Tax incentives and minimum effective taxation

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On July 1st 2021, 130 countries approved a statement providing a framework for reform of the international tax rules. Countries reached a consensus-based two-pillar solution to ensure fairness and equity in the tax systems in order to fortify the international tax framework in the face of new and changing business models. These agreements were called Pillar 1, Pillar 2 and the commitment to eliminate unilateral tax measures on digital services. Among the three, the measures developing Pillar 2 seem to be the most developed both at domestic and international level. Despite that fact, many important aspects claim specific attention considering the concerns that have generated among a great number of countries, mainly developing countries.

Pilar 2 has been developed to ensure minimum effective taxation of multinational groups exceeding 750 million euros turnover. It provides for two complementary basic rules: an income inclusion rule (IIR) and an undertaxed profits rule (UTPR). As a result of the IIR, a domestic top-up tax might apply on income of foreign branches and subsidiaries of an ultimate parent company in its jurisdiction if the tax paid in a foreign jurisdiction do not pay a minimum effective tax rate.

The adoption of Pilar 2 as part of the international tax consensus has restricted considerably the ability of developing countries to use their taxing powers to attract foreign direct investment. Despite the fact that tax competition is still possible, the top-up tax and the complementary UTPR condition their application in many cases. As a result, most jurisdictions are forced to review, to reassess and if necessary to reformulate their tax incentives regulation and their tax policy to attract foreign direct investment in general.

Regardless of the consideration of the effectiveness of tax incentives to attract foreign investment, it seems obvious that the rection generated by the Inclusive Framework and the OECD developing the global consensus on minimum effective taxation leaves little room of manoeuvre for developing countries to adapt to the new standards. This situation may be untenable for many countries and it is for their interest to find mechanisms that allows them to keep certain control on attracting real and substantial investments in their territory using tax policy mechanisms.

In that sense, it would be of particular interest for States represented in the United Nations Framework Convention on International Tax Cooperation that the Committee took as one of its first substantive topics the elaboration of terms of reference regarding the valid relationship between the use of tax incentives and value creation in the territory of the jurisdiction without undermining the minimum effective level of taxation of the investors concerned, looking for different alternatives for effective taxation. As for tax incentives, recent history of tax agreeements show different alternatives of how to recognize the specific circumstances of certain jurisdictions in order to establish transition mechanisms to enable them to foster the international commitments.

Several considerations and topics could be taken into account by the Committee, namely and among others:

-Adequacy of different types of tax incentives to foster and enhance economic and social development: systematization of implementation measures.

-Elaboration of simplified safe harbor standards or rules for determining minimum effective taxation for developing countries to enable proper implementation and control by tax administrations of developing countries.

-Development of alternative standards and policy options to the qualified domestic minimum top up tax to adapt to the special collection needs of developing countries.

-Reconsideration of the carve-out clause regarding substance-based income exclusion (SBIE).

-Transitory mechanisms to enable jurisdictions to finally adapt the international tax agreed framework.

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