporate profits, but rather to impose that tax on more mobile taxable profits generated by more mobile, intangible, assets—and thus to minimize loss of revenue from MNEs caused by their tax-avoiding profit shifting strategies. This is explored further in Section 4 below.

The SBIE does not pose a choice for LICs that want to participate in the GloBE rules; it is an integral part of that structure. Indeed, the desired position of many LICs and emerging market countries in regard to competition for investment is clear from the fact that many of those countries were strong advocates for such a carve out from in-scope profits for "real" investments in their jurisdictions. The SBIE allows them to continue to compete for investment within the range of taxable profit carved out by the SBIE.

Until the December Model Rules were promulgated, the "somewhere" that a top up tax would be imposed was in the first instance the headquarters jurisdiction of the parent entity of the MNE group. This is the included income rule, now known as the IIR. If that jurisdiction failed to impose the top up tax, nor did any of its direct subsidiary entities do so down the chain of ownership, then a back-up under taxed payments/profits rule, now known as the UTPR, would permit all other jurisdictions with CEs of the MNE to tax a portion of the top up amount—in another innovation, allocated using a formulaic key. Note that this entire approach would give essentially no right to the additional top up tax to the source country hosting the actual activity in question. [14]

[12] Much of this section draws on previous work by the author. *See* Perry, 2022.

[13] To start, this carve out is equal to 10 percent of payroll costs and 8 percent of the carrying value of tangible assets in a jurisdiction. Over the ensuing 10 years these ratios phase down to 5 percent each.

[14] Except to the small extent (given the allocation key) that a CE located there could as a fall-back position receive a UTPR allocation.

In a surprise move in December 2021, however, the Model Rules introduced a "qualified domestic top up tax" (QDMTT), which would permit the source countries that chose to do so to have the first bite at any top up tax generated within their jurisdiction. This then is the first operative question for LICs, if they have any in-scope MNEs with in-scope excess profits: should they adopt such a QDMTT? [15]

The answer to that is – if a sufficient critical mass of advanced countries adopts the GloBE—certainly yes. This would not have a negative impact on their competitiveness. The whole idea of a "floor" on tax competition created by a global minimum tax is that the MNE will pay the top up tax to some jurisdiction. There is thus no competitive edge to be gained by leaving that new extra tax to other jurisdictions. If some jurisdiction is going to get that tax, it might as well be the source LIC country. And this is why, before the advent of the QDMTT, there could have been spillover benefits but few direct revenue benefits for LIC source countries. The pressure to compete away their tax bases for MNE investment would have been limited at least in regard to the excess profits covered by the GloBE for their jurisdiction—thus indirectly potentially creating more revenue.

For some LICs though this obvious choice may pose some difficulty, where tax incentives that already exist are subject to tax stabilization agreements with investors. Imposing a QDMTT would typically violate the letter of such an agreement. But it may be desirable and possible to negotiate a compromise position if the top up tax is going to be paid somewhere anyway. A difficultly is that for most LICs, the calculations of impact—to adopt, to negotiate—are quite difficult or impossible to make themselves. Only the MNE group itself is likely to make those calculations with any degree of certainty.

There are several other issues—and choices—that will face LICs which could affect their competitive positions: other domestic minimum taxes, the qualified refundable tax credit (QRTC), and the STTR are the main ones under Pillar 2, along with more traditional issues of transfer pricing enforcement. [16]

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[15] Commentators are still raising some ambiguity around the question whether a jurisdiction can adopt a domestic top up tax mirroring the GloBE rules that will qualify as a QDMTT, that is, be directly creditable against any IRR top up tax that could be imposed elsewhere (thus "soaking up" the top up tax), if that jurisdiction does not also buy in to the whole package—which in essence apparently means adopting an IRR/UTPR package of legislation. *The better answer appears, though, to be yes, a properly designed QDMTT will be qualify anyway*—so that question is not addressed further here. Any proposed QDMTT is in any event to be subject to peer review of some sort, to ensure that it does meet the rules.

[16] This paper will not deal extensively with the QRTC or the STTR. For more complete analysis, see Perry 2022. LICs grapple with difficulty in the monitoring of transfer pricing practices by MNEs doing business in their jurisdictions. The GloBE will not eliminate this issue—financial accounting income within the jurisdiction depends upon transfer prices between MNE CEs, as does the domestic tax base for such entities. The impact of such income stripping practices – shifting profits to lower taxed recipient entities – is to reduce the domestic tax base in the LIC, in either case. To the extent that this could have been viewed as a competitive advantage—intentional or not, on the part of the jurisdiction—it's impact will be mitigated but not eliminated, just as in the case of any other tax incentive grant, by the introduction of the GloBE top up tax.

The first of these, domestic minimum taxes (DMTs) that preexist or differ from the QDMTT as calculated under the rules of the GloBE, have always presented LICs (and other countries) with a choice. Such domestic minimum taxes essentially offset to some extent the tax benefits granted through tax incentives and exemptions—requiring that target companies pay at least some alternatively calculated amount of corporate tax where otherwise the benefits of the exemptions would reduce the company's local CIT below that level, or even to zero. They thus serve the purpose of setting some local, domestic floor on effective tax rates—and thus, a floor, however low, on tax competition through actions taken by that jurisdiction. How such existing—or perhaps new—domestic minimum taxes will interact with the GloBE depends upon whether a minimum tax is deemed to constitute a "covered tax," for purposes of calculating the GloBE effective tax rate. If yes, then the impact of the domestic minimum tax is subsumed under that of the GloBE top up tax (whether collected through a QDMTT or an IIR); if no, then most of the extra domestic minimum tax – above 15 percent of the domestic minimum tax amount – remains to increase the effective tax rate. [17] So LICs with such gross turnover-based add-on taxes may want to reconsider whether they wish to retain them, or to change their bases, if the GloBE comes into play.

Second, LICs may be faced with the choice of whether to adopt or convert tax incentives from simple tax holidays, or free zones, both of which can give rise to reductions in covered taxes that could result in a top up tax, to qualified refundable tax credits (QRTCs) as defined under the Model Rules. The QRTC is another example, like the SBIE, of a provision that makes it clear that the GloBE rules are by no means intended to stop all tax competition—or perhaps even most of it. In order to be qualified, a tax credit must be designed in such a way that it is refundable within 4 years of the entitlement having arisen, if it has not already been offset against the taxpayer's income by then. The regime works by treating QRTCs as GloBE income in the year the entitlement to the credit arises, rather than as a reduction in covered taxes [18]—in other words, as if they were direct grants from government to taxpayers, which are outside the scope of the rules altogether. Conversely, non-qualified refundable (or non-refundable) tax credits are treated like other tax incentives—not included in GloBE income and excluded from covered taxes. [19] The appropriateness of this rule is considered in Section 4 below.

This can create a dilemma for LICs. On the one hand, such QRTCs permit the effective tax rate on excess profits—after the SBIE—to fall below 15 percent, in some scenarios, far below. So this is certainly an effective avenue for tax competition. However, administering a refundable credit is not trivial—and LICs do not use them, partly for that reason. In fact, LICs have a very difficult time handling even the more straightforward VAT refunds that are an integral part of the VAT—and often lag, or fail altogether, in giving such refunds. This stems from a fear of fraud, in part, and administrative difficulty in policing that. Further, in many LICs, domestic

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[17] A table showing how this works is found in Appendix A.

[18] December 2021 Model Rules, Article 3.2.4; March 2022 Commentary, Article 3.2.4 paragraphs 110-114; Article 10 paragraphs 134-138.

[19] An example of how this can affect the top up tax amount is found in Appendix B.

budgetary rules require that no checks can be written to taxpayers without having been included in an explicit budget line. This has been a significant problem in the proper operation of the VAT. And presumably those problems would also arise with CIT refundable credits. Yet, it seems quite likely—some tax planners would say certain—that in at least some cases LICs will come under pressure to adopt QRTCs as a means of competing if the GloBE comes widely into effect.

And finally, beyond the GloBE minimum tax, LICs will need to think about how to deal with the STTR, if it may be applicable to them. Appendix C describes this issue.

Section 3: Current Estimates of Revenue and FDI Impacts of Pillar 2 on LICs

LICs do stand to gain, at the margin, in both revenue and foreign direct investment, according to the best recent estimates. The extent of the former will depend upon whether an individual country with in scope excess profits chooses to adopt the QDMTT, or to leave any top up tax to residence countries, as discussed in Section 2. In any event, some amount of revenue will be on the table for at least some LICs.

Recent revenue estimates from the IMF [20] find that as a direct static effect global corporate income tax revenues from Pillar 2 as structured in the Model Rules would increase by about 5.7 percent ($150 billion). [21] If all source countries acted to capture the top up tax, then this would fall to them, including to some degree to LICs. [22] The same exercise found that the indirect impact on revenues from a reduction in global tax competition would be somewhat higher, adding another 8.1 percent of global corporate income tax revenues.

UNCTAD [23] found that the combination of the introduction of the minimum tax rate on source countries effective tax rates, together with the reduction in profit shifting, would increase government revenues collected by host countries on FDI generated tax revenues by about 20 percent globally. [24] This translates into about a 15 percent increase in FDI generated tax revenues in developing economies (including emerging economies, beyond just LICs). Developed economies were projected to gain, by comparison, about 31 percent of FDI generated tax revenues. While LICs relative share of these gains is lower, it is still an absolute gain—again assuming that they adopt the QDMTT. These are aggregate estimates—as in the case of the IMF estimates. Individual LICs could stand to gain a good deal more, depending upon the exactly nature and size of the FDI which they host, and the shape of their existing tax systems. In any case, however, it behooves LICs with in-scope CEs to adopt in the short term QDMTTs in order to capture whatever top up taxes may arise for their jurisdictions.

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[20] International Monetary Fund, April 2022 Fiscal Monitor, Chapter 2: Coordinating Taxation Across Borders.
[21] Or, notably, about 7.6 percent if there were no SBIE. Interestingly, $150 billion is roughly in line with the OECD's original 2020 global estimates for Pillar 2.
[22] Given the aggregate macro data approach of the calculations, this degree is not specified.
[23] UNCTAD World Investment Report 2022, "International Tax Reforms and Sustainable Investment."
[24] This assumed that all source countries adopted the QDMTT, that all pre-Pillar 2 offshore financial center income is (un)shifted, and that there was no SBIE carve-out.

Researchers from the EU Tax Observatory [25] have recently estimated the impact of Pillar 2 on profit-shifting, and thus on potential revenues, for individual countries using 2016 and 2017 country-by-country reporting data (publicly available on the OECD website), supplemented by other data including from Orbis. This does not provide much information on low income individual countries. However, the report's overall estimates –including an attempt to model behavioural responses by MNEs—while somewhat higher, are within similar ranges.

Of even more direct relevance to the tax competition question is the issue of how FDI to LICs will likely be affected by Pillar 2. This depends to a large extent on the exact nature of the incentives that they now offer,[26] but aggregate estimates have been made by the IMF and UNCTAD for this question as well. Notably, the IMF, which addresses the question only relatively briefly, finds that the incremental global effective tax rate on investment does increase modestly, but that world aggregate investment in fixed assets remains approximately constant. There would, though, be "large differences in country specific effects."

The UNCTAD report is aimed specifically at this question, with a very sophisticated analysis of the impact of relevant effective tax rates on investment in various types of economies. It finds that offshore financial centers lose their tax advantages, unsurprisingly—and that developing countries do stand to gain investment from diversion from those centers. In fact this effect could be relatively much larger for developing than developed economies—1.5 to 2.9 percent, versus only 0.4 to 0.6 percent. Most salient for purposes of LICs, for Africa the range found is 2.4 to 4.6 percent. Thus, to date the best aggregate analyses do not find that the global minimum tax would adversely impact overall FDI in LICs—though conditions could vary locally—but rather the converse. Nonetheless, this could still leave individual LICs to compete with one another over this new slightly enlarged pool of FDI. It will remain the object of desire for LICs that are played off against one another.

In order to make any informed decisions, LICs will have to ascertain what MNE CEs are in-scope within their jurisdiction, and what effective rate of tax, as calculated under the GloBE rules, is being imposed on the excess profits of those entities. This may not be possible for many LICs—who will be likely to have to simply accept calculations being made by the affected entities themselves. Only a very few LICs have yet qualified to receive the detailed non-public country-by-country reports as provided for under the original BEPS project, due to concerns regarding their ability to safeguard the information. [27] This further hobbles their ability to make the necessary analyses for the GloBE. The methodology adds a further layer of complexity on top of

[25] Barake et al

[26] OECD October 2022, *"Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules."*

[27] As of October, 2021, only 3 LICs were qualified to receive country-by-country reports. OECD (2021), "*Developing Countries and the OECD/G20 Inclusive Framework on BEPS: OECD Report for the G20 Finance Ministers and Central Bank Governors,"* p. 19, October 2021, Italy, OECD, Paris, *https://www.oecd.org/tax/beps/developingcountries-and-the-oecd-g20-inclusive-framework-on-beps.htm.* By October 2022, the number had risen only to 5.

the LICs existing struggles to determine the appropriate taxes on their MNE entities under their own domestic tax rules and their available tax return information.

Section 4: Is the current version of the SBIE the best approach?

Pressures among the advanced economies in particular have resulted in a model that does not in fact create a minimum tax. Rather it achieves another approach to reducing profit shifting by MNEs, but one more sweeping than the last BEPS effort. Through the SBIE, countries under the Model Rules are allowed, indeed encouraged, to continue or increase competition for "real" investment in their jurisdictions—by excluding from the minimum tax certain returns to that tangible investment and activity—while other profits are all subject to the minimum tax. [28] This raises three questions: (i) would it be possible to do—and should the world implement—the GloBE without a "carve-out"? (ii) if not, is there a better way of doing the carve out? and (iii) how would LICs be affected?

Why do the GloBE model rules include the SBIE? The facile answer is because jurisdictions would not agree to the whole plan otherwise, as they wished to continue tax competition. But this section examines the economic justification for the carve out as designed—and finds that it makes sense from the standpoint of LICs, if there is to be a carve out at all.

Justification for the current design of the carve out

Essentially, as noted above, the SBIE allows countries to continue to compete over tangible investments—in both capital assets and labor—up to a certain point. And that point, under the SBIE as currently proposed, is (very roughly) aimed at "normal" returns to such tangible investments[29]—excluding from the carve out "normal returns" to intangible investments, and "excess profits" above a proxy for overall normal return (more technically, economic rents).

A more efficient way to design a carve-out intended to impose the global minimum tax only on economic rents would be to adopt the approach taken under an allowance for corporate equity and debt—sometimes referred to as an ACC. Instead of attempting to directly measure investment in assets (whether tangible or intangible) and employment, total net corporate capital would be used as the basis for the carve out, with the carve out equal to a percentage deemed a "normal return" on that invested capital. [30] This would exclude from the minimum

[28] This approach follows that adopted by the US in the 2017 GILTI minimum tax that it unilaterally adopted for its own MNEs.

[29] In practice, in some cases the percentage returns chosen for the SBIE undoubtedly will exceed the normal return on tangible investment, though in others they will probably fall short.

[30] Of course, just as in the case of an ACE (allowance for corporate equity) or an ACC, choosing the "correct" deemed rate of normal return is an issue. And this should be chosen at the global entity level for the entire unitary enterprise—given the economic reality that the borrowing capacity of members of the group cannot really be assessed separately from the whole—and otherwise, were this done on a jurisdiction by jurisdiction basis, there

tax—unlike the current SBIE design—normal returns to intangible investments as well as tangible ones. [31] If one did wish to exclude the normal return on intangibles, this would indeed be a preferable approach to a bottom-up determination of value on an asset-by-asset basis in a jurisdiction (as is done for tangible assets under the SBIE as designed), because of the possibility of easily mispricing (and moving) such intangibles—particularly where they are transferred within global MNEs (eg, in the case of intellectual property).

Carving out intangible investment as well as tangible would arguably better – or more purely—represent a move toward a more efficient corporate tax system, in that economic rents can be taxed up to their full extent without distorting behavior—and taxing the normal return to investment cannot. This might point to the wisdom of imposing the global minimum tax only on economic rents—ideally by using something like an ACC methodology. But would this be a good idea particularly from the point of view of, and effect on, LICs?

LICs and tangible versus intangible investments

It is quite likely that tax competition for specific foreign investments is a more cost-efficient means of incentivizing that investment for LICs than a broad reduction in all corporate taxes through the statutory rate. There are two possible rationales for such competition among LICs, one of which may be economically efficient—versus the other, engagements in which countries lose and investors win. The former is a model in which low taxes on profit are seen as necessary to increase the after-tax profit rate for foreign investors to offset perceived negative features and lacking factors of the host country—for example, lack of physical infrastructure or poor skills in the labor force which impose costs on the investor, and/or heightened risks to the investment as a result of unstable political situations and poor governance (including corruption).

The second model, on the other hand, is a zero-sum game from countries' point of view. Peer countries compete with each other, through granting increases in after-tax profit rates, for a perceived limited pool of foreign capital, and for specific projects. In such a competition, in particular, it is quite possible that effective tax rates are competed down to such a level that considerable surplus benefit may accrue to foreign investors, beyond that which would have been needed to attract them to a country in the absence of competing venues. In other words, some portion of excess profits are being ceded to the investing MNEs without tax—the opposite of what would be economically efficient. LICs would ideally try to determine whether their competitive tax exemptions and incentives have exceeded the level of return required by their investing MNE constituent entities, and thus represent a windfall to those MNEs, rather

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would be an incentive to manipulate capital on local subsidiary/constituent entity balance sheets. This analysis abstracts from the rate issue, given its other conclusions.

[31] See, for example of a potential problem, the complaints of the global insurance industry that the insurance business model is not reliant upon tangible investments, but that (essentially) that does not mean that all of its profits are "excess", or rents. Global Federation of Insurance Associations, *Response to OECD Public Consultation on the Implementation Framework of the Global Minimum Tax,* April 2022—arguing that there should be an economic substance exemption (ie., carve out) for financial services companies based upon their required regulatory capital.

than a compensation for negative aspects of local investment. Could this be done by groups of LICs that view themselves in competition, it would provide a basis for collaboration among themselves to limit the damage to their revenue bases from giving such incentives. In other words, LICs could avoid the zero-sum game aspect of their competition. But this was true—though impossible, or not done—before the advent of Pillar 2 as well. Pillar 2 does not help with this to the extent that there is any carve out. It may though limit excessive zero-sum competition beyond that.

Would there be any advantage to LICs in allowing tax competition over a normal return to intangible assets? The answer to this is likely no, since attracting intangible assets (or financial capital, to the extent it is not invested in local tangible assets and payrolls) without taxing the economic return on those assets will not benefit the country in question—where the owners of the assets are outside the country. Competing for the "location" of intangibles through zero taxation of the return on those intangibles is exactly what low tax jurisdictions (tax havens) do. And to the extent they benefit from this business model—as they obviously must—it is exactly through tax substitutes (eg corporate fees, albeit realized at a very small fraction of a hypothetical profits tax), and through the (tangible) location of some numbers of actual workers in both direct and indirect support functions within the jurisdiction. All surplus benefits—in the form of no taxation of either the normal return to those intangible assets or the excess profits (rents) that they generate—accrue to the owners of the assets outside the jurisdiction.

Thus, to the extent that intangible and financial assets may be attracted to LICs, it does not behoove them to compete over the normal return to those assets, or at least it behooves them to a relatively much smaller degree than in the case of tangible assets. This would support an argument that the current version of the SBIE is a sensible solution.

Should there be a carve out at all?

If there were no carve out, there would be no exclusion of normal returns from the disincentive to tax competition. The current version of the SBIE, as assessed above, is a sort of compromise between a design that would in the extreme of permitted competition lead to the taxation of only excess profits (ie., rents), and a prohibition on competition that would attempt to include all normal returns in the protected category. Arguably, carving out normal economic returns—and thus permitting them to be competed away from the tax base—could be a desirable step toward an efficient corporate tax system that taxed only economic rents. [32]

Where does this leave the QRTC?

It seems clear that, while the SBIE as written aims to allow competition only over normal returns to tangible assets, the QRTC goes much further, permitting competition to continue

[32] See Devereux, et al, 2021.

over some part of economic rents. As such, there is a clear case for eliminating it from the proposed model rules.

Section 5: Conclusions

The proposed Global Minimum Tax represents a major positive milestone in the evolution of the international corporate tax system, albeit a very complex milestone. This paper assesses the impact of the Substance Based Income Exclusion on low-income countries—essentially source-only jurisdictions that compete heavily with one another for inbound foreign direct investment. LICs are more heavily dependent, relatively, for tax revenue from corporate income taxes than are the most advanced economies. Thus the question whether the present design of the GloBE is appropriate for them is key.

The SBIE as presently proposed would permit tax competition over a proxy for the normal economic return to tangible investment within a jurisdiction. While in some cases this competition serves to offset negative features of the local jurisdiction in question by increasing the after-tax rate of return on investment, in others such competition represents a zero-sum game for competing jurisdictions—with the surplus going to the investors. The SBIE itself cannot distinguish between these two cases though it can at least set some floor under the latter.

The currently designed GloBE with SBIE would subject all returns to intangible investments and assets, as well as all "excess profits,"—a proxy for economic rents—to the new global minimum tax. This would eliminate the advantage for a jurisdiction to compete away the tax on those returns, since a minimum tax would be paid in any event somewhere. As little real advantage may accrue to LICs from intangible assets, minimizing tax competition for those assets is a sensible solution. And from an economic efficiency standpoint, shifting the tax burden away from a normal return and toward economic rents ("excess profits") more broadly also makes sense. Relatedly, however, there is no justification for the QRTC insofar as it permits competition well beyond a normal return on investment.

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Appendix A: Interaction of the GloBE and a 1 percent turnover-based DMT

	No GloBE and no DMT (base case)	**DMT and no GloBE**	**GloBE and no DMT**	**Both GloBE and DMT; DMT is a covered tax**	**Both GloBE and DMT; DMT is not a CT**
Turnover	10000	10000	10000	10000	10000
Financial accounting profit ignoring taxes	1000	1000	1000	1000	1000
Profit subject to CIT statutory rate = 25 percent	240	240	240	240	240
tax	***60***	***60***	***60***	***60***	***60***
Profit subject to Tax Holiday: rate = 0 percent	760	760	760	760	760
tax	***0***	***0***	***0***	***0***	***0***
DMT = 1 percent of turnover (less CIT paid)	***n/a***	***40***	***0***	***40***	***40***
Financial accounting profit after taxes	940	900	940	900	900
Globe net income	n/a	n/a	1000	1000	960
Covered tax	n/a	n/a	60	100	60
ETR	n/a	n/a	60/1000= 6%	100/1000=10%	60/960 = 6.25%
Top up tax	n/a	n/a	.09 x 1000 = ***90***	.05 x 1000 = ***50***	.0875x960=***84***
TOTAL tax	***60***	***100***	***150***	***150***	***184***

Source: Perry, Oxford Centre for Businsess Taxation WP 22/13, September 2022.

In most regions and countries, alternative DMTs are based upon a measure of deemed return on assets or a measure of financial income—that is, some alternative measure of corporate income, albeit calculated with a different base. In about a third of SSA countries, however, there are domestic minimum taxes calculated based upon gross turnover. [33] Rates of these DMTs range from 0.5 percent of gross turnover up to 2.0 percent, with most centering around

[33] Aqib Aslam and Maria Coelho, "*Characteristics and Impact of Corporate Minimum Taxation: A Firm Lower Bound,"* IMF WP/21/161.

1.0 percent. Whether such gross turnover based DMTs will constitute covered taxes is not clear from the Model Rules and Commentary. "Simplified methods" that serve as taxes "in lieu of" generally applicable CITs will count, where they operate as substitutes; this would appear to cover presumptive income taxes levied on small businesses, for example. And net income-based taxes operating in addition to the regular CIT such as resource rent taxes on extractive industries (specifically cited) also count as covered taxes. However, a tax "imposed on an alternative basis that applies in addition to, and not as a substitute for, a generally applicable income tax … would not fall under the "in lieu of" test for Covered Taxes." [34]

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[34] Commentary (March 2022), Paragraph 32, on Article 4.2.1, p. 93.

Appendix B: Illustrative Impact of QRTC—CIT rate of 10 percent before credits

	Base Case (no credit)	QRTC = 50	Non-qual credit = 50
Financial acc't profit	1000	1000	1000
Tax paid pre-credit	100	100	100
Credit	n/a	50	50
GloBE income	1000	1050	1000
Covered tax	100	100	50
Effective tax rate as defined for GloBE calculation (ETR)	10 %	9.5 %	5 %
Top up tax	(.05*1000)=50	(.055*1050)=55	(.10*1000)=100
Total tax paid	(100+50)=150	(100-50+55)=105	(100-50+100)=150
Overall tax paid as percentage of residual profit	150/1000= 15 %	105/1000 = 10.5 %	150/1000 = 15 %

Source: Perry, Oxford Centre for Businsess Taxation WP 22/13, September 2022.

This concept is modeled upon incentives used in a few highly advanced economies especially in regard to research and development incentives.

Appendix C: the STTR

The STTR will allow lower income countries [35] that have relatively low rates of gross withholding on interest and royalties (and possibly other payments to be specified later) under existing bi-lateral treaties to require their treaty partners to revise the treaties to permit the payor country to top up those rates to 9 percent, on a payment-by-payment basis, if certain rules are met. That is, unlike the GloBE top up tax, no overall effective rate is calculated. The STTR is to apply only where: (i) the payee is a "connected person," defined in relation to the OECD and UN model treaty definition of "closely related" parties; (ii) the nominal rate of tax applicable to the payment in the hands of the payee is less than 9 percent; [36] and (iii) some threshold is met. The last is not yet specified; the Blueprint notes that its design is to be studied and may involve payment size, MNE scale, or other more complex parameters.

The OECD description of the STTR specifically contrasts its intent – *to reduce profit shifting* – with that of the recent UN Model treaty article 12A which is designed to apply cross border gross withholding taxes to many service payments between both related and unrelated parties, and thus explicitly intended to allocate a greater proportion of tax to source countries. The STTR is specifically *not* intended to "[revisit] the current allocation of taxing rights between jurisdictions." In other words, the idea is to reduce related party profit shifting using treaties with low tax countries. The payments to be covered are those that relate to "mobile capital, assets, or risk." Note that depending upon one's definition of "allocation," this means that some taxing rights that were given up to intermediate countries could in fact be reallocated back to lower income countries, if they so choose. The prevalence of treaties in LICs with withholding rates below 9 percent is not trivial [37] at this point—and (before the QDMTT) LICs lobbied hard for this provision, in hopes that it would give them some additional tax under Pillar 2. Given the strict limits imposed under the STTR as it evolved, though, those hopes would be unlikely to be realized. And there is already evidence that some treaty partner countries are amending their domestic tax provisions to ensure that a nominal rate of 9 percent will apply to payments coming from LIC partners that have lower rates of withholding in their bi-lateral tax treaties, [38] thus entirely vitiating the possibility that the LIC partner(s) can require a renegotiation that would result in shifting tax base to them from the payee countries.

Nonetheless, should any treaties remain to an LIC that would in fact be subject to amendment under a new STTR MLI, it falls to the LIC to decide whether to require its treaty partner to change the withholding rates in the treaty to bring the total tax on the payment up to at least 9

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[35] Defined as countries with a GNI per capita of 12,535 or less in US dollars. OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (8 October 2021).

[36] The specific rate of 9 percent was also introduced in the October 2021 OECD document.

[37] See Perry, Victoria, *"Pillar 2, Tax Competition, and Low Income Sub-Saharan African Countries," working paper, forthcoming in InterTax.*

[38] Wardell-Burrus, Heydon, "*Pillar Two and Developing Countries: The STTR and GloBE Implementation,"* WP Oxford Centre for Business Taxation (WP 22/13) 16 September 2022.

percent. Here, unlike the case of the QDMTT, there would in fact be a negative competitive impact were this to apply. In other words, such a modification would create an actual increase in the tax rate on gross flows of interest and royalties out of the LIC—and that would not happen if the LIC did not choose to impose the higher withholding. It should be understood, in thinking about this, that withholding provisions in treaties between source-only countries and more advanced economies—let alone tax planning hub jurisdictions—are not two-way streets. The negotiation of such low withholding provisions is, rather, designed to set the stage for the stripping of the tax base from the higher tax LIC to a low tax jurisdiction; it is designed exactly as another means of profit shifting. This is recognized through the design of the STTR with its related party rules. So, again, the LIC would have to decide in this case what position it wishes to adopt in regard to continued tax competition.