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BEPS reform: The end of fiscal incentives to attract FDI?

by
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Host countries have traditionally offered MNEs such tax incentives as tax credits and tax holidays to attract FDI. Although the effectiveness of fiscal incentives is controversial, their widespread use has resulted in a "race to the bottom" in international taxation: countries offer increasingly lower tax rates when competing to attract FDI.

The OECD's newest iteration of the Base Erosion and Profit Shifting (BEPS) reform attempts to significantly erode tax competition through a two-pillar agreement joined by 137 countries.[1] Pillar 1 shifts tax rights over certain major companies to final consumers' jurisdictions; Pillar 2 is encapsulated in the Global Anti-Base Erosion (GloBE) rules. Since the timeline for Pillar 1 is uncertain and Pillar 2 is likely to implicate a much larger portion of the international economy, this *Perspective* offers policy recommendations for host countries' responses to Pillar 2.

Pillar 2 imposes a minimum corporate income tax (CIT) rate of 15% on all companies with annual revenues of €750 million or more and allows home countries to impose a "top-up" tax whenever MNEs' effective tax rates are below 15% in any given jurisdiction. Host countries can still opt for corporate tax rates below 15%, but home countries will then likely impose the top-up to raise the tax rate on affected MNEs to 15%. Hence, with limited exceptions, host countries will lose any purported investment-promoting benefit attributable to the low rate—they would merely relinquish revenues to MNEs' home countries.

How should host countries respond?

- The primary policy recommendation for host countries is *not* to lower effective corporate tax rates for covered MNEs below 15% or, if they are below that threshold, to apply a domestic minimum top-up tax to raise effective rates for in-scope entities to 15%. This implicates statutory tax rates, tax holidays, tax credits, and most tax provisions contained in contracts with MNEs.

- Jurisdictions that have not yet joined the GloBE Rules should do so to establish a convincing argument to exit fiscal stabilization arrangements that maintain sub-15% rates.[2]

However, host countries retain policy options to offer fiscal incentives that do not trigger top-up taxes if they choose to use this instrument. They can do the following:

- *The 15% top-up ceiling*. The top-up mechanism allows home country governments to impose an additional layer of tax only until a 15% effective rate is achieved, so host countries are free to compete on lowering corporate taxes down to that threshold—if they believe this could be effective. Because the average statutory corporate tax rate around the world is currently 24%, many host countries appear to retain policy space to do that. However, the top-up is based on *effective*, not statutory rates, which are to be calculated using a complex formula. Host countries that lower statutory rates should in general ensure that their effective GloBE rates do not dip below 15%.
- *The substance-based income exclusion*. Pillar 2 allows MNEs to exclude from GloBE income a value equal to 5% of payroll and tangible assets in a jurisdiction. Host countries can continue to offer tax rates below 15% on this income without incurring a top-up.
- *Qualified refundable tax credits*. Pillar 2 includes these credits in GloBE income instead of treating them as a reduction in taxes paid, leading to a smaller reduction in an entity's effective tax rate per dollar of credit. This renders such credits, which must be repaid within four years after corporations satisfy conditions for receiving them, proportionally more attractive to corporations from a tax standpoint than tax holidays or non-qualified credits.
- *Accelerated depreciation*. The GloBE Rules require most deferred tax liabilities to be recast at the 15% minimum rate, meaning that deductions greater than 15% of an asset's value may trigger the top-up mechanism. Depreciation deductions will therefore carry a lower value in jurisdictions with tax rates above 15% than they did prior to the Agreement. Many countries already have accelerated depreciation policies in place and may choose to continue to allow them, but should be mindful of this change.
- *Non-corporate tax incentives*. Under Pillar 2's definition of covered taxes, host countries remain free to offer incentives on such levies as customs and import duties and VAT. The effectiveness of a non-CIT incentive strategy depends on current rates of non-CIT levies, but can be costly for developing countries that heavily rely on those taxes.
- *Unlimited loss carryforwards*. Companies can use prior losses to offset current gains indefinitely. Host countries could relax loss carryforward regimes, keeping in mind that loss deductions are recast at 15% in the same manner as accelerated depreciation deductions.

While experts debate the efficacy of downwards tax competition to attract investment, virtually all host countries currently rely on such measures. Regardless of host countries' views on fiscal incentives, however, they should raise corporate effective rates to 15% or impose domestic top-ups to avoid losing revenue to home jurisdictions.

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[1] See Lorraine Eden, "Taxing multinationals: The GloBE proposal for a global minimum tax," *Bloomberg Tax Daily Tax Report* (Dec. 6, 2019).

[2] This may require renegotiating contracts and other arrangements. But since the tax effect for MNEs should be neutral, at least in principle, this may be possible.

For further information, including information regarding submission to the *Perspectives*, please contact: Columbia Center on Sustainable Investment, Riccardo Loschi, riccardo.loschi@columbia.edu.

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