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PILLAR TWO AND TAX INCENTIVES IN DEVELOPING COUNTRIES AS LOW-TAX JURISDICTIONS

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List of abbreviations and acronyms

BEPS	-	*Base Erosion Profit Shifting*
CE	-	*Constituent Entity*
DMTT	-	*Domestic Minimum Top-up Tax*
ETR	-	*Effective Tax Rate*
GILTI	-	*Global Intangible Low-Taxed Income*
GloBE	-	*Global Anti-Base Erosion*
GNI	-	*Gross National Income*
IAS	-	*International Accounting Standard*
IF	-	*Inclusive Framework*
IFRS	-	*International Financial Reporting Standards*
IIR	-	*Income Inclusion Rule*
IPE	-	*Intermediate Parent Entity*
LDC	-	*Least Developed Country*
LTCE	-	*Low-Taxed Constituent Entity*
LTJ	-	*Low-Tax Jurisdiction*
MNE	-	*Multinational*
NQRTC	-	*Non-Qualified Refundable Tax Credit*
OECD	-	*Organization for Economic Cooperation and Development*
POPE	-	*Partially-Owned Parent Entity*
QDMTT	-	*Qualified Domestic Minimum Top-up Tax*
QRTC	-	*Qualified Refundable Tax Credit*
SBIE	-	*Substance-based Income Exclusion*
STTR	-	*Subject to Tax Rule*
UN	-	*United Nations*
UPE	-	*Ultimate Parent Entity*
UTPR	-	*Undertaxed Payment Rule*

Abstract

The global tax agreement, which has Pillar Two as one of its products, aims to impose a 15% global minimum tax. The few references to developing countries and the heterogeneous reality of jurisdictions classified in this category raise doubts about the possibility of these countries continue to use their tax systems as a way of attracting foreign investment direct. This article discusses how Pillar Two impacts these jurisdictions and the tax incentives they provide. It analyzes how the interaction between the Model Rules and the ordinary forms of tax incentives occurs and evaluates how the current STTR, SBIE and de minimis exclusion rules operate to preserve such incentives. Noting that the current rules do not provide differential treatment for developing countries and do not guarantee that developing countries will be able to continue to compete by providing incentives, this article suggests both ways of redesigning incentives and modifications to the current rules in order to consider the level of development of each jurisdiction, allowing the attraction of investment.

Keywords

pillar two, tax incentives, developing countries, minimum tax, tax competition, foreign direct investment

1. Introduction

The use of tax systems as a means of attracting foreign direct investment is a practice usually adopted by countries, especially the ones that do not have other competitive advantages capable of influencing the investor decisively in their decision making.

Through mechanisms such as granting benefits, the jurisdictions provide tax reduction, which improves the return indicators on the capital of economic enterprises, making them, at times, feasible.

However, according to the normative design, these tax instruments may be used both to attract substantive economic activity and to promote harmful tax competition, stimulating the transfer of so-called paper profits. This latter possibility has been boosted by digital economy, demanding coordinated actions from the countries, initially within the BEPS Project and, most recently, through the solution based on two pillars, which are about measures proposed by the OECD.

The second pillar of this solution aims to tax the MNE groups covered by the proposal scope at a minimum rate of 15%, regardless of where the profit was generated.

By setting this global minimum rate, the logic beneath the OECD proposal has been to limit harmful profit shifting by multinationals to low-tax jurisdictions, as well as to impose a limit on tax competition; since that, at first, the advantage gained from tax incentives granted by one jurisdiction will make the MNE group pay additional taxes in another jurisdiction, thus eliminating the effect of tax advantage.

The scope of a supposed agreement on the adoption of this two-pillar solution has been widely disseminated by the OECD, including effusively highlighting, being accepted by more than 130 out of 141 countries that make up the so-called Inclusive Framework. That is, having the support of even developing countries, a set of countries that usually adopt tax systems as the main mechanism for attracting foreign investment, which raises concerns about the possibility of maintaining tax incentives in the face of these new rules and, consequently, the competitive capacity of these States.

The proposal, however, seems not to make any distinction between tax systems that adopt unintended non-taxation and those in which non-taxation occurs intentionally with the purpose of achieving results that may promote economic growth. Thus, if on the one hand the adoption of a global minimum tax seeks to put an end to harmful tax competition, once it relies on the same instrument – low or no taxation –, it may reach tax competition triggered aiming to attracting substantive economic activity.

Therefore, even in potential terms, the setting of a global minimum rate may limit the possibility for countries to use their tax systems as a means to attract foreign direct investment, thus affecting their potential for economic growth.

As a consequence of this situation, a concern arises over developing countries, provided that, in general, by the fact of not having other competitive advantages, they count on tax incentives as the only or most used mechanism to attract economic enterprises.

Although they are often referred to by the term *developing countries*, the methodologies used by institutions for grouping them into this or similar categories may reveal the existence of varied economic levels within this very set of countries; warning that the adoption of wide-ranging impact measures, including the ones of fiscal nature, should consider these very intra-group inequalities; so that, when they are designed, they should aim to reduce such economic differences.

In this context, based on the analysis of GloBE Rules, its comments and preparatory documents published by the OECD, as well as academic papers and publishings by international institutions released so far, it seeks to understand how the global tax agreement achieves the tax incentives granted by least developed jurisdictions and, consequently, their tax competitiveness; critically ascertaining, whether and in what circumstances, there is room for maintenance or reformulation of the usual normative models of tax incentives. If not, whether mechanisms have been adopted to provide a differentiated treatment between countries according to their level of vulnerability.

In order to achieve its purpose, the analysis carried out within this article is divided into three parts. The first part aims at presenting an overview of the *Top-up Tax* calculation under the rules established by the OECD and classifying the developing countries in accordance with classification criteria and requirements adopted by international organizations, as well as assess the position of these countries in the application order of GloBE Rules, verifying how these rules benefit or harm them. The second part explains how the Pillar Two operational mechanisms reach and impact the different modalities of tax incentives usually adopted by this set of countries. The third part is intended to measure the potential of certain rules that make up the Pillar Two in minimizing the effects on these countries, the possible actions to be adopted by these economies, the discussion on some alternative ways to respect the differences among the developing countries themselves and to minimize the impact of the Pillar Two implementation by most developed economies at those most vulnerable jurisdictions. Finally, some final considerations are made.

2. Pillar two and developing countries: an overview

The solution based on two pillars[1], nominated as Pillar One and Pillar Two[2], came up as a response of OCDE Inclusive Framework to cope with the challenges derived from digital economy.[3]

In accordance with the Policy Note[4] issued by the Inclusive Framework on 23 January 2019, the BEPS Action Plan, especially the Action 1 Final Report[5], identified tax challenges from economy digitalization as one of the main areas to be focused on. The document pointed out that all economy patterns were under digitalization and ring-fencing digital economy would be a quite impossible task. In addition, the Tax Challenges Arising from Digitalisation – Interim Report 2018[6], published by the Task Force on the Digital Economy (TFDE) of the Inclusive Framework, concluded that the value creation in new business models developed within the context of digitalization arises tax challenges including BEPS risks related to certain income shifting factors due to ease of mobility to low-taxation jurisdictions.

Thus, from analysis carried in the Action 1 Final Report and in the Interim Report, the Inclusive Framework agreed with assessing proposals involving a solution based on two pillars. The first, focused on economy digitalization challenges and the allocation of taxing rights. Whereas the second would focus on the remaining issues related to base erosion and profit shifting (BEPS).[7]

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1 Although it is presented as a single packet, defined as an international tax agreement, the pillars meet radically different goals, *see* Leopoldo Parada, *El Acuerdo Fiscal Internacional: Impacto En economías Emergentes*, SSRN Electronic Journal 1-32 (2021), https://doi.org/10.2139/ssrn.3984969, (accessed 24 May. 2022).

2 This article will be restricted to the Pillar Two analysis.

3 OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy – 8 October 2021*, (OECD, 2021), https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf, (accessed 10 May. 2022) (hereinafter: OECD, *Statement*), at 1.

4 OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note*, (OECD, 2019), https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf, (accessed 9 Jul. 2022) (hereinafter: OECD, *Policy Note*), at 1.

5 OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, (OECD, 2015), https://doi.org/10.1787/9789264241046-en, (accessed 31 May. 2022).

6 OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, (OECD, 2018), https://doi.org/10.1787/9789264293083-en, (accessed 10 May. 2022).

7 OECD, *Policy Note*, *supra* n. 4, at 1.

Subsequently, on 8 October 2021 the OECD announced[8] that the Inclusive Framework had reached an agreement on a two-pillar solution, then disclosing the components of *Pillar One* and *Pillar Two*, as well as an implementation plan.

The Pillar Two, object of this article, is based on the *Global-anti-Base Erosion Rules* (hereinafter: GloBE Rules) and on the *Subject to Tax Rule* (hereinafter: STTR).

The GloBE Rules consist of two interconnected rules: the *Income Inclusion Rule* (hereinafter: IIR) and the *Undertaxed Payment Rule*[9] (hereinafter: UTPR).

Concerning the personal scope, the GloBE Rules shall be applied to large MNE groups[10], and thus being those ones with consolidated revenues of at least EUR 750 million for at least two out of the last four fiscal years, a limit[11] similar to that used for the purposes of *Country-by-Country Reporting* (CbCR)[12].

Generally speaking, through the IIR, a *Top-up Tax*, that is, a complementary tax, is required from a Parent Entity by the fact of a Constituent Entity[13] (hereinafter: CE) has its income taxed at low tax rates[14]. On the other hand, the UTPR is applicable when the income that has been taxed at a reduced rate is not subject to the IIR. Through the UTPR, deductions are rejected or an adjustment that is equivalent to such reduction is required. On the other hand, the STTR is a rule that will allow source jurisdictions to impose limited taxation on certain payments that, when made to related parties, are subject to a tax rate lower than a minimum rate[15]. Tax generated due to the STTR application is used for the purpose of calculating the application parameters of GloBE Rules, for which we can say that within the Pillar Two, the STTR takes precedence over the GloBE Rules.

8 OECD, *Statement*, *supra* n.3, at. 1.

9 When compared to the *Blueprint*, the Model Rules make it clear a change of perspective (from payment to profits) in the UTPR operationalization, that is why some documents have adopted the term *Undertaxed Profit Rule*.

10 In addition to MNE groups, the EU directive proposal also included large national groups in the subjective scope. *See* European Commission, *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union*, Brussels, 2021, https://taxation-customs.ec.europa.eu/system/files/2021-12/COM_2021_823_1_EN_ACT_part1_v11.pdf, (accessed 6 Jun. 2022).

11 The OECD estimates that with this threshold it is possible to reach 90% of the overall corporate tax base, *see* OECD, *Global Anti-Base Erosion Model Rules (Pillar Two) Frequently Asked Questions,* (OECD, 2021), https://www.oecd.org/tax/beps/pillar-two-model-GloBE-rules-faqs.pdf, (accessed 31 May. 2022), at 2.

12 About the CbC Report, *see* OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, 2015), http://dx.doi.org/10.1787/9789264241480-en, (accessed 10 May. 2022).

13 The Article 1.3 of the Model Rules defines a Constituent Entity as any Entity that is included in a Group, including any Permanent Establishment of that Entity. Under Model Rules the permanent establishment qualified as a Constituent Entity is treated as a separate entity from the main entity or any other permanent establishment of that main entity.

14 The minimum rates adopted for the purpose of triggers of GloBE Rules (IIR and UTPR) and of STTR are of 15% and 9% respectively, cf. OECD, *Statement*, *supra* n. 3, at 4-5.

15 OECD, *Statement*, *supra* n. 3, at 3.

In this sense, the Model Rules were designed to ensure multinational companies, subject to the GloBE Rules, to pay a minimum tax rate, set at 15%, on income from each jurisdiction in which they operate.

Thus, according to Leopoldo Parada[16], these are coordinate rules which final objective is the setting of a minimum effective tax capable of discouraging multinational companies to exploit effective rates in low-tax countries. Also according to the author, the GloBE Rules work on the compensatory idea, through which a state will have the power to react according to another state action or inaction[17].

Ruth Mason[18] points out that rules of this nature have been classified by the term *fiscal fail-safe rules*, working on the filling of a fiscal gap by meeting certain conditions, recovering benefits of tax planning and tax incentives granted by the State, and so discouraging both aggressive tax planning and tax competition.

From the perspective of tax competition, analyzing the Pillar Two and its set of rules, they seem to rise the tax competition base[19] from the current 0% to percentages close to the minimum rates adopted by the rules.

2.1 *Overview of Top-up Tax calculation*

The evidence of an *Effective Tax Rate* (hereinafter: ETR) lower than the *Minimum Rate* of 15% is the factor that triggers the application of the GloBE Rules (IIR and UTPR), and that may lead to the collection of a *Top-up Tax*[20].

The ETR is calculated by jurisdiction and for each fiscal year. Thus, it corresponds to the sum of *Adjusted Covered Taxes* of each CE of MNE group, located in that jurisdiction, divided by the *Net GloBE Income* of the jurisdiction for that fiscal year[21].

The *Adjusted Covered Taxes*, numerator of ETR calculation, correspond to the sum of the *Current tax Expense* of each CE in respect to the *Covered Taxes* accrued in for net income or loss

16 Leopoldo Parada, *La propuesta de un impuesto mínimo global: Una mirada crítica*, SSRN Electronic Journal 1-26 (2021), https://doi.org/10.2139/ssrn.3916919, (accessed 24 May. 2022), at 7.

17 *Ibid.,* at 9.

18 Ruth Mason, *The Transformation of International Tax*, 114(3) American Journal of International Law 353-402 (2020), https://doi.org/10.1017/ajil.2020.33, (accessed 4 Jun. 2022), at 376.

19 In the same sense, Ana Paula Dourado, *The Pillar Two Top-Up Taxes: Interplay, Characterization, and Tax Treaties*, 50(5) Intertax 388-395 (2022), https://kluwerlawonline.com/journalarticle/Intertax/50.5/TAXI2022045, (accessed 24 May. 2022), at 394, states that 'the IIR together with the UTPR, DMTT, and STTR aim to prevent tax competition below a certain tax rate'.

20 The ETR calculation lower than 15% does not necessarily lead to the collection of *Top-up Tax*, since other mechanisms, such as SBIE and QDMTT can reset the basis on which the *Top-up Tax* is calculated.

21 Article 5.1.1. of Model Rules: OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, (OECD, 2021), https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-theeconomy-global-anti-base-erosion-model-rules-pillar-two.htm, (accessed 10 May. 2022) (hereinafter: OECD, *Model Rules* or Model Rules), at 28.

according to the financial statements, what make the *Covered Taxes* suffer adjusts[22] due to additions, reductions, deferrals and other adjustments provided in the Model Rules.[23]

The *Net GloBE Income* equals the difference between the *GloBE Income* and *GloBE Losses* of all the *Constituent Entities* of the jurisdiction[24].

As can be seen, the *GloBE Income or Losses*, which result in the *Net GloBE Income* of the jurisdiction, build up the denominator on which the ETR will be determined. They are calculated using the *Net Income or Loss* of the CE calculated by the financial accounting[25] in the preparation of the consolidated financial statements of UPE, before any intra-group adjustment, and adjusted as provided in Articles 3.2 to 3.5 of Model Rules[26].

In case there is an ETR lower than the *Minimum Rate* of 15% and having *Net GloBE Income*, that is, if there is a positive result according to the GloBE Rules, the jurisdiction is classified as a *Low-Tax Jurisdiction*[27] (hereinafter: LTJ). Consequently, the other rules necessary for the calculation of the *Top-up Tax* are trigged. Otherwise, if the ETR is equal to or higher than the *Minimum Rate*, no additional procedure is required in that jurisdiction.

Thus, with an ETR lower than 15%, the next step is the determination of the *Top-up Tax Percentage* of that jurisdiction, which corresponds to the positive difference between the *Minimum Rate* (15%) and the ETR[28] verified in the previous step.

Once the *Top-up Tax Percentage* is known, it must be calculated the base on which it will be levied on to determine the *Jurisdictional Top-up Tax*.

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22 The adjustments applied to *covered taxes* will be analyzed in the following chapter, since they reflect the effects of some tax incentives.

23 Article 4.1.1., OECD, *Model Rules, supra* n. 21.

24 Article 5.1.2., OECD, *Model Rules, supra* n. 21.

25 The GloBE Rules adopt an approach from which financial accounting is the starting point for the measurement of several quantitative elements necessary for the determination and allocation of the *Top-up Tax*. If, on the one hand, the financial accounting and standards adopted by the jurisdictions where the Ultimate Parent Entities are located provides a uniform approach to all jurisdictions. On the other hand, it opens room for the occurrence of what can be called 'GAAP Shopping', expression adopted by Professor Eva Eberhartinger in the panel 'Pillar 2 and the Accounting Standards' presented at the Seminar on Pillar Two, held on 21 and 22 April 2022 in Lisbon, promoted by the Centre for Research in European, Economic, Financial and Tax Law (CIDEEFF), and used to refer to the possibility that those entities will choose jurisdictions where they will settle, depending on that the GAAP (Generally Accepted Accounting Principles) adopted is most favorable for ETR determination.

26 According to Article 3.2 of the Model Rules, the following must be excluded: net tax expenses, excluded dividends, excluded equity gains or losses, included revaluation method gain or loss, gains or losses from disposition of assets and liabilities excluded as a result of the provisions applicable to corporate reorganizations, asymmetric foreign currency gains or losses, policy disallowed expenses, prior period errors and changes in accounting principles, and accrued pension expense.

27 According to chapter 10 of the Model Rules, in the context of an MNE group, a low-taxation jurisdiction is equivalent to one in which *Net GloBE Income* is subject to an ETR lower than the minimum rate.

28 Article 5.2.1., OECD, *Model Rules, supra* n. 21.

So, initially the *Excess Profit* is determined, which corresponds to the difference between the *Net GloBE Income* of that jurisdiction and the *Substance-based Income Exclusion*[29] (hereinafter: SBIE). It is on this that the *Top-up Tax Percentage* will be multiplied.

The SBIE corresponds to an exclusion calculated on the basis of payroll and tangible assets[30], provided that the eligibility criteria set forth in the Model Rules are met. It is a *carve-out* that assumes a fixed return from the amounts of those two factors.

The determination of the Jurisdictional Top-up Tax is also carried out with the sum of the Additional Current Top-up Tax and with the subtraction of the *Domestic Top-up Tax*[31] (hereinafter: DMTT), amount paid in the jurisdiction in a given fiscal year due to the application of a *Qualified Domestic Minimum Top-Up Tax (*hereinafter: QDMTT)[32].

The measurement of the *Jurisdictional Top-up Tax* is not by itself sufficient for the application of the IIR or UTPR. As the ownership chains have several formats, it is necessary to determine the amount of the *Top-up Tax* for each CE that had income calculated according to the GloBE Rules[33]. This allocation is carried out according to the following formula, in which the determination of the *Aggregate GloBE Income of all CEs* is made exclusively with the sum of income of the entities that had positive *GloBE* results, thus disregarding the *GloBE Losses*.

$$Top\ up\ tax\ of\ a\ CE = Jurisdictional\ Top\ up\ Tax \times \frac{GloBE\ Income\ of\ the\ CE}{Aggregate\ GloBE\ Income\ of\ all\ CEs}$$

Therefore, it is from the amount of the *Top-up Tax* of each CE, which will be applied the rules IIR and UTPR, and made the allocations of the *Top-up Tax* in the corresponding jurisdictions. The allocation rules of the *Top-up Tax* will be presented in section 2.3, in which an analysis will be done from the perspective of the location of the developing countries, object of analysis in section 2.2.

2.2 *Developing countries: a heterogeneous reality*

The adoption of criteria for categorization of countries that is made by several organizations allows the adoption of comparison bases, as well as the establishment of parameters the actions of those who use it. One of the most common ways of grouping countries is the union of these into groups according to the degree of development.

However, there is no single definition or criteria for classifying countries as *developed* or *developing*. Thus, despite the common reference to these terms, they are far from representing

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29 Article 5.2.2., OECD, *Model Rules, supra* n. 21.

30 Initially 10% of payroll and 8% of tangible assets.

31 Article 5.2.3., OECD, *Model Rules, supra* n. 21.

32 Article 5.2.3.a, OECD, *Model Rules, supra* n. 21.

33 Article 5.2.4.a, OECD, *Model Rules, supra* n. 21.

categories of countries with uniform characteristics[34], sometimes bringing together within the same group a set of countries with very heterogeneous characteristics.

Some institutions have developed methodologies for grouping countries that have similar characteristics according to the objectives purposed by each of them. That is the case of the United Nations (hereinafter: UN) and the World Bank. The latter, through the Atlas Method[35], adopts a classification based on the criterion of Gross National Income (hereinafter: GNI) *per capita*.

According to the criterion adopted, in 2022, the World Bank[36] classified countries into four groups: (a) high-income economy (GNI *per capita* greater than USD 12,695); (b) upper-middle-income economy (GNI *per capita* greater than or equal to USD 4,096 and less than or equal to USD 12,695); (c) lower-middle-income economy (GNI *per capita* greater than or equal to USD 1,046 and less than or equal to USD 4,095; and (d) low-income economy (GNI *per capita* less than USD 1,046).

That year, this methodology indicated that there were 80 countries classified as high-income ones, 55 as upper-middle-income ones, 55 as lower-middle-income ones, and 27 as low-income ones.[37]

The UN[38], in turn, adopts the denomination *Least Developed Country* (hereinafter: LDC) and employs the following three criteria to classify in this category the countries that present the lowest indicators: (a) GNI *per capita*; (b) Human Asset Index; and (c) The economic and environmental vulnerability index. The first criterion is based on the GNI per capita calculated by the World Bank and is enhanced with some adjustments. The second criterion consists of two groups with three indicators, which assess aspects related to health and education respectively. Finally, the third criterion consists of a set of 8 indicators, grouped into two groups of four indicators each, which measure economic vulnerability and environmental vulnerability respectively.

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34 The observation that the concept encompasses countries with most different characteristics led Klaus Vogel to question whether it would still make sense to adopt such a broad concept as the developing country in order to refer to a variety of countries that present obtuse differences among themselves, *see* Klaus Vogel, *Importância do Direito Tributário Internacional para os Países em Desenvolvimento*, in *Princípios tributários no direito brasileiro e comparado – Estudos em homenagem a Gilberto Ulhôa Canto* 470-487 (Tavolaro, Machado e Martins coords., Forense 1988), at 470.

35 About the methodology adopted in the World Bank Atlas Method, *see* <https://datahelpdesk.worldbank.org/knowledgebase/articles/378832-what-is-the-world-bank-atlas-method>.

36 Regarding the historical parameters and the classification of the countries according to the criterion adopted by the World Bank, *see* <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups>.

37 A list of countries is available in: <http://databank.worldbank.org/data/download/site-content/OGHIST.xlsx>

38 As for the methodology employed, weights and thresholds used in the classification, *see* United Nations, *Handbook on the Least Developed Country Category: Inclusion, Graduation and Special Support Measures*, (United Nations 4th ed. 2021), https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/LDC-Handbook-2021.pdf, (accessed 8 Jul. 2022).

In 2021, according to the methodology developed by the UN, there were 46 countries considered to be least developed ones[39]. When analyzed under the World Bank methodology, out of these 46 countries, 25 are qualified as low-income ones, 20 as low-middle-income ones, and 1 as upper-middle-income ones.

The criteria adopted and the results found with the application of these two methodologies signal that it may be mistaken the hermetic implementation and standardized measures to those countries generically referred to as *developing* or *least developed* ones without considering their proper characteristics and goals as well as the challenges faced in various fields by each of them.

In this perspective, despite the adoption of varied criteria and methodologies that resume the qualification of quite diverse countries under a single term, Klaus Vogel[40] highlights a common characteristic observed in countries defined as developing: on the one hand, they purpose to create an environment that favors the increase of exports to developed countries; and on the other hand, they purpose to attract investments from these countries in order to create jobs and generate income.

The scope of the second objective, in particular, involves the existence of competitive advantages capable of influencing the business decision regarding the implementation of an economic enterprise in a given country rather than another.

These advantages are presented, for example, in the form of economic and political stability, monetary regulation, legal certainty, proper functioning of justice, skilled labor, good infrastructure (public goods), in addition to offering tax advantages.

In this scenario, the use of tax systems as an instrument to attract foreign direct investments by granting incentives capable of raising indicators of return on invested capital is one of the main mechanisms used by developing countries given the ease of this competitive advantage can be achieved when compared to other advantages, which development requires a complex conjunctural conformation usually achieved in the long term.

However, the design of the domestic tax system and the rules of the treaties agreed by the jurisdictions in which foreign investors are residents may erode the tax advantage granted by the jurisdiction, where the investment is being made, in order to transfer it from the investor to the State where he is resident[41].

In this context, the recently announced international tax agreement raises at least two questions of interest to the present study: (a) whether developing countries were adequately treated from the consideration that within this denomination it is included jurisdictions with really different characteristics and levels of economic development; and (b) if mechanisms

39 The list of countries is available in: https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/Snapshots2021.pdf

40 Klaus Vogel, *supra* n. 34, at 471.

41 Klaus Vogel calls this phenomenon the 'tax benefit absorption effect', whereby an advantage granted by the developing country is absorbed by the tax authorities of the state of domicile, *see* Klaus Vogel, *supra* n. 34, at 484.

were adopted to preserve the tax incentives granted by these countries, ensuring the fiscal competitiveness of these jurisdictions.

Although references to developing countries are rare in the set of documents issued by the OECD and that ended up in the GloBE proposal, an initial analysis of these publishings highlights two sets of concerns when referring to those jurisdictions: (a) to emphasize that those countries are members of the OECD's Inclusive Framework; and (b) to justify that the adoption of STTR is an integral part of reaching a consensus on Pillar Two for developing countries[42].

In this second reference, the OCDE[43] points out as a criterion for classification as a developing country[44] the one that in 2019 had a GNI *per capita* of USD 12,535[45] or less, a parameter defined from the Atlas Method of the World Bank, regularly updated.

Thus, within the threshold used by the organization for qualification as a developing country are countries considered as low-income, lower-middle-income, and upper-middle-income ones. That is, despite the clear disparity in the criterion adopted, the OECD places under the same categorization countries such as Brazil, Angola and Rwanda, which in 2021 had a GNI *per capita* that classified them as upper-middle-income, lower-middle-income, and low-income country respectively.

Therefore, considering the criterion adopted by the OECD to refer to that group of countries, a heterogeneity of jurisdictions are framed as developing countries, which have quite different economic, political and social realities, and which reflect, for example, in their ability to attract foreign investment and provide welfare.

Given this scenario, the answer to the first of the questions raised above seems to focus on the absence, within the scope of the GloBE Rule, of treatment consistent with the characteristics and degree of development of each country, thus raising an additional question that concerns the paths that could be adopted to mitigate the effects of the global tax agreement on these countries' ability to attract real economic activity.

2.3 *Rule order and the position of developing countries*

The threshold adopted to determine the subjective scope of the GloBE Rules, which is the same used for the purposes of the CbC Report, removes from the scope of the proposal about

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42 This can be extracted, for example, from: OECD, *Statement*, *supra* n. 3, at 5.

43 OECD, *Statement*, *supra* n. 3, at 5.

44 As seen, in its methodology, the World Bank does not categorize countries as 'developed' or 'developing'. This is a characterization set by third parties, based on the groups used in the Atlas Method, as does the OECD.

45 For the year 2020 the limit is USD 12.695, *see* <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups>. The classification of the countries according to these limits are available in: <https://data.worldbank.org/indicator/NY.GNP.PCAP.CD?end=2020&name_desc=false&start=2000&view=chart>.

85% to 90% of the MNE groups[46]-[47], preventing small and medium groups from suffering the eventual impacts arising from the measure.

Actually, in relation to those situations which have been established in developing countries the Constituent Entities of MNE groups that do not qualify as an Ultimate Parent Entity[48] (hereinafter: UPE), the limitation of scope tends not to harm this set of countries, since the adoption of the GloBE Rules by UPE's jurisdiction will not be applied to this MNE group, and therefore it will not affect the tax advantages granted by the developing country.

On the other hand, within the scope of the GloBE Rules, the MNE group must calculate the ETR in each jurisdiction where it is applied[49] and, when concluding the application of *Top-up Tax*, verify which entities will be responsible for the collection of that tax.

Thus, being determined the *Top-up Tax* due, its collection is made through two rules that work in an interconnected way, the IIR and UTPR[50], and that in systematic terms they ensure that all MNE groups pay a minimum tax rate on their profits that exceeds a routine income in the jurisdictions where they operate.

The IIR is the priority rule, whereas the UTPR is a backstop rule and is only applicable when it is not possible to impose the collection of a Top-up Tax through the IIR.[51] From this, it is verified that the design of the GloBE Rules prioritizes the application of the IIR over UTPR.

Noam Noked[52], probably referring to the IIR, states that the Pillar Two proposal presented in the Blueprint[53] was heavily criticized since the design proposed in that document gave priority to income taxation in the country of residence, generally a developed one, being a noticeable

46 The Article 1.2.1 of the Model Rules define MNE group as 'any Group that includes at least one Entity or Permanent Establishment that is not located in the jurisdiction of the Ultimate Parent Entity'.

47 The proposal of Directive from the European Union Council extends the application to large national groups, *see* Article 2, para. 1 of the European Commission, *supra* n. 10.

48 According to Article 1.4 of the Model Rules, a UPE is 'an Entity that owns directly or indirectly a Controlling Interest in any other Entity and is not owned, with a Controlling Interest, directly or indirectly by another Entity; or the Main Entity of a Group'.

49 This aspect constitutes a relevant difference between the GloBE Rules and GILTI, since the latter adopts a global approach and not a jurisdictional approach.

50 Regarding the implementation and validity of the GloBE Rules, it is expected that Pillar Two will be approved by the jurisdictions in 2022, being effective in 2023, with the exception of the UTPR rule, which will be effective in 2024, *see* OECD, *Statement*, *supra* n. 3, at 5. These expectations have been frustrated because of the difficulty of approval by some countries and communities such as the European Union.

51 OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, (OECD, 2022), https://www.oecd.org/tax/beps/tax-challenges-arising-from-thedigitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf, (accessed 10 May. 2022) (hereinafter: OECD, *Commentary* or Commentary), at 24, para. 1.

52 Noam Noked, *The Case for Domestic Minimum Taxes on Multinationals*, 105(6) Tax Notes International 667-674 (2022), https://ssrn.com/abstract=4053407, (accessed 24 May. 2022), at 667.

53 OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD, 2020), https://doi.org/10.1787/abb4c3d1-en, (accessed 13 Jul. 2022) (hereinafter: OECD, *Blueprint* or Blueprint).

harm to developing countries, usually countries which are sources of income. However, the author points out that in its final design, when setting the QDMTT, the GloBE Rules give priority to developing countries and source jurisdictions. As we will see below, we understand that the possibility of setting a QDMTT cannot be seen as an entirely positive aspect, given its effects on the level of tax competition in developing countries.

The IIR is applied using the *top-down approach*[54]. This approach consists of an ordering rule that is applied on a top-down basis and generally gives priority to the application of the IIR and the consequent allocation of the *Top-up Tax* to the jurisdictions where are located the Parent Entities which are at the top of ownership chain of the MNE group, that is, the jurisdiction of the UPE, in case this one has implemented an IIR; or to the jurisdiction of the Parent Entities closest to the top of ownership chain of the MNE[55] group[56].

In case the UPE jurisdiction has adopted the IIR, the main rule is that this jurisdiction must impose the Top-up Tax on the Constituent Entities of the MNE group that have been low taxed, and the IIR is to be applied exclusively in that jurisdiction, if the UPE adopts a Qualified IIR[57] and none Low-Taxed Constituent Entity (hereinafter: LTCE) is kept by a POPE for which a Qualified IIR is required to be applied.

When the IIR is not applied by the UPE, the top-down approach determines that the application of the income inclusion rule will fall to one or more Intermediate Parent Entity[58] (hereinafter IPE), according to the *Allocable Share of the Top-up Tax* corresponding to the proportion of the ownership interest held, directly or indirectly, in the LTCE.

From a different angle, when the LTCE presents a split-ownership structure, that is, when there is a significant minority participation (more than 20%) of shareholders outside the MNE group, the GloBE Rules depart from the top-down approach and determine that the Partially-Owned Parent Entity[59] (hereinafter: POPE) apply the IIR, even though it is located at a lower

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54 OECD, *Commentary*, *supra* n. 51, at 24-25.

55 The Article 1.2. of the Modal Rules defines a MNE group as 'any Group that includes at least one Entity or Permanent Establishment that is not located in the jurisdiction of the Ultimate Parent Entity'. Thus, the groups constituted exclusively by companies located in the same jurisdiction of UPE are not within the scope of the Model Rules, even if they have an ETR lower than 15%.

56 The Articles 1.2.2. and 1.2.3. of the Model Rules define Group as 'a collection of Entities that are related through ownership or control such that the assets, liabilities, income, expenses and cash flows of those Entities are included in the Consolidated Financial Statements of the Ultimate Parent Entity, or are excluded from the Consolidated Financial Statements of the Ultimate Parent Entity solely on size or materiality grounds, or on the grounds that the Entity is held for sale. A Group also means an Entity that is located in one jurisdiction and has one or more Permanent Establishments located in other jurisdictions'.

57 OECD, *Commentary*, *supra* n. 51, at 24.

58 According to the Article 10 of the Model Rules, an IPE is 'a Constituent Entity (other than a Ultimate Parent Entity, Partially-Owned Parent Entity, Permanent Establishment, or Investment Entity) that owns (directly or indirectly) an Ownership Interest in another Constituent Entity in the same MNE Group'.

59 According to the Article 10 of the Model Rules, a POPE is 'a Constituent Entity (other than a Ultimate Parent Entity, Permanent Establishment, or Investment Entity) that (a) owns (directly or indirectly) an Ownership Interest in another Constituent Entity of the same MNE Group; and; (b) has more than 20% of the Ownership Interests in its profits held directly or indirectly by persons that are not Constituent Entities of the MNE Group'.

level of the ownership chain. That is, the rules of split ownership constitute an exception to the top-down approach, since the priority in the application of the IIR is conferred on the POPE, nevertheless the UPE or IPE, as the case may be, can also apply a Qualified IIR.

In this case, the application of the rules provided in Articles 2.1 and 2.2 of the Model Rules could invariably lead to situations in which there would be double income taxation, an issue settled by Article 2.3 providing for an Offset Mechanism which main objective is to avoid this double taxation.

All this demonstrates that the application of the IIR, from the taxpayer's perspective, undermines any tax advantage arising from the allocation of investments in low-tax jurisdictions. Ana Paula Dourado[60], pointing out that the neutralization of this tax advantage is an objective of IIR, she warns that this rule also ends up neutralizing any competitive advantage of the other jurisdiction.

For its part, the application of the UTPR occurs when the jurisdiction of UPE: (a) does not adopt an IIR, or (b) despite applying so, it is located in an LTJ. This explains the complementary nature of the UTPR.

While through the IIR a *Top-up Tax* is imposed on a Parent Entity, in relation to an LTCE, through the UTPR, the *Top-up Tax* related to an LTCE, that is not subject to tax through the IIR, is charged through the denial of deductions or adoption of equivalent adjustment in the Constituent Entities of the MNE group located in jurisdictions that adopt a Qualified UTPR.

Through the UTPR, the allocation of the *Top-up Tax* amount is determined from the use of two factors: the number of employees and the value of tangible assets. For the OECD[61], these factors reflect the relative substance of the MNE group in each UTPR Jurisdiction and reveals the jurisdictions in which there is more tax capacity to absorb adjustments under the UTPR.

Thus, the UTPR *Top-up Tax* percentage of a jurisdiction applying a Qualified UTPR is obtained from the following formula:

$$\left(50\% \times \frac{(number\ of\ workers\ in\ the\ jurisdiction)}{(number\ of\ workers\ in\ all\ UTPR\ jurisdictions)}\right)$$
$$+\left(50\% \times \frac{(total\ value\ of\ Tangible\ Assets\ in\ the\ jurisdiction)}{(total\ value\ of\ Tangible\ Assets\ in\ all\ UTPR\ jurisdictions)}\right)$$

As can be seen, the *UTPR Top-up Tax Amount* allocation rule gives priority to those jurisdictions that, having adopted a Qualified UTPR, have the highest number of workers and the highest volume of tangible assets.

60 Ana Paula Dourado, *supra* n. 19, at 392.

61 OECD, *Commentary*, *supra* n. 51, at 39, para. 81.

Analyzing the IIR and UTPR from a perspective that compares the rule order and economic classification of the countries where the Entities of the MNE group ownership chain are located, it is assumed that, in general, the Parent Entities, whether UPE, IPE or POPE are not mostly located in developing countries, since the Constituent Entities at the end of the ownership chain are usually located in such countries. In this scenario, the top-down approach privileges the countries that adopt the GloBE Rules or a Qualified IIR, which, in general, are the most developed economies.

According to Ana Paula Dourado[62], the top-down approach generally guarantees the application of the IIR to Parent Entities that are at the top of the ownership chain; and by prevailing over the UTPR rule, it privileges the interests of the residence states, which are generally the capital exporters.

Developing countries cannot lose sight of the fact that upon a scenario with Constituent Entities qualified as LTCE, and that such rules are adopted by other jurisdictions where Parent Entities are located, the MNE group will always be subject to the imposition of a *Top-up Tax*, which makes the decision for not rising its ETR into a kind of tax revenue waiver that, given its disinterest, will be collected by another jurisdiction.

Although these countries are characterized, in general, as capital importers, they will have located, probably to a lesser extent, entities that according to the Model Rules would be qualified as UPE, IPE, POPE or LTCE. Notwithstanding there may be the predominance especially of the latter three ones, given the level of economic development of the developing countries. Some UPE will be invariably located in these jurisdictions, a residual situation in which those countries can benefit from the GloBE Rules.

When the jurisdiction of a UPE, even if the majority of legal persons resident there present ETR higher than 15%, if it will constitute an LTJ, the option for not applying the GloBE Rules or a Qualified IIR will allow the *Top-up Tax* arising from these rules is charged in the jurisdictions where the IPE, POPE or LTCE are located and such rules are applied, which represents another possibility of losing resources by developing countries.

In the scenario here outlined and considering the initial setting for the operationalization of the Pillar Two mechanisms, the developing countries may be impacted to a greater or lesser extent depending on the location of the entities responsible for tax collection. Especially, if they constitute LTJ where the Constituent Entities are located, and which the *Top-up Tax* will be collected in another jurisdiction, or when they constitute the jurisdictions of the Constituent Entities responsible for collecting the tax, especially those qualified as UPE, IPE or POP ones.

The table below is the result of cross-referencing the information available in the *CbC Report* (location of the UPE and Constituent Entities) with the classification of the countries according to the grouping adopted by the World Bank. It allows us to identify where the UPE and their corresponding Constituent Entities are located.

62 Ana Paula Dourado, *supra* n. 19, at 389.

Table 1 – Location of UPE and CE according to income rates of the countries

		UPE			
		High-income	**Upper-middle-income**	**Lower-middle-income**	**Total**
CE	**High-income**	225,260	17,340	3,160	245,760
	Upper-middle-income	60,886	3,705	831	65,422
	Lower-middle-income	14,592	1,968	471	17,031
	Low-income	568	383	128	1,079
	Others	86,683	1,141	9	87,833
	Total	**387,989**	**24,537**	**4,599**	**417,125**

Source: developed by the author[63]

Although high-income countries are expected to concentrate large numbers of both Parent Entities and Constituent Entities, the Table 1 aims to show that there is also a large number of these entities in the jurisdictions of the economies considered by the OECD as developing, with special emphasis on the economies classified as upper-middle-income and low-middle-income. It is also noteworthy that there is no information about UPE in the jurisdictions of low-income countries. According to the table, the latter are jurisdictions where Constituent Entities are highly located. In short, the above table shows that developing countries are jurisdictions that concentrate more Constituent Entities (at least 83,532) than Parent Entities (at least 29,136).

In this sense, considering the scenario of inertia within these economies concerning the adoption of GloBE Rules and, regarding the application order of these rules, the immediate conclusion is that the *Top-up Tax* due will mostly benefit the developed countries whereas the UPEs are located. On the other hand, when developing countries are jurisdictions where UPEs are located and do not adopt the GloBE Rules, the application order of these rules determines that the *Top-up Tax* collection must be made in another jurisdiction, as the case may be, which may transfer tax to developed country jurisdictions.

63 The CbC Report data was taken from <https://stats.oecd.org/Index.aspx?DataSetCode=CBCR> and <https://www.taxobservatory.eu/repository/the-cbcr-explorer/> with access on 13th June 2022. The CbC Report filing rules allow, in certain circumstances, the argument of jurisdictions without the exact jurisdiction identification. In these cases, all such Contituent Entities have been grouped together on the line for 'Others'. Here, Constituent Entities are Entities other than UPE, IPE and POPE.

3. The pillar two and tax incentives

According to documents published by the OECD, the Pillar Two was designed as a coordinated set of rules to cope with the risks arising from structures that allow multinational corporations to shift profits to jurisdictions where they are subject to zero or really low taxation.

The reasons for adopting the Pillar Two and the remaining concerns about profit shifting and tax base erosion reveal that the introduction of anti-avoidance measures and the elimination of mismatches in the context of the BEPS project were insufficient[64], so that now, through the GloBE Rules and the setting of a minimum taxation at 15%, it is aimed to eliminate a precondition for aggressive tax planning that is about low taxation[65]. Thus, the setting of this minimum tax rate would discourage the exploitation of low effective tax rates by shifting profits from intangible assets to low-tax jurisdictions[66], and it would be achieved the idea advocated by the OECD that profits come to be sufficiently taxed somewhere[67].

The Pillar Two proposes a coordination of rates, a measure that according to Ana Paula Dourado[68] was approached by the OECD in the *1998 Report on Harmful Tax Practices*[69] and defined harmful tax regimes based on four criteria, among which was the existence of low effective tax rates, a reference that was removed in the following report[70].

The setting of the minimum taxation rate is presented as a quite comprehensive approach, which raises concerns about its scope on tax regimes set for attracting substantive activity. In this

64 Ana Paula Dourado, *The Global Anti-Base Erosion Proposal (GloBE) in Pillar II*, 48(2) Intertax 152-156 (2020), https://kluwerlawonline.com/journalarticle/Intertax/48.2/TAXI2020014, (accessed 24 May. 2022), at 153.

65 Suranjali Tandon, *The Need for Global Minimum Tax: Assessing Pillar Two Reform*, 50(5) Intertax 1-18 (2022), https://kluwerlawonline.com/journalarticle/Intertax/50.5/TAXI2022037, (accessed 24 May. 2022), at 11.

66 Leopoldo Parada, *supra* n. 1, at 15.

67 *Ibid.*, at 7.

68 Ana Paula Dourado, *supra* n. 64, at 153.

69 OECD, *Harmful Tax Competition: An Emerging Global Issue*, (OECD Publishing, 1998), https://read.oecd-ilibrary.org/taxation/harmful-tax-competition_9789264162945-en, (accessed 31 May. 2022).

70 OECD, *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report 4*, (OECD Publishing, 2001), https://www.oecd.org/ctp/harmful/2664438.pdf, (accessed 10 May. 2022).

sense, Aitor Navarro[71] points out that the rationale behind the GloBE proposal surpasses the parameter hitherto developed by the OECD, which sought to prevent harmful tax practices consisting in regimes with zero or low taxation and without substantial or transparent requirements.

The measure seems to disregard that tax systems can be designed by their governments both in the form of *weaponized tax systems* and in the form of *mobilized tax systems*. According to Steven A. Dean and Attiya Waris[72], the former are designed to allow tax avoidance practices. While the latter, according to Afton Titus[73], are designed in order to encourage substantial investments in specific sectors in order to increase employment, spending, and economic growth levels.

In this scenario, the approach adopted to prevent global harmful tax competition does not make the necessary distinction between real tax competition, whereby countries compete fiscally with each other by attracting real economic activities, and virtual tax competition, through which countries compete to attract paper profits, that is, without a corresponding real economic activity[74].

It should be noted that the term tax competition is used sparingly by the OECD in the set of published documents related to the two-pillar solution. It can be found in the Programme of Work[75] and in the Public Consultation from 2019[76], not being referred to in the following documents.

The *Policy Note*[77] did not explicitly approach any aspects related to the granting of tax incentives for attracting real activity, but merely stated that the solutions adopted should include a review of the rules for allocating taxing rights, with an emphasis on nexus rules as well as anti-BEPS rules; and when referring to the Pillar Two, it emphasized that such proposal would explore a measure that allows the taxation of profits by other jurisdictions when a jurisdiction that has the original right to tax does not exercise it or exercises it at a low effective rate.

This allows us to state that the objective scope of the Pillar Two does not reflect the original reasons that culminated in the proposition of measures. What in the words of Aitor Navarro

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71 Aitor Navarro, *Jurisdiction Not To Tax, Tax Sparing Clauses, And The OECD Minimum Taxation (Globe) Proposal*, 1 Nordic Tax Journal 6-19 (2021), https://doi.org/10.2478/ntaxj-2021-0004, (accessed 24 May. 2022), at 9.

72 Steven A. Dean & Attiya Waris, *Ten Truths About Tax Havens: Inclusion and the 'Liberia' Problem*, 70(8) Emory Law Journal 1659-1684 (2021), https://scholarlycommons.law.emory.edu/elj/vol70/iss7/8, (accessed 1 Jun. 2022), at 1666.

73 Afton Titus, *Global Minimum Corporate Tax: A Death Knell for African Country Tax Policies*, 50(5) Intertax 414-423, https://kluwerlawonline.com/journalarticle/Intertax/50.5/TAXI2022038, (accessed 24 May. 2022), at 420.

74 Afton Titus, *supra* n. 73, at 423.

75 OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy,* OECD/G20 Inclusive Framework on BEPS, (OECD, 2019), https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf, (accessed 18 Jun. 2022), at 27, para. 62.

76 OECD, *Public consultation document. Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two. 8 November 2019 – 2 December 2019*, (OECD, 2019), https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf, (accessed 13 Jul. 2022).

77 OECD, *Policy Note*, *supra* n. 4, at 1.

'entails a significant amendment of the policy objectives pursued by the OECD, as GloBE targets tax competition at a comprehensive level and not only harmful tax competition, as BEPS did'[78].

From a different angle, Ana Paula Dourado[79] highlights that the limitation of the subjective scope to multinationals with a certain income level, the existence of carve-out from the objective scope as well as the effects of the adoption of a domestic top-up-tax cast doubt on the scope of the purpose concerning tax competition.

Considering this whole in which tax incentives are instruments that can be used by jurisdictions both for attracting real activity and paper profits, being one of the main mechanisms adopted for tax competition, it is relevant to analyze these mechanisms in the context of the rule design that makes up the Pillar Two, especially checking if any distinction is made concerning the intended purpose. For this analysis, which will be made in the next section, the terms 'tax incentives' and 'tax benefits' were used as synonyms, since it is not the object of this article the analysis of dogmatic issues related to the distinction between these expressions.

3.1 *Tax incentives and ETR calculation*

The definition of the term *tax incentives* does not reach consensus either in the doctrine or in the publishings of most international organizations. In the definition offered by Ogazón Juárez and Calderón Manrique[80], tax incentives consist of distancing from general and neutral rules of the tax system, implemented through various forms, and that results in a favored tax treatment or in the reduction of investor's tax burden.

In the same direction, and including finalistic character, Ana Paula Dourado[81] points out that they are 'tax reliefs that introduce exceptions to tax incidence and that pursue non-tax purposes (extra tax ones)'.

Tax incentives take various forms and they are achieved through several methods, being possible to identify a variety of types and implementation techniques, such as exemptions (total or partial ones), tax deductions, and other mechanisms such as tax credits, accelerated depreciation, reduced rates, among others.[82]

They are considered an important tax policy instrument used to attract direct foreign investment and for the development of strategic sectors, such as research, development and innovation. They gain greater relevance in least developed economies, since these latter ones

78 Aitor Navarro, *supra* n. 71, at 6.

79 Ana Paula Dourado, *Pillar Two Model Rules: Inequalities Raised by the GloBE Rules, the Scope, and Carve-Outs*, 50(4) Intertax 1-4 (2022), https://kluwerlawonline.com/journalarticle/Intertax/50.4/TAXI2022035, (accessed 24 May. 2022), at 2.

80 Lydia G. Ogazón Juárez & Diana Calderón Manrique, *Introduction to Tax Incentives in the BEPS Era*, in *Tax Incentives in the BEPS Era*, IBFD Tax Research Series, vol. 3 (Cotrut e Munyandi eds, IBFD 2018), at 4.

81 Ana Paula Dourado, *Direito Fiscal,* (Almedina 6th ed. 2021), at 90.

82 *Ibid.*, at 90.

sometimes lack other competitive advantages capable of decisively influencing business decisions, such as it occurs about tax incentives.

In the perspective which effective minimum taxation is imposed, a new challenge arises for least developed economies that have tax incentives as the main mechanism for attracting economic activity: maintaining competitiveness through tax incentives under the GloBE Rules. In this scenario, a question that arises is whether it is still possible to use tax incentives as a way to attract foreign investment without the MNE group being burdened in another jurisdiction.

In principle, the answer seems to be positive, however, this possibility depends on some conditions, such as the representativeness of the incentive itself in determining the amount of taxes on Constituent Entities as well as the SBIE effects.

In view of this, it is important to understand the interaction among Model Rules and some types of tax benefits, since this analysis allows both taxpayers and tax administrations to assess the effects of such rules, thus offering a perspective that also allows an assessment concerning the possibility of reformulating tax policies.

Thus, in this section, we will verify how the Model Rules operate in relation to the most usual forms of granting tax benefits, assessing, when applicable, the possible alternatives for preserving tax advantages.

3.1.1 *Exemptions*

Exemptions are instruments traditionally used in the formulation of tax policies designed to attract foreign direct investment. In general, they are granted for a defined period of time, and may be or not granted to enterprises located in the context of a particular economic zone, such as the so-called free zones[83].

In practical terms, by means of an income tax exemption, the taxable person does not collect any tax on exempt income.

Bringing such mechanics into the operationalization of the GloBE Rules, we have as a starting point the ETR calculation. As seen in section 2.1, the ETR corresponds to the ratio between *Adjusted Covered Taxes* and *Net GloBE Income*, calculated from a jurisdictional perspective.[84]

The *Adjusted Covered Taxes* adopt as a reference, among others, the current tax expense accrued in the financial accounting of the CE in a fiscal year, and the adjustments defined in the Model Rules must be considered[85].

Since it is an amount accumulated in the result calculated for the purposes of financial accounting, this is what gives us the definition of current tax expense. Thus, according to Inter-

83 Lydia G. Ogazón Juárez & Diana Calderón Manrique, *supra* n. 80, at 4.

84 Article 5.1.1, OECD, *Model Rules, supra* n. 21.

85 Articles 4.1 and 4.2, OECD, *Model Rules, supra* n. 21.

national Accounting Standards[86], the current tax expense is the amount to be paid (to be recovered) of income taxes relating to the taxable profit (loss) of a time period.

In this formulation, once the profit is exempt from income tax, the exemption culminates in the non-existence of an amount to pay tax. Consequently, in these situations we will be facing a current tax expense that will total zero and it will lead to a ETR of 0%, triggering the application of the other rules and possibly[87] resulting in a *Top-up Tax* to be collected in another jurisdiction.

In other words, given the mechanics adopted by the GloBE Rules for measuring the ETR, the conclusion reached is that tax incentives granted in the form of corporate income tax exemptions will be directly impacted by the GloBE Rules, since they tend to lead to an ETR of less than 15%.

Therefore, based on the finding of Emily Muyaa[88], that the granting of exemptions is more frequent in developing countries than in developed countries because the former ones cannot provide financial incentives such as government grants, subsidiary loans or guaranteed loans, as it occurs in the latter ones, we can conclude that Constituent Entities benefiting from tax exemptions established in developing countries will be directly impacted by the GloBE Rules, which ultimately may cause MNE groups to reevaluate their decisions on whether to establish themselves in these jurisdictions.

3.1.2 *Zero tax rate and reduced tax rate*

The benefits consisting in granting zero or reduced tax rate for income tax are tax types that guarantee advantages compared to the tax rate applicable on a general regime for certain economic sectors, company types, specific regions, or selected sources of income.[89]

According to the percentage adopted, these benefits may be impacted by the GloBE Rule due to the design suggested for the operationalization of these rules and the ETR.

Tax incentives consisting in the adoption of a reduced rate in relation to the ordinary rate but higher than 15% may be initially maintained, since, as a general rule, they will not lead to an ETR lower than the *Minimum Rate* of 15%. However, since the Model Rules have their own criteria for calculating the ETR and may differ from those adopted for the purpose of calculating the tax basis adopted by corporate income tax, such as the adoption of financial accounting as a starting point, it is not possible to guarantee that a rate higher than 15% will never lead to an ETR lower than that percentage, so the calculation should be done on a case-by-case basis.

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86 IFRS Foundation, *International Accounting Standard 12 Income Taxes*, https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards/english/2022/issued/part-a/ias-12-income-taxes.pdf, (accessed 10 May. 2022), para. 5.

87 This is a possibility, not a certainty, since, as seen in section 2.1, the *Excess Profit* on which the *Top-up Tax* is calculated can be substantially reduced according to the amount of SBIE, which will be analyzed in more detail in the following section.

88 Emily Muyaa, *Tax Holidays*, in *Global Minimum Taxation? An Analysis of the Global Anti-Base Erosion Initiative*, IBDF Tax Research Series, Vol. 4 (Perdelwitz e Turina eds., IBFD 2021), at 29.

89 Lydia G. Ogazón Juárez & Diana Calderón Manrique, *supra* n. 80, at 5.

On the other hand, both the adoption of zero tax rate and the adoption of rates lower than 15% will be affected by the GloBE Rules. In the adopted formulation, a zero tax rate or a rate lower than 15% results in an amount of *Adjusted Covered Taxes* which, divided by the denominator, will lead to an ETR lower than 15%, triggering the mechanisms of *Top-up Tax* imposition.

Thus, if no measure has been adopted by the jurisdiction that grants tax incentives or if the SBIE does not eliminate *Excess Profit*, it will lead to collection of *Top-up Tax* through IIR or UTPR in a jurisdiction that applies such rules. Consequently, the effect of tax incentive received by the LTCE low taxed and the MNE group will be eliminated due to the increase of tax burden and the jurisdiction that grants it will have its rights to tax transferred to another jurisdiction.

3.1.3 *Tax basis reduction*

The tax rules regarding corporate income tax usually lead to due tax determination by multiplying the nominal tax rate by the tax basis applied for taxation purposes.

Although the exemption and benefits granted through the reduction of nominal tax rate operate by reducing the rate itself, sometimes the tax systems grant tax incentives consisting in the tax basis reduction on which the applicable nominal rate will be multiplied.

The amount to be reduced from the tax basis can be scaled according to several factors. For example, the use of fixed reduction rates for specific activities and sector as well as the location of the enterprise, in addition to the exclusion of certain revenues or income that are not intended to be taxed.

Both granting of rate reduction and granting of tax basis reduction itself will lead to the calculation of a tax amount lower than the due tax calculated by applying ordinary rules of the tax system.

In this sense, in principle, both types of tax benefits will be equally affected by the GloBE Rules, except for the situations presented in the previous sections and which may lead to an ETR higher than 15%. Thus, in the application of the Model Rules in a scenario in which the CE receives a tax benefit through the reduction of the tax calculation basis, we tend to observe an amount of *Adjusted Covered Taxes* lower than it would be considered due tax by ordinary rules of the taxation system. Likewise, if there is usually a difference between the *Net GloBE Income* and the tax basis, it is possible that there will be an even greater gap between them, since the tax basis will be reduced due to the benefit received by the CE.

Therefore, we can conclude that tax benefits consisting in the granting of advantages that lead to tax basis reduction will also be affected by the GloBE Rules; and if no measures are taken by the jurisdiction that grants tax benefits, it will imply the transfer of taxing right to the jurisdiction in charge of collecting the *Top-up Tax*, in addition to increase the tax burden of the MNE group.

3.1.4 *Accelerated depreciation, immediate expensing and tax loss*

The differences between the rules adopted by financial accounting and domestic tax legislation, concerning the circumstance in which expenses and revenues are classified, bring out temporary differences[90] that, from the perspective of financial accounting, give rise to deferred tax assets and liabilities[91], in the case of a deferred tax right or obligation respectively.

This is the situation with the rules on asset depreciation, for which some jurisdictions confer tax advantage[92] consisting in accelerating depreciation or in the immediate consideration of asset costs as a deductible expense. In addition, deferred tax assets may also arise as a result from the calculation of tax losses.

This gap between tax and accounting rules ends up generating significant temporary differences that, despite being solved over time[93], may cause some distortion in the ETR calculation concerning Model Rules, since their starting point is the financial accounting, which does not reflect the tax treatment of depreciations.

In the face of Model Rules, the accelerated depreciation and immediate deduction could result in an ETR lower than 15% in the initial time period when the tax advantage is granted and, consequently, trigger the application of the IIR and UTPR since the jurisdiction will be considered a LTJ.

The *Blueprint*[94] suggested that the GloBE Rules could deal with temporary differences through two approaches: the deferred tax accounting approach and the carry-forward approach.

In the Model Rules, the problem of temporary differences is solved through two mechanisms connected to Article 4.1. that rules the Adjusted Covered Taxes.

The first mechanism suggested to deal with the impact of temporary differences is provided for in Article 4.4., which adopts the deferred tax accounting approach[95], that is the Total Deferred Tax Adjustment Amount. This is an adjustment to be applied to the current tax ex-

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90 According to that is noted in the OECD, *Blueprint, supra* n. 53, at *84,* para. 288*,* temporary differences are not differences in the type of income or expense allowed for the purpose of calculating net income. Instead of that, there are differences in the appropriate time period for including these items in the net income calculation.

91 Under the International Accounting and Financial Reporting Standards, it is the IAS 12- Income Taxes, the standard that governs the recognition of deferred tax assets and liabilities. According to this standard, it constitutes a deferred tax liability 'the value of the tax on profit due in the future period related to the temporary differences taxable', whereas it is considered a deferred tax asset 'the value of the tax on recoverable profit in the future period related to: (a) deductible temporary differences; (b) future compensation of unused tax losses; and (c) future compensation of unused tax credits', cf. IFRS Foundation, *supra* n. 86.

92 Although there is some doctrinal discussion on accelerated depreciation and immediate expenses as a tax benefit, since there is only a time displacement of its effects, OECD, *Blueprint*, *supra* n. 53, at 65, para. 220, recognizes these mechanisms as one of tax incentives related to tax income most commonly granted by jurisdictions.

93 According to the report of OECD, *Blueprint, supra* n. 53, *at 84,* para. *289,* 'temporary differences may be the only cause of a low ETR at the beginning of the temporary difference and a high ETR at the reversal and vice versa. They have an effect on the periodic measurement of ETR but do not affect the average ETR over the life of the entity'.

94 OECD, *Blueprint, supra* n. 53, at 85, para. 292.

95 As highlighted by the OECD, *Blueprint*, *supra* n. 53, at 85, para. 92, 'concerning the money value in time, the deferred tax accounting is generally more favorable to taxpayers because it keeps valid the benefits of immediate asset expenses in place, accelerated depreciation and other tax deferral mechanisms that are commonly adopted by jurisdictions to encourage capital investment and for other reasons. The basic transport approach with some changes may preserve the most significant of these benefits but does not fully align with the tax deferral benefits allowed in all local jurisdictions'.

pense to achieve the Adjusted Covered Taxes, provided for in paragraph (b) of Article 4.1.1., which operates in a way to consider certain deferred tax assets and liabilities by adjusting the temporary differences in time.

The Commentary[96] in the Article 4.4.1 elicit that 'the starting point for the Total Deferred Tax Adjustment Amount is the amount of deferred tax expense accrued in the financial accounts of a Constituent Entity if the applicable tax rate is below the Minimum Rate or, in any other case, such deferred tax expense recast at the Minimum Rate'. The deferred tax expense for the Fiscal Year is 'comprised of the net movement in deferred tax assets and liabilities between the beginning and end of the Fiscal Year. When established, deferred tax assets are recorded as negative tax expense (i.e., income tax benefit) whereas deferred tax liabilities are recorded as tax expense'.

In addition to this mechanism provided in Article 4.4, it is also provided in Article 4.5. of the Model Rules, a rule appointed as GloBE Loss Election, which adopts the transfer approach. This rule can be adopted by the CE, at its option, rather than the rules contained in Article 4.4, that is, in case this rule is chosen, it will be applied instead of the temporary differences approach, based on deferred tax accounting, provided in Article 4.4.[97]

When the CE chooses the GloBE Loss Election for a jurisdiction, a GloBE Loss Deferred Tax Asset, equivalent to the Net GloBE Loss in a fiscal year for the jurisdiction multiplied by the *Minimum Rate* of 15%, is established in each fiscal year when there is a Net GloBE Loss for the jurisdiction.[98]

This asset and any other occasional balances verified after use are transposed to subsequent fiscal years and can be used whenever there is *GloBE Income*[99]. When using the tax asset, the entity adds the amount used to *Covered Taxes*, thus reflecting in the increase of ETR in that fiscal year.[100]

Due to this second mechanism, the amount of the GloBE Loss Deferred Tax Asset – that according to paragraph (b) of Article 4.1.2. it consists of an addition to the *Covered Taxes* of the CE in the fiscal time period –, is reflected in the *Adjusted Covered Taxes*, which is an ETR numerator, due to the provision within paragraph (a) of Article 4.1.1., which provides the additions and reductions of the *Covered Taxes* as adjustments to be made to the current tax expense related to the *Covered Taxes*.

In summary, regarding the temporary differences caused by the adoption of mechanisms such as accelerated depreciation or full deduction of expenses, as well as the transposition of

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96 OECD, *Commentary*, *supra* n. 51, at 101, para. 70.

97 It is understood that the 'GloBE Loss Election' has been a simplified mechanism with great utility especially for jurisdictions that do not have a corporate income tax or that adopt quite low rates, cf. OECD, *Commentary,* supra n. 51, at 109, para. 113.

98 Article 4.5.1., OECD, *Model Rules, supra* n. 21, at 26.

99 As laid down in Article 4.5.3. of the Model Rules, the amount to be used will correspond to the lowest value between (a) the balance of the available tax asset and (b) the value resulting from the multiplication of *Net GloBE Income* at the minimum rate of 15%.

100 OECD, *Commentary*, *supra* n. 51, at 110, para. 114.

tax losses, it is concluded that the Model Rules are endowed with provisions that maintain the tax effect of those benefits and, therefore, do not imply the cancellation of the objectives intended by the domestic legislation that establishes them.

3.1.5 *Government grants*

Having the Model Rules adopted financial accounting as a starting point for the calculation of the tax basis and ETR measurement, it is also from the accounting that should be assessed the framework of government grants as income or as a reduction of tax obligation.[101].

In this sense, the accounting standard applicable to government grants determines that they must be recognised as income on a systematic basis over the time period when the spending related to them are identified[102].

The elimination of tax exemption and government grants increases the amount of *Adjusted Covered Taxes*. If there is no exemption to the CE, it will present current tax Expense in its financial accounting. In addition, it will also rise the amount of *Net GloBE Income*.

This accounting treatment and its consequent fiscal reflection under the Model Rules produce, as a consequence, the possibility of conversion of tax benefits granted in the form of tax exemptions or tax basis reductions on government grants, as a way of maintaining the effects conferred by tax exemptions, which is about granting a tax advantage capable of influencing the decisive of installing or maintaining Constituent Entities in the jurisdiction that grants the benefit.

It is the analysis of each case that will effectively allow to conclude whether the transformation of a tax incentive into another will be able to keep the tax advantage granted to the CE without triggering the payment of a *Top-up Tax* in another jurisdiction, since that in the context of Model Rules, and more specifically in the ETR calculation, the conversion of exemptions into government grants makes it possible to rise both the numerator and the denominator of the calculation formula and, in theory, it generates some residual *Top-up Tax*.

Therefore, the conversion of current tax incentives into government grants arises as an alternative for developing countries in the face of the limitations imposed by the Model Rules. However, its normative design should pay attention to both the correct framework in the applicable accounting standard and its correct dimensioning in order to compensate for the benefit that has been replaced.

3.2 ***The qualifying issue of Refundable Tax Credits***

The Refundable Tax Credits are also an important tax policy mechanism used by jurisdictions to promote activities, sectors and regions.

101 OECD, *Blueprint*, *supra* n. 53, at 67, paras 230-231.

102 IFRS Foundation, *International Accounting Standard 20 Accounting for government grants and disclosure of government assistance*, https://www.ifrs.org/content/dam/ifrs/publications/pdf-standards/english/2021/issued/part-a/ias-20-accounting-for-government-grants-and-disclosure-of-government-assistance.pdf, (accessed 10 May. 2022), para. 14.

They are government incentives granted through the tax system in cash or equivalent form. Through these credits, the government stimulates the taxpayer's engagement in specific activities or spending and effectively pays for such spending, through a reimbursement mechanism, so that the instrument is quite similar to a government grant.[103]

Although they also set up a tax benefit granting instrument, the tax credits will be approached here separately from the other benefits due to a most thorough treatment conferred to them by the Model Rules as well as their effects on the ETR that vary according to the received classification.

The Model Rules treat the effects of Refundable Tax Credits differently as they receive or not the classification of *qualified*, so we can refer to them as Qualified Refundable Tax Credits (hereinafter: QRTC) and Non-Qualified Refundable Credits (hereinafter: NQRTC).

A Refundable Tax Credit is classified as *qualified* when it is established to be paid to the CE in cash or cash equivalent within four years from the time the Entity meets the requirements for its receiving under applicable legislation.[104] On the other hand, a tax credit is classified as *non-qualified* when, although being refundable in whole or in part, it does not meet the requirements to be categorized as *qualified*.[105] A credit that can only be used to reduce Covered Taxes is not considered refundable for the purposes of these qualifications, that is, it cannot be received in cash, nor credited against another type of tax[106].

In calculating the ETR, both the numerator and the denominator can be adjusted by the tax credit according to whether it is qualifies QRTC[107] or NQRTC[108].

The QRTCs must be treated as *GloBE Income*. Therefore, if they have not been considered net income or losses of financial accounting, the QRTC must be added. Consequently, they impact positively on the denominator of ETR, reducing it, and cannot be treated as a tax reducer of the CE. On the other hand, if they have already been computed in the financial accounting, no adjustment is needed[109]. This treatment reflects the similarity of a qualified credit to a government grant, in a way that both are granted to support certain activities, and thus must be treated as part of income.[110]

Also in relation to QRTC, if these credits have been recorded as a reduction of the current tax expense, they must be added to the *Covered Taxes*[111]. This treatment reverses the effect

103 OECD, *Commentary*, *supra* n. 51, at. 64.

104 OECD, *Model Rules, supra* n. 21, at 65.

105 *Ibid.*, at 62.

106 OECD, *Commentary*, *supra* n. 51, at 215.

107 Article 3.2.4, OECD, *Model Rules, supra* n. 21.

108 Article 4.1.3, OECD, *Model Rules, supra* n. 21.

109 OECD, *Commentary*, *supra* n. 51, at 112.

110 *Ibid.*, at 64, para. 111.

111 Article 4.1.2(d), OECD, *Model Rules, supra* n. 21, at 22.

on the current tax expense because the credit has been treated as a reduction of that expense when it should have been considered as income. In this situation, the reversal rises the numerator of ETR calculation formula.

From another angle, the NQRTC must not be part of the *GloBE Income* and must be removed from the *Adjusted Covered Taxes*[112]. In case the CE has treated a NQRTC as income in its financial accounting, it must be deducted for purposes of measuring of the GloBE Income; as well as be reduced from the *Covered Taxes*[113]. Consequently, since they constitute a reduction of the numerator, the NQRTC also reduce the ETR.

As noted, the Refundable Tax Credits, each one in their own way, impact negatively on the ETR calculation. While the QRTC expands the denominator, the NQRTC reduces the numerator. In both cases, they operate by reducing the ETR. Despite this rate being influenced in both cases, the impact of tax credits on the reduction of the ETR is greater when categorized as NQRTC. This is explained by the fact that the numerator amount is generally smaller than the denominator amount.

Taking as an example the hypothetical situation in which the amount of *Covered Taxes* is EUR 16 million, the *GloBE Income* is EUR 100 million, and that there is a Refundable Tax Credit of EUR 2 million. In this scenario, if the credit is categorized as QRTC, we will have an ETR of 15.7% (16 / (100 + 2)), therefore, higher than the *Minimum Rate*. On the other hand, if considered NQRTC, the ETR would be 14% ((16 - 2) / 100)), that is, lower than the *Minimum Rate*, which would make it possible to categorize the jurisdiction as an LTJ and the Constituent Entity as an LTCE, subjecting the MNE group to the application of the IIR or UTPR, as appropriate.

Therefore, the classification of Refundable Tax Credits as QRTC or NQRTC is an aspect that should bring up some concern and impact the reality of developing countries that use measures of this nature to attract investments. As seen, according to the quality of those credits, the impact may be greater or lesser in the quantification of ETR and, in some circumstances, may determine the trigging of IIR or UTPR.

Considering the permanent necessity of assessing the efficiency and effectiveness of tax incentives, the implementation of the GloBE Rules by the Parent Entity jurisdictions will reinforce this need to re-assess the incentives granted.

The difference observed in the way they affect the ETR calculation should prompt the reformulation of these incentives. At least about the necessity of adapting them so that they can be classified as Qualified Refundable Tax Credit and, therefore, have less impact on the ETR calculation. It is one of the ways for countries, and especially developing countries, to redesign their tax incentives in a way to minimize the impact of the GloBE Rules on the capacity of these jurisdictions to attract foreign direct investment.

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112 Article 4.1.3(b), OECD, *Model Rules, supra* n. 21, at 22.

113 OECD, *Commentary*, *supra* n. 51, at 64, para. 113 and at. 89.

In this direction, the minimization of effects can take place not only through the aforementioned transformation of the current NQRTC into QRTC, but also by using QRTC to replace the benefits approached in the previous section, which will be heavily impacted by the implementation of the Pillar Two.

In the wake of this procedure, jurisdictions should pay attention to the requirements elected by the GloBE Rules for the purposes of classification as a *qualified* credit, namely that it must be effectively refundable in cash or cash equivalent, and not exclusively offset against tax; and that the refund must occur within 4 years from the fulfillment of the requirements set forth in the law.

On the other hand, it is possible that both countries and taxpayers will face difficulties concerning the implementation of these measures. Regarding the countries, as this is usually a mechanism that requires inclusion in the budget, some difficulties may be faced in the approval process of these measures because, depending on the domestic legislation and as a consequence of the scarcity of resources, they may take the place of other expenses previously foreseen in the national budget. Regarding taxpayers, they may face difficulties related to the reimbursement procedure itself, which may have delays when conditioned to cash availability and approval as well as validation procedures of credits by the countries.

3.3 *The STTR as a mechanism to reduce the impacts of the GloBE Rules on tax incentives*

As observed in the previous section, the interaction of tax incentives, in their several forms, with the mechanisms adopted by the Model Rules for the calculation of ETR, generally lead to reduced ETR when confronted with nominal rates.

According to the factual reality of the CE, the receiving of tax incentives can lead to an ETR lower than the rate of 15%, and thus trigging the payment of a *Top-up Tax* through IIR and/or UTPR.

Although it has not been developed specifically for the solution of this problem, the STTR, which complements the GloBE Rules, has the potential to reduce the effects on the ETR, therefore checking whether developing countries can benefit from this rule as a mechanism to smooth the impacts of the GloBE Rules on tax incentives.

According to the *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* issued on 1 July 2021[114] and also on 8 October 2021[115], the members of the Inclusive Framework recognised that the adoption of the STTR for developing countries is part of the consensus on the Pillar Two, and for that reason, when asked to do so, the IF members which applies nominal rates lower than the *Minimum Rate* of the STTR rule for interests, royalties and other kinds of payment, will implement the rule in their bilateral trea-

114 OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy – 1 July 2021*, (OECD, 2021), https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf, (accessed 10 May. 2022).

115 OECD, *Statement*, *supra* n. 3, at 5.

ties with developing countries, limiting the right to tax to the difference between the *Minimum Rate* of the STTR rule, set at 9%, and the tax rate on payment.

Therefore, through the STTR, developing countries which so request will be granted the right to tax payments related to interests, royalties and other kinds of payment, in which such incomes are subject to nominal rates lower than 9% in the other jurisdiction. In such situations, the developing country from which the payment is made will have the right to tax the income at a rate corresponding to the difference between the 9% and the rate applicable to that income.

OECD[116] understands that STTR is intended to protect the source State tax base because taxation rights, before ceded by virtue of a tax treaty, are restored to that State in case of income benefiting from treaty protection is not taxed or is taxed lower than the *Minimum Rate* in the other contracting jurisdiction.

In other words, it is a rule that expresses one of the rationales adopted by the OECD, in that it provides a jurisdiction with the right to tax up to the agreed *Minimum Rate*, when another jurisdiction does not exercise its right to do so or exercises it at rates lower than the agreed one.

Unlike the GloBE Rules, which implementation involves their introduction into national legislation, the STTR is a rule that depends on the conclusion or amendment of a treaty, but which will be operationalized through a specific provision, with all details of its elements, so that it will not be changed, for example, conventional articles regulate interests or royalties[117].

Concerning the implementation of the STTR, the *Statement*[118] explains that by the end of November 2021 a model treaty provision would be developed to give effect to the rule, and that this provision model would be complemented by comments that would describe the purpose and how the STTR rule would be operationalized. In addition, the Inclusive Framework would develop by mid-2022 a multilateral instrument with the aim of facilitating the rapid and consistent implementation of bilateral treaties.

From another perspective, the design of the intended rules beneath the STTR reveals a concern to prevent both tax administrations and taxpayers from being burdened in their tax calculation. Thus, the rule will seek to reach certain payments that have materiality and that are made among associated persons. In these situations these amounts will be adjusted through a top-up approach so that the tax is collected in the jurisdiction of the paying entity[119].

The idea that the STTR rule benefits developing countries should be viewed sparingly and should consider their position as a country that considers payment as revenue or as an expense. When the developing country is in the position of the jurisdiction where the CE that makes the

116 OECD, *Blueprint*, *supra* n. 53, at 150.

117 OECD, *Blueprint*, *supra* n. 53, at 150.

118 OECD, *Statement*, *supra* n. 3, at 7.

119 For further details about the payments covered by the rule, the definition of associated persons, materiality and the adjustments to be made to operationalize the rule, *see* OECD, *Blueprint*, *supra* n. 53, at 152-169.

payment is located, that is, that it considers it as an expense, the developing country can benefit from the rule that it will collect the tax arising from the application of the STTR. On the other hand, when it is the jurisdiction of the CE that receives the payment and that taxes are lower than *Minimum Rate* estimated due to the purposes of the STTR, the developing country will consider the additional tax charged by the other jurisdiction as a *covered tax* for the purposes of calculating the ETR and applying the GloBE Rules, although it has not collected the tax revenue.

In describing the STTR, the statements on the two-pillar solution issued in July[120] and December[121] 2021, declares that 'IF members that apply nominal corporate income tax rates below the STTR minimum rate to interest, royalties and a defined set of other payments would implement the STTR into their bilateral treaties with developing IF members when requested to do so' (emphasis added).

The excerpt above suggests that developing countries are positioned as paying Constituent Entity jurisdiction, while other countries are positioned as jurisdictions which payments constitute income. In this scenario, it follows that the application of the STTR will allow the collection of tax in developing countries. However, this tax will be considered for the purposes of calculating the ETR in the developed country, where the payment is considered income[122].

Therefore, although the developing country effectively collects the tax, it does not affect the ETR calculation of the CE located in that jurisdiction. Thus, in case the jurisdiction is considered as LTJ, it will be due the *Top-up Tax* set according to the GloBE Rules, and it will be collected in another jurisdiction.

In other words, the STTR benefits the developing country as it has the potential to increase its tax revenues. However, this increase does not change the situation of the CE located there, and therefore it is unable to influence the jurisdiction qualification as LTJ.

In this scenario, when analyzing the effects of the STTR from the MNE group perspective, we will observe an increase in the tax paid and a decrease in the profitability indicators, situation that may make it reevaluate the feasibility of maintaining its activity in the jurisdiction of the developing country.

Additionally, although the application of STTR may increase tax revenue[123] of developing countries, the materiality thresholds may reduce the potential of this measure. The setting of a threshold is based on the general perspective that seeks not to increase the compliance burdens of tax administrations and taxpayers, which should have been seen as a positive measure.

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120 OECD, *supra* n. 114, at 5.

121 OECD, *Statement*, *supra* n. 3, at 5.

122 As prescribed in paragraph 671 of the Blueprint. *See* OECD, *Blueprint*, *supra* n. 53, at 171.

123 In analyzing the STTR and the possible consequences of its adoption for developing countries, Ana Paula Dourado states that the precedence of STTR over IIR and UTPR is seen as positive in terms of international tax justice but that the measure is not seen as the mechanism that will rise tax revenues sufficiently for developing countries, and that these ones may eventually lose revenue, being preferable that developing countries with few treaties and that practice retention rates higher than 9%, the minimum rate of that rule, do not sign agreements related to Pillar Two, *see* Ana Paula Dourado, *supra* n. 79, at 1-2.

From another angle, only when the developing country constitutes the jurisdiction of the CE that receives the payment and considers it as income is that the application of the STTR could have a positive effect on the calculation of the ETR and, consequently, in disqualification from the jurisdiction as LTJ. And this is due to the tax collected by the other jurisdiction is considered as *covered tax* in the jurisdiction of a CE that considered it as income, falling under Article 4.2.1.(c)[124]. In this scenario, according to the representativeness of these taxes compared to the others, it could effectively contribute to the jurisdiction not being considered as one of low taxation.

Being only in this design, the STTR contributes to reduce the impacts of any tax incentives granted and that impact on the calculation of ETR. This hypothesis benefits developing countries, however, it presupposes that the assets that give rise to the right to income are within them, such as intangibles and financing from which the revenues of royalties and interest derive from. However, when analyzing a typical ownership chain, it does not seem natural that these assets are located in developing countries. It does not mean that they are not located in jurisdictions of low taxation, but the ones with high-income and high level of development.

Therefore, despite the possible effects for the increase of tax collection in these countries, only if the assets are within them, that is, when they come to be a jurisdiction of Constituent Entities receiver of income, is that the tax paid may have some effect on the ETR calculation and its qualification as a low-tax jurisdiction. Otherwise, it seems to us that the tax incentives granted by them will continue to be impacted, which will invariably lead to the re-evaluation of the maintenance of economic activity in that jurisdiction by the MNE group.

Given what we have seen so far, we can conclude, on the one hand, that the STTR will hardly soften the effects of the GloBE Rules on the tax incentives that mostly will be affected by them. They, however, do not directly prohibit the granting of incentives by jurisdictions, which may continue to grant them freely.

However, the adoption of that set of rules by the States where the Entities that will apply the IIR or the UTPR are located, with the consequent imposition of a minimum tax, tends to undermine the effects of tax incentives offered by the jurisdictions where the Constituent Entities have an ETR lower than 15%.

In this case, the granting of the tax benefit will no longer have the effect of attracting investment, but of transferring the tax rights from the jurisdiction that grants the incentive to the one that will collect the *Top-up Tax*, undermining the essence of what is meant by a tax incentive and revealing to be false the premise that the GloBE Rules are not prohibitive and that jurisdictions would be free to continue granting those tax advantages.

Meanwhile, the SBIE and *de minimis exclusion*, two rules provided for in the Model Rules, seem to minimize the effects of Pillar Two on tax incentives, which would allow them to be preserved. These rules and their possible enhancement are analyzed in the next section.

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124 *See* paragraph 31 of Commentary to Article 4.2.1.(c), cf. OECD, *Commentary, supra* n. 51, at 93.

4. The SBIE and de minimis exclusion as mechanisms to preserve tax incentives

The imposition of a floor on tax competition has the potential to remove from developing countries the capacity to use their tax systems as instrument to attract foreign direct investment and, consequently, to promote economic growth through these mechanisms.

In the scenario proposed by the GloBE Rules, there will be the interest of investors in these economies only in the hypothesis that there are, or come to be created, other competitive advantages that allow them to compensate or mitigate the economic loss from the collection of an additional tax.

The operationalization of the GloBE Rules leads to the elimination of effects from various benefits and, in practice, the jurisdiction that grants them ends up transferring the rights to tax to the jurisdictions where the *Top-up Tax* will be collected.

Thus, if the jurisdiction chooses to follow the precepts of the GloBE Rules, it can adopt some tax policy options, such as: (a) modifying its corporate income tax system, adopting mechanisms that rise the ETR to 15% for all taxpayers; (b) maintaining incentives for entities out of the scope of the GloBE Rules, rising the ETR only for entities within the scope of those rules; or (c) adopting a QDMTT in order to impose a minimum taxation on entities within the scope of the GloBE Rules.

All alternatives lead, to a greater or lesser degree, to the increase of the tax charged by the jurisdiction to the Constituent Entities located in there and despite preserving the tax rights, it eliminates tax competitiveness because they represent an increase in the tax burden, affecting the maintenance or implementation of enterprises in that jurisdiction.

That is, under the formal aspect, the Pillar Two does not remove from countries their right not to adopt a tax system on income or to fix their tax rates, thus fulfilling the premise set out in the *Policy Note*[125]. However, its rules undermine the right of countries to set tax benefits that lead to ETR lower than the *Minimum Rate*, an aspect not approached in that document.

Keeping with the argument that it is necessary to adopt multilateral measures avoiding uncoordinated unilateral actions, the Inclusive Framework should also consider multilateral coor-

125 OECD, *Policy Note*, *supra* n. 4, at 2.

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dination mechanisms that would provide the preservation of tax competitiveness of developing countries, guaranteeing the possibility that they can grant tax advantages for the attraction of real economic activity. The GloBE Rules, unfortunately, do not seem to have concerns of this nature.

Given this threatening scenario for developing countries, this chapter seeks to analyze two mechanisms adopted in the Model Rules, the SBIE and de *minimis exclusion*, reflecting whether the current design is able to preserve tax competitiveness of such countries, and if not, how its redesign could be carried out in order to preserve the competitive capacity of those jurisdictions, even considering the heterogeneity of the jurisdictions usually so-called *developing* ones.

4.1 *The SBIE and the* de minimis exclusion *in their current rules*

The chapter 5 of the Model Rules provides that the *Net GloBE Income* must undergo a Substance-based Income Exclusion for the purpose of determining the *Excess Profit*[126], reference basis on which the *Top-up Tax Percentage* is multiplied[127]-[128].

For the OECD, the adoption of a *carve-out* that removes from the incidence of the *Top-up Tax* an amount supposedly corresponding to an income based on the substance seeks to focus the GloBE Rules on income most susceptible to base erosion and profit shifting, that is, the income related to intangible assets[129].

Therefore, if the premise is that profit shifting is essentially practiced with intangible assets, the adoption of the SBIE would focus on the incidence of *Top-up Tax* on profits derived from production factors that present ease of mobility, discouraging the setting of tax regimes that favor the attraction of these assets, that supposedly do not generate substantive economic activity.

Thus, the SBIE is a mechanism that reduces the exposure of *GloBE Income* to the minimum tax from the suppression of an amount, a portion considered to be income based on substance, calculated on the basis of percentages of payroll and tangible assets. In this approach, which adopts a formula for measuring this income, the portion corresponding to the payroll is equivalent to the application of the percentage of 10% on eligible payroll, and the amount corresponding to the tangible assets equals the multiplication of the initial percentage of 8% by the amount of eligible tangible assets.[130]

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126 Article 5.3.1., OECD, *Model Rules, supra* n. 21.

127 According to the formula provided in the Article 5.2.3 in the Model Rules.

128 If the amount calculated in relation to the SBIE is greater than or equal to *Net GloBE Income* and there is no additional complementary tax, there will be no *Excess Profit*, and therefore no complementary tax will be considered. In addition, in case the SBIE is greater than the *Net GloBE Income*, the excess SBIE cannot be transferred to prior or subsequent tax periods. Cf. OECD, *Commentary*, *supra* n. 51, at 120, para. 27.

129 OECD, *Commentary, supra* n. 51, at 119, para. 25.

130 Article 9.2 of the Model Rules provides a transition rule for these percentages. According to the table therein, they decrease annually, starting from 10% (eligible payroll) and 8% (tangible assets) in 2023 until they both reach 5% in 2033.

This implies that those LTCE that present high amounts of payroll and tangible assets will face a reduction of the *Top-up Tax* to be collected in the jurisdiction that applies the GloBE Rules, and it may even reach zero.

In this scenario, a practical and immediate effect of adopting the SBIE is the reduction of the floor on tax competition from 15% of the *Net Globe Income* to 15% of *Excess Profit*, that is, the portion of *Net GloBE Income* that exceeds the income presumably derived from expenses with *tangible assets* and *payroll*.

For these reasons, Joachim Englisch[131] states that with the SBIE and consequent exclusion of substance-based activity, the international tax competition for real investment remains with no changes.

Analyzing the SBIE from the perspective of developing countries and emerging economies and considering that these usually attract economic activities that depend strongly on physical presence, usually referred to as *brick and mortar industries*, and for which payroll and tangible assets represent a significant portion of their expenditures, Ana Paula Dourado[132] concludes that in these cases, those countries would not undergo a radical change in their positions, differently from what would occur with their capacity to attract industries in the research and development sectors, in which the presence of those two factors is most reduced and on which the GloBE Rules would impact most strongly.

Aligned with the aspect mentioned above, Luís Eduardo Schoueri[133] criticizes the formula adopted because it would allow the application of the IIR to exclude only the least sophisticated activities with low profit margins, ignoring, for example, the income generated and taxed under intellectual property regimes, even if the creation of value and substantial activity are present there.

Thus, taking the example of research and development activities, the GloBE Rules may eliminate a substantial part of the effects of tax incentives, removing the possibility that developing countries could attract and develop more sophisticated activities. In this scenario, the Pillar Two operates as a mechanism to concentrate technological development in most developed countries, which tends to contribute to the increase of inequality.

Still with regard to the SBIE, one should not lose sight of the fact that the identification, measurement and implementation of administrative controls, for example, it may present an administrative burden and complexity that exceeds the benefits of the SBIE, which is why the MNE groups may decide not to use it. Thus, although the default rule is to exclude those revenues, the MNE group may, on an annual basis, opt out of the exclusion on a jurisdictional basis.[134]

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131 Joachim Englisch, *International Effective Minimum Taxation – Analysis of Globe (Pillar Two)*, SSRN Electronic Journal (2021), https://doi.org/10.2139/ssrn.3829104, (accessed 24 May. 2022), at 10.

132 Ana Paula Dourado, *supra* n. 79, at 3.

133 Luís Eduardo Schoueri, *Some Considerations on the Limitation of Substance-Based Carve-Out in the Income Inclusion Rule of Pillar Two*, 75 Bulletin for International Taxation 543-548 (2021), https://research.ibfd.org/#/doc?url=/collections/bit/html/bit_2021_11_o2_10.html, (accessed 24 May. 2022), at 546.

134 OECD, *Commentary, supra* n. 51, at 120, paras 28-29.

In some situations, the exclusive adoption of the SBIE by itself would still generate *Top-up Tax* to be collected by the MNE group in the jurisdiction of a Parent Entity, to the detriment of its collection in the source jurisdiction, where the LTCE is located. In these situations, and in order not to lose that tax revenue, the source jurisdictions may resort to a QDMTT[135].

The implementation of a QDMTT, however, affects the competitiveness of countries that practiced ETR lower than the minimum rate of the GloBE Rules. For example, the situation in which the country regarding to attract real economic activity, it grants tax incentive consisting in the corporate income tax exemption. Without the adoption of a QDMTT, a Top-up Tax would be charged by the jurisdiction of the Parent Entity, so that the economic effect of the tax benefit would be partially[136] eliminated, thus affecting the tax competitiveness of the country that grants the incentive. With the adoption of a QDMTT, and the corresponding requirement of a minimum tax in the country of the CE, the attraction capacity is equally affected, differing from the first situation only by the fact that the tax will be collected in that country and not in the country of the Parent Entity. In any of the situations, the economic advantage obtained by the MNE group before the adoption of the GloBE Rules will be impacted and reduced, regardless of the option or not by adopting a QDMTT.

In this sense, we partially disagree with the position defended by Devereux, Vella and Wadell-Burrus[137], when they state that a country can introduce a QDMTT being aware that this would not affect its competitive position because the Top-up Tax would be charged by another country if it were not charged through the QDMTT, and thus countries have a strong incentive to introduce a QDMTT. In our view, this conclusion is only valid when, at the beginning of the term of the GloBE Rules, the jurisdiction of the CE does not yet grant any tax incentive that implies an ETR lower than 15%. In this circumstance, the subsequent granting of a tax incentive followed by the adoption of a QDMTT, in fact, does not change the competitive position because the tax burden on the MNE group is not increased. Unlike what happens when there is already a tax incentive granted at the beginning of the term of the GloBE Rules. In this case, the adoption of QDMTT increases the tax burden on the MNE group and it may change the competitive position of the jurisdiction.

In the perspective of collecting tax revenue that would be lost, we agree with the conclusion of Ana Paula Dourado[138] that the QDMTT would be one of the ways to ensure the interests

135 According to definitions provided in the Model Rules, a Qualified Domestic Minimum Top-up Tax means a minimum tax that is included in the domestic law of a jurisdiction and that: (a) determines the Excess Profits of the Constituent Entities located in the jurisdiction (domestic Excess Profits) in a manner that is equivalent to the GloBE Rules; (b) operates to increase domestic tax liability with respect to domestic Excess Profits to the Minimum Rate for the jurisdiction and Constituent Entities for a Fiscal Year; and (c) is implemented and administered in a way that is consistent with the outcomes provided for under the GloBE Rules and the Commentary, provided that such jurisdiction does not provide any benefits that are related to such rules. Cf. OECD, *Model Rules, supra* n. 21, Article 10.1., at 64.

136 As we have seen previously, because the application of the SBIE, part of the incentive still remains due to the exclusion of part of the income from the top-up tax calculation.

137 Michael P. Devereux, John Vella, and Heydon Wardell-Burrus, *Pillar 2: Rule Order, Incentives, and Tax Competition*, Oxford University Centre for Business Taxation (2022), https://doi.org/10.2139/ssrn.4009002, (accessed 24 May. 2022), at 4.

138 Ana Paula Dourado, *supra* n. 19, at 389.

of source jurisdictions. However, we understand that the real interest of source jurisdictions, in which developing countries are included, is the preservation of the ability to attract economic activity through the use of their tax systems, which is not guaranteed in a definitive way either by QDMTT or by the completeness of the GloBE Rules.

In addition to the SBIE approached in this section, the Model Rules also provide a mechanism that, under certain conditions, will lead to a *Top-up Tax* in the amount of zero. This is *de minimis exclusion*.

In accordance with that provision, provided in Article 5.5., the *Top-up Tax* of the Constituent Entities located in a jurisdiction for a given fiscal year will be considered zero if two cumulative conditions are met: (a) the average[139] of *GloBE Revenue*[140] in that jurisdiction is lower than EUR 10 million; and (b) the average of GloBE Income or Loss[141] of that jurisdiction is lower than EUR 1 million. Once these requirements are met, the MNE group may opt for the adoption of de minimis exclusion.[142]

It is thus an optional rule whose effect on the jurisdiction of the CE depends on the formulation of an option by the MNE group. When the option is made, the tax incentives received by entities located in the jurisdiction are not affected by the GloBE Rules, which reveals the possibility of improving the rule in order to preserve the tax competitiveness of developing countries.

Finally, we should not lose sight of the fact that the ETR calculation, a trigger for the complex calculation of the *Top-up Tax*, generates high costs both for tax administrations (administrative costs) and taxpayers (compliance costs).

Thus, the adoption of de minimis exclusion is based on the fact that the amount of the *Top-up Tax* calculated in these situations does not justify the costs incurred for its calculation.[143]

The analysis undertaken so far allows us to conclude that the guarantee of preserving tax competitiveness, by means of the possibility of attracting direct foreign investment through the concession of tax incentives, was not a concern explicitly and normatively determined by the proposal of GloBE Rules.

In this scenario, Aitor Navarro[144] warns that since the publication of the report *Harmful Tax Competition* by the OECD in 1998, a change in opinion regarding the results of the adoption of

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139 The average, both for the purposes of Revenues and for the purposes of Income or Loss, is calculated considering the current fiscal year and the previous two ones, cf. OECD, *Model Rules, supra* n. 21*,* Article 5.5.2.

140 The *GloBE Revenue* of a jurisdiction is the sum of the revenues of all Constituent Entities located in that jurisdiction in that fiscal year, determined in accordance with the adjustments provided for in Chapter 3 of the Modal Rules, cf. OECD, *Model Rules, supra* n. 21, Article 5.5.3.(a), at 32.

141 The GloBE Income or Loss of a jurisdiction for a given fiscal year corresponds to the sum of the *Net Globe Income* or the Net GloBE Loss of that jurisdiction, cf. OECD, *Model Rules, supra* n. 21, Article 5.5.3.(b), at 32.

142 Article 5.5.1., OECD, *Model Rules, supra* n. 21, at 32.

143 OECD, *Commentary*, *supra* n. 51, at 129, para. 74.

144 Aitor Navarro, *supra* n. 71, at 8.

tax incentives has been observed, and that their use as an important policy instrument may be not applied both due to the results of the BEPS Project and the Pillar Two. According to the author[145], 'the sequence of events that has taken place after BEPS points towards a severe undermining of a tax incentives-oriented policy'.

The understanding that there is a difference in the concept of tax competition when analyzed from the perspective of developing countries and the OECD lead Leopoldo Parada[146] to highlight that is incomplete, the view that Pillar Two is only an altruistic measure that will end tax competition and the transfer of benefits to low-tax countries.

According to Afton Titus[147], he points out this set of rules removes from developing countries any possibility of weighing[148] tax revenues that would be lost and the gains in terms of economic development with the granting of tax incentives. In other words, they force emerging economies to dispense with their corporate taxes as an instrument to attract investment, making these countries adopt other means of competitiveness[149].

As seen, developing countries are a heterogeneous reality, being grouped under such classification those countries that have different levels of socioeconomic development. Therefore, by not differentiating them because of these disparities, the OECD assumes that each one is in an equal position as to the existence of competitive advantages as well as to their ability to compete for attraction of investments.

In the next section, we will discuss two alternatives for mitigating the effects on developing countries, considering both the heterogeneity of this classification, and the need to maintain coherence in the adoption of the Pillar Two mechanisms.

4.2 *The necessity of SBIE gradation and expansion of* de minimis exclusion *according to the development level of countries*

In their current rules, both SBIE and *de minimis exclusion* do not consider the *quality* of jurisdictions. That is, in a comprehensive way, in light of the GloBE Rules, it is irrelevant whether a country is qualified as high-income, upper-middle-income, lower-middle-income, low-income, developed or developing ones. He will be harmed or benefited with no necessary distinction.

Considering that the results of SBIE depend substantially on the factual scenario of the CE in which it is applied, in particular on the participation of payroll and tangible assets, there is no guarantee concerning its effectiveness, but there is great possibility for it to be partially ineffective.

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145 *Ibid.*, at 6.

146 Leopoldo Parada, *supra* n. 1, at 3-25.

147 Afton Titus, *supra* n. 73, at 420.

148 Michael P. Devereux, John Vella, and Heydon Wardell-Burrus, *supra* n. 137, at 4-5, in decision-making regarding tax competition, a country evaluates and weighs the benefits (direct and indirect, resulting from the option made by a multinational to settle in it in view of the benefit achieved by it with the reduction of its tax burden) and the margin costs (loss of tax revenue as a result of the benefit granted) due to changes in the domestic taxation rule.

149 Leopoldo Parada, *supra* n. 1, at 28.

Given everything that has been approached so far, we agree with the conclusions reached by Ana Paula Dourado[150] when she states that jurisdictions seeking for multinational companies will have to develop new forms of incentives, and that in this scenario, unlike the richer countries, the developing economies are not sufficiently organized and strong enough to promote the transition from traditional tax advantages to government grants or taxes of another nature.

Therefore, the adoption of the GloBE Rules and the elimination or mitigation of tax competition may shift the focus of multinationals to seek for other advantages such as environmental deregulation, occupational safety standards and social protection for workers.

By assuming (a) that the UPE are not mostly located in developing countries, (b) that the countries where they are located will implement the Pillar Two, especially the GloBE Rules, (c) that developing countries make use of tax incentives in the form of income tax exemption or reduction as a way to attract economic enterprises, (d) that the implementation of the GloBE Rules by the jurisdictions of Parent Entities has as immediate effect the collection, in that jurisdiction, of the tax that had been waived due to the tax incentives imposed by developing countries, (e) that the *carve-out* resulted from the SBIE is the one which effectively reduces the effects of the GloBE Rules, (f) that the adoption of a QDMTT by developing countries may discourage the attraction of economic enterprises, (g) that the adoption of the ETR lower than 15% is not a practice limited to developing countries, being also adopted by the most developed economies, and (h) whereas developing countries are a heterogeneous reality and need to be treated differently and favoured in order to enable them to continue to attract businesses, it is necessary to adopt some mechanism to enable least developed economies to use income tax as an instrument for attracting foreign investment.

In this sense, it seems that the ideal measure would be the exclusion of developing countries from the Pillar Two scope[151]. However, given the apparent impossibility of doing so, we understand that two measures can be implemented as a way of preserving competitiveness. Firstly, the adoption of a gradation factor of the SBIE, inversely proportional to the development level of the jurisdiction. Secondly, the mandatory application and extension of the *de minimis exclusion* rule, aligned with the criteria suggested by the OECD for the creation of *safe harbours* in the STTR.

The adoption of a factor which we can call *development factor* or *factor d*, developed from internationally accepted indicators, such as those adopted by the UN or the World Bank for classification of the countries could either preserve the effectiveness of the Pillar Two when applicable to developed economies which tax income in ETR lower than 15%, or mitigate the effects of adopting the GloBE Rules on least developed economies.

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150 Ana Paula Dourado, *supra* n. 79, at 4.

151 This measure is also defended by Afton Titus, *supra* n. 73, at 423. The author states that as the tax competition in which developing countries are generally involved relates to real competition, not virtual competition, these countries should be excluded from the OECD global agenda concerning harmful tax competition.

The *factor d* would be graded inversely proportional to the development level of the jurisdiction, operating as a multiple of the SBIE, so that the more vulnerable is the jurisdiction the higher should be the multiple and, consequently, lower, or preferably nil, the *Excess Profit* on which the *Top-up Tax* will be levied. In these terms, the *factor d* would suit the methodology for calculating those two quantities as follows:

$$\begin{aligned} Excess\ Profit \\ &= Net\ GloBE\ Income \\ &- (Factor\ d \times Substance\ \ based\ Income\ Exclusion) \end{aligned}$$

From another perspective, regarding the *de minimis exclusion* rule, it seems that the concerns expressed by the Inclusive Framework in dealing with the STTR, which is textually considered as a concession made by developed countries to developing countries, were not adopted in the formulation of the GloBE Rules.

The adoption of materiality thresholds for STTR implementation is recommended in the *Blueprint*[152]. It is suggested, for example, that thresholds shall be used based on the size of the MNE group, the payment value, and the representativeness of the amount paid in relation to the total spending of the company making the payment.

Thus, consistent with this guideline, and considering that the *Blueprint*[153] suggests that micro, small and medium-sized enterprises should be excluded from the scope of STTR application, it seems that this same rule, that is, the threshold used for qualification as an SME, could be applicable under the IIR and UTPR for the purposes of non-submission of Constituent Entities located in developing countries. And the justifications there used are fully transposable: minimize compliance costs for companies and operationalization costs for tax administrations.

The document suggests the formulation of a threshold for the SMEs, based on Recommendation 2003/361 of the European Commission, according to which 'the category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million'[154].

Therefore, differently from the *de minimis exclusion* currently provided in the Model Rules, applicable indistinctly to developed and developing countries, it would be consistent with the recommended practice under the STTR, the adoption of a rule that excluded from the ETR calculation the Constituent Entities located in developing countries that fall under the concept of micro, small and medium-sized enterprises, provided in the Recommendation 2003/361. That

152 OECD, *Blueprint*, *supra* n. 53, at 160-161, paras 623-626.

153 *Ibid.*, at 161, para. 628.

154 European Commission, *Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (Text with EEA relevance) (notified under document number C(2003) 1422)*, https://eur-lex.europa.eu/eli/reco/2003/361/oj, (accessed 6 Jun. 2022), Article 2.

is, the three requirements should be cumulatively considered: number of employees, annual turnover and balance sheet total.

Additionally, and focusing on the need to preserve the competitiveness of most vulnerable jurisdictions, we understand that the application of the *de minimis exclusion* cannot depend on a choice of the MNE group, that is, we consider that the application of the rule should have an imposing nature, in such a way that it would contribute both to the maintenance of the competitiveness of those jurisdictions and to the reduction of the complexity and costs of the implementation of the GloBE Rules.

Certainly, the adoption of this new exclusion criterion alone would not completely shield the tax incentive of the developing countries where the Constituent Entities are located. However, the combination of this criterion with the potentiation of the SBIE, now calibrated according to the degree of development of the jurisdiction of the CE, would contribute to the preservation of the investment attractiveness of these jurisdictions.

To sum up, the adoption of these measures aims to avoid, although not entirely, that, due to the application of the GloBE Rules, the tax incentives granted by developing countries are undermined due to the transfer of tax advantage, previously computed by the MNE group, for jurisdictions that will collect the *Top-up Tax*.

4.3 *A transitional rule for reviewing tax incentives in developing countries*

The adoption of the mechanisms approached in the previous section should be followed by others that lead, within a reasonable time period, to the effective use of tax systems. Otherwise, there is a risk that jurisdictions will be forever dependent of the new and most tolerant rules.

In this sense, such improvements should be followed by mechanisms that eliminate the adverse effects of setting limits from which beneficiaries no longer receive the benefits conferred by them, as it is about not only the vulnerability or development level and the basis beneath the *factor d* proposal, but also the criteria for the expansion of the *de minimis exclusion*.

One of the effects of such thresholds is related to what psychology calls *Peter Pan Syndrome*[155]. That is, in the context of the suggestions made in which the setting of rules linked to the degree of development of the countries and/or the number of employees, gross revenue and assets of a company, the public policy may operate as a limiting instrument for the development of countries and companies, since upon the possibility of undergoing a fiscal intrusion, they will prefer to avoid growth higher than those limits.

155 The expression 'Peter Pan Syndrome' is attributed to Dr. Dan Kiley, author of the book 'The Peter Pan Syndrome: Men Who Have Never Grown Up', published in 1983, and it is used to describe adults who, for example, adopt childish behaviors for fear of assuming certain responsibility of adult life, that is, despite having all the attributes for a life end up not wanting or not feeling the necessary capacity to grow up, *see* Dan Kiley, *The Peter Pan Syndrome: Men Who Have Never Grown Up* (Dodd, Mead and Company, 1983).

In this scenario, we understand that two sets of measures could be applied parallel to the mechanisms that mitigate the application of the GloBE Rules to developing countries.

The first set of measures concerns the setting of a validity period for these mitigating rules (*factor d* and extension of the *de minimis exclusion* rule). A kind of *sunset clause*, as it is adopted in *tax sparing clauses*, which, in a context of tax treaties, aim to preserve the tax incentives granted by a contracting state[156].

The adoption of such a rule would operates in such a way as to oblige the beneficiary countries to develop other competitive advantages, while at the same time granting a reasonable time period for the adoption of the second mechanism: the peer review of tax benefits.

Considering that the alleged inefficiency of part of these incentives was one of the concerns that motivated the Pillar Two proposition[157]-[158], this assessment would come up as an opportunity for countries, and especially those classified as developing ones, to appreciate the effectiveness of their tax policies.

Thus, this second mechanism would aim to promote the analysis of tax benefits granted by the members of the Inclusive Framework, through a peer review capable of scrutinizing the normative design of the tax benefit, qualifying or disqualifying it as a benefit granted to the stimulate substantive activities. In the event that the benefit was qualified as a promoter of real economic activity, the GloBE Rule should be improved in order to exclude from the ETR calculation of the jurisdiction both the occasional tax and the income allusive to that tax benefit. On the other hand, to the *Net GloBE Income* related to unqualified benefits in this way should not even be applied the current SBIE rule.

It should be noted that the assessment of tax regimes is not a new measure within the scope of the activities developed by the OECD, for example, as it occurs with the peer review of preferential tax regimes, a measure inserted in the context of Action 5 of the BEPS Project. That is, the organization already has some experience developed in this field.

In summary, if on the one hand the proposals presented in this section allow a differentiated and favored treatment to most vulnerable countries by expanding the scope of SBIE and *de minimis exclusion*, on the other hand, it seeks within a reasonable time limit to promote the improvement of tax incentives granted by these countries, which directly attack the harmful tax competition, generator of the BEPS, revealing the coherence of the suggestions presented here with the founding purposes of the two-pillar solution.

156 About the *Tax Sparing Clauses see* Aitor Navarro, *supra* n. 71, at 6.

157 OECD, *supra* n. 75, at 25, para. 54.

158 OECD, *supra* n. 76, at 7, para. 8.

5. Conclusions

The criteria usually adopted by the methodologies that classify the countries show that the expressions adopted to set levels, such as *developing*, *least developed*, or other ones, are insufficient to represent the heterogeneous set of countries that it is applied, being unable to reflect the diverse socioeconomic realities of each of them.

In the tax context, given the difficulty of developing other competitive advantages such as providing a developed infrastructure and a qualified workforce, or ensuring political stability and a regulated financial market, the developing countries are a group of economies that make great use of their tax systems as a means of attracting foreign direct investment by setting tax incentives.

However, this instrument of attracting investment is threatened by the possibility of implementing the global tax agreement that, without distinguishing the different forms of tax competition, rises the floor through a minimum global taxation, so that the income taxed lower than that minimum rate will be subject to the collection of a *Top-up Tax* regardless of where the income is generated.

In this scenario, by failing to differentiate between harmful tax competition and beneficial tax competition, the OECD disregarded that not all jurisdictions with ETR lower than the agreed minimum rate make use of tax competition to the attraction of paper profits, thus reaching countries that use tax systems as a mechanism for attracting real investment.

In the scope of the GloBE Rules, the interaction between the various types of tax incentives and the Model Rule leads, in general, to the elimination of the effects from those tax advantages and, within an inertia framework of the jurisdictions where the LTCEs are located, it leads to the transfer of tax revenue corresponding to jurisdictions that have priority in the application of IIR and UTPR generally in developed countries.

From another angle, and in principle, the STTR is not able to reduce the impact caused by the GloBE Rule on tax incentives, since developing countries are usually jurisdictions where it is located the entities responsible for paying the tax and not for receiving the income.

Alternatively, the transformation of some tax incentives into modalities that would lead to a lower impact on the ETR calculation, as it occurs with the government grants and refundable tax credits, can cause difficulties for both tax administrations and MNE groups.

From another perspective, the neutral character of the SBIE, especially as to the type of activity, place of practice or economic sector of the CE and the jurisdiction where it is located, as well as the indicators that make up the formula adopted in that *carve-out*, does not give certainty to its effectiveness as a mechanism to prevent harmful tax competition and to preserve full benefits destined to the attraction of real economic activity.

Therefore, in the scenario where the GloBE Rules will not be changed in order to give a favored and differentiated treatment to developing countries, the adoption of a QDMTT seems to be the natural way to be followed by these economies.

However, there are doubts whether this additional tax remains feasible, in economic and comparative terms with other jurisdictions, the permanence of the CE of the MNE group in the jurisdiction of developing countries that do not have other comparative advantages such as infrastructure, regulatory stability of financial markets, political stability, among others.

As alternative ways to the adoption of the QDMTT and the consequent increase of the tax burden supported by the MNE groups that implement substantive economic activity in developing countries, this Article defended the exclusion of Constituent Entities located in most vulnerable jurisdictions within the scope of Pillar Two, as well as the increase of *de minimis exclusion*, in addition to the possibility of graduation of SBIE effect according to the development degree of the CE jurisdiction.

At the same time, it is suggested to fix a deadline at the end of which the privileged and favored treatment conferred on those jurisdictions would end, as well as the peer review of tax incentives currently granted seeking to ascertain their purpose and, if they are designed as stimulators of real economic activity, are automatically excluded from the scope of the Pillar Two. The same thing should not occur with those seeking to attract paper profits, on which we understand that it should not even be applied to SBIE.

In the absence of such measures, the adoption of the current design of the GloBE Rule will have the immediate effect of reducing the tax competitiveness of least developed jurisdictions. In this scenario, the effect of those rules on attracting investments to these countries will depend substantially on their ability to transpose tax competition to other fields by transforming incentives once granted through income tax into advantages of other tax natures or types, which can lead to deregulation and weakening of other areas.

It is thus a huge challenge to be faced by least developed jurisdictions, since these countries, in general, are not endowed with a level of organization or fiscal margin for the granting of incentives through instruments other than the income tax.

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