KPMG

Tax alert

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OECD: Report on tax incentives and global minimum tax

On 6 October 2022, the Organisation for Economic Cooperation and Development (OECD) released a report titled *Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules*. Prepared at the request of Indonesia, which will host the G20 Summit in November, the nearly 80-page report provides a number of concrete considerations for countries to take into account as they prepare for the implementation of Pillar Two.

The main thrust of the report is the need for jurisdictions to assess their current tax incentives in preparation for the arrival of Pillar Two, including stabilisation clauses in contracts which may arise from investment agreements.

It points out that taxpayers will be impacted differently as the Global Anti-Base Erosion (GloBE) Rules, a core component of Pillar Two, may alter the effectiveness of certain tax incentives, noting that:

- many firms will be under the 750 million-euro threshold;
- the substance-based income exclusion (SBIE) will mean firms with greater substance in a jurisdiction will be less affected; and
- targeted incentives are less likely to be impacted than broad ones, all else being equal.

Leveraging past work undertaken by the OECD, the report asserts that expenditure-based tax incentives are more effective than income-based incentives — particularly for those based on payroll and tangible assets. It notes that the GloBE Rules do not impact incentives for tangible assets in terms of faster cost recovery and immediate expensing given the treatment of timing differences. It also states that refundable tax credits, often research and development (R&D) incentives, are treated in a similar manner to cash grants and may therefore not be adversely impacted.

Use of tax incentives around the world

The report points out the proliferation of new tax incentives throughout the globe to attract economic activity in recent times: there were five times more jurisdictions in the OECD offering support for innovation-related income in 2021 than in 2000. These tax incentives also enable many multinational enterprises (MNEs) to have companies with effective tax rates (ETRs) below 15% despite being in jurisdictions with high headline rates. Among developing countries, broadly targeted tax incentives are prominent partly due to their non-discretionary format and departure from the need for governments to pick winners or evaluate eligibility on a case-by-case basis. It has been observed that excessive reliance on tax incentives can be counter-productive where capacity is low and may encourage the channelling of income rather than activities.

The report also refers to the use of contractual arrangements between governments and firms as a potential impediment to policy updates. Many older investment treaties do not exclude tax from their purview.

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

Key elements of GloBE Rules that impact tax incentives

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

The **first tier** refers to the **jurisdiction level**, where 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. Notably, with income and jurisdictional blending, income taxed below 15% due to incentives may not be impacted, such as by a top-up tax.

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

The **third layer** is the **tax incentive level**. If a tax incentive has substance requirements based on the level of payroll and tangibles, impact could be low due to the SBIE. If the incentive reflects a timing difference on tangible property or falls within the concept of a refundable tax credit, the impact may be minimal or naught.

Design of GloBE Rules and tax incentives

The report uses the concept of an 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 employs stylised examples to highlight the impact of GloBE Rules 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, investment tax allowances and 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, the Rules may impact intangible assets where temporary differences last longer than five years because there is a recapture rule that effectively "regularises" top-up taxes over a period if the timing benefit is not reversed within five 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 labour and capital costs — will have a greater impact than those not based on substance. 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 policy options regarding the impact of the GloBE Rules to ensure they remain fit for purpose.

Factors businesses should consider

Although the report is focused on what governments should do, it is our view that businesses should start considering their current tax incentives and assess their effectiveness in a Pillar Two 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.

Impact of Pillar Two on Singapore

Singapore offers a wide range of tax incentives to investors. These include income-based incentives offering concessionary tax rates, such as the Development and Expansion Incentive, Financial Sector Incentive Scheme, Global Trader Programme and various Singapore fund tax incentives, and expenditure-based incentives such as the Investment Allowance Scheme and R&D enhanced tax deductions.

It is important that businesses potentially within the scope of Pillar Two rules and currently enjoying or intending to apply for these incentives consider the impact of the impending GloBE Rules.

The SBIE can mitigate some impact from the GloBE Rules, especially for expenditure-based incentives such as the Investment Allowance Scheme and R&D enhanced tax deductions. Non-tax incentives such as grants may not be adversely impacted by the GloBE Rules, depending on the tax treatment of such grants.

Investment funds should note that the provision of Singapore fund tax incentive schemes (e.g. Sections 13D, 13O and 13U Schemes) for Singapore-managed fund vehicles is consistent with the tax-neutrality principle. It is the same principle which underpins the OECD's decision to treat fund vehicles that meet the definition of "investment fund" and that are ultimate parent entities in their own right as "excluded entities" for GloBE Rules purposes.

Most Singapore-managed investment funds, regardless of whether they are exempted under tax incentive schemes, will not be affected by the GloBE Rules.

This is because the funds either qualify as "excluded entities" in their own right or are part of an MNE group (i.e. the funds are controlled and consolidated for accounting purposes by the ultimate parent entity of the MNE Group) that does not cross the 750 million-euro revenue threshold.

Hence, it is expected that only controlled funds which are part of an in-scope MNE group may be affected by GloBE Rules.

However, it should be noted that certain dividends and equity gains/losses from non-portfolio investments, commonly derived by investment funds, are excluded from GloBE income, so the Pillar Two impact may be mitigated to some extent.

A Singapore fund management company that falls within the scope of Pillar Two (i.e. is part of an in-scope MNE group) and is awarded the FSI-FM status (which is taxed on qualifying income at the concessionary tax rate of 10%) may see the tax effectiveness of their FSI-FM award impacted by Pillar Two rules. However, the fund management company may avail itself of the substance-based income exclusion under GloBE Rules such that a fixed return on substantive activities in Singapore may be excluded from the application of top-up tax.

Importantly, the GloBE Rules require the effective tax rate to be computed on a jurisdictionally blended basis. As such, any impact needs to be considered taking into account all group entities in Singapore — whether they receive tax incentives or not. Modelling the impact of the GloBE rules will help businesses to identify the tax impact of these rules and provide decision makers with guidance in reviewing their incentive toolkits and approaches.

How we can help

Our dedicated team of BEPS specialists provide impact assessments, scenario modelling, group structure planning and data management solutions to address upcoming BEPS 2.0 compliance obligations.

Working together with our R&D and Grants Consulting team, we are able to assist businesses with reviews of existing and future tax and non-tax incentive strategies and support their discussions with relevant government authorities.

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