SOUTH CENTRE

TAX COOPERATION POLICY BRIEF

www.southcentre.int

No. 22 ● 12 January 2022

Global Minimum Corporate Tax: Interaction of Income Inclusion Rule with Controlled Foreign Corporation and Tax-sparing Provisions

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Abstract

The OECD/G20 Inclusive Framework on BEPS (the Inclusive Framework) agreed on 8 October 2021 to the Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy. The Two-Pillar Solution will ensure that MNEs will be subject to a minimum tax rate of 15%, and will re-allocate profit of the largest and most profitable MNEs to countries worldwide. Under these recommendations, *inter alia*, Pillar Two consists of two interlocking domestic rules (together the Global Anti-Base Erosion Rules (GloBE)), which includes an Income Inclusion Rule (IIR) to impose a top-up tax on a parent entity in respect of the low taxed income of a constituent entity. The IIR shall be incorporated in domestic laws of opting jurisdictions, and seems to have profound interaction with the Controlled Foreign Corporation (CFC) and tax-sparing provisions. The IIR operates in a way that is closely comparable to a CFC rule and raises the same treaty questions as raised by CFC rules, although there are a number of differences between the IIR and the CFC rules. In the context of IIR, there may be a case when the Ultimate Parent Entity (UPE) is taxed on the Constituent Entities' (CEs) income and the spared tax is not considered as covered taxes for calculating the Effective Tax Rate (ETR) of the CE. This generates a situation for developing countries in which they have to shore up their ETR by overhauling their tax incentive regimes and retooling domestic legal framework for more effective taxation of MNEs to avoid losing a significant portion of their tax right/base to a developed country. Adoption of IIR (which is an extension of CFC rules) under Pillar Two is therefore going to create conflict with the tax-sparing rules. From the perspective of developing countries, the adoption of GloBE implies losing tax incentives as a tax policy instrument to attract foreign direct investment. This is why every country involved, but especially developing countries, should undertake a thorough examination to determine whether such measures are convenient for their interests in the long run.

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Le Cadre inclusif OCDE/G20 sur l'érosion de la base d'imposition et le transfert de bénéfices (le Cadre inclusif) a approuvé le 8 octobre 2021 la Déclaration sur une solution reposant sur deux piliers pour résoudre les défis fiscaux soulevés par la numérisation de l'économie. Cette solution vise à introduire un impôt mondial minimum sur les sociétés, dont le taux a été fixé à 15 %, et à garantir une répartition plus équitable entre les pays des bénéfices concernant les entreprises multinationales les plus grandes et les plus rentables. Le Pilier 2 se compose de deux règles nationales interdépendantes (également appelées « Règles globales de lutte contre l'érosion de la base d'imposition » ou « Règles GloBE ») parmi lesquelles figure la règle d'inclusion des revenus, qui consiste à assujettir une entité mère à un impôt supplémentaire portant sur le revenu faiblement impose d'une entité constitutive. Cette règle, qui nécessite une transposition dans les législations nationales des pays membres, fonctionne en interaction avec les règles applicables aux sociétés étrangères contrôlées (SEC) et à l'octroi de crédits d'impôt. L'application de la règle d'inclusion des revenus est très comparable à celles relatives aux SEC et soulève les mêmes questions conventionnelles, bien qu'il existe un

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Acknowledgements and thanks are due to the helpful and detailed comments of Carlos Protto, Member of the United Nations Tax Committee and Argentina's representative in the Steering Group of the OECD/G20 Inclusive Framework on BEPS.

certain nombre de différences entre elles. Elle peut avoir pour conséquence que la société mère ultime sera imposée sur le revenu de ses entités constitutives, les crédits d'impôt dont elle bénéficie n'étant pas considéré comme un impôt couvert pour le calcul du taux d'imposition effectif de la société constitutive. Les pays en développement se retrouvent ainsi dans une situation où ils doivent augmenter leur taux d'imposition effectif en modifiant leurs régimes d'incitation fiscale et en réorganisant leur cadre juridique national afin de permettre une imposition plus efficace des entreprises multinationales et d'éviter de perdre une part importante de leurs recettes fiscales au profit d'un pays développé. L'adoption de la règle d'inclusion des revenus (qui constitue une extension des règles applicables aux sociétés étrangères contrôlées) dans le cadre du Pilier 2 va donc créer un conflit avec les règles relatives à l'octroi de crédits d'impôt. Du point de vue des pays en développement, l'adoption des règles GloBE implique de renoncer aux incitations fiscales en tant qu'instrument de politique fiscale pour attirer les investissements directs étrangers. C'est pourquoi il est recommandé à tous les pays concernés, mais surtout aux pays en développement, de procéder à un examen approfondi afin de déterminer si de telles mesures sont dans leur intérêt sur le long terme.

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El Marco Inclusivo sobre BEPS de la OCDE y el G20 (el Marco Inclusivo) acordó el 8 de octubre de 2021 una declaración sobre la solución de dos pilares para abordar los desafíos fiscales derivados de la digitalización de la economía. La solución de dos pilares asegurará que las empresas multinacionales (EMN) estén sujetas a un tipo impositivo mínimo del 15 %, y redistribuirá los beneficios de las EMN más grandes y más rentables en países de todo el mundo. Con arreglo a estas recomendaciones, entre otras, el Segundo Pilar comprende dos reglas nacionales entrelazadas (junto con las reglas GloBE, del inglés *Global Anti-Base Erosion*), que incluyen una regla de inclusión de rentas (RIR) que impone un impuesto complementario a una entidad matriz por los ingresos sujetos a tipos impositivos bajos de una entidad constituyente. La RIR se incorporará a la legislación nacional de las jurisdicciones pertinentes, y parece que tiene una interacción arraigada con las disposiciones relativas a las sociedades extranjeras controladas (SEC) y al descuento por impuesto exonerado. La RIR opera de una manera muy semejante a una regla aplicable a las SEC y plantea las mismas cuestiones de tratado que plantea las reglas de SEC, aunque con diferencias entre ambas. En el contexto de la RIR, puede ocurrir que se grave a la empresa matriz última (EMU) por los ingresos de las entidades constitutivas (EC) y no se considere el descuento por impuesto exonerado como impuestos cubiertos a la hora de calcular el tipo impositivo efectivo (TIE) de la EC. Esta situación obliga a los países en desarrollo a apuntalar su TIE mediante el replanteamiento de sus regímenes de incentivos fiscales y la remodelación del marco jurídico nacional para recoger una imposición más efectiva a las EMN a fin de evitar perder una parte importante de su derecho de gravamen/base imponible a un país desarrollado. Por lo tanto, la adopción de la RIR (que es una ampliación de las reglas aplicables a las SEC) con arreglo al Segundo Pilar va a generar un conflicto con las reglas de descuento por impuesto exonerado. Desde el punto de vista de los países en desarrollo, la adopción de las reglas GloBE implica la pérdida de incentivos fiscales como un instrumento de política tributaria para atraer la inversión extranjera directa. Por esta razón, todos los países implicados, aunque especialmente los países en desarrollo, deberán someterse a un examen escrupuloso a fin de determinar si esas medidas favorecen a sus intereses a largo plazo.

Introduction

Digitalisation and globalisation have had a profound impact on economies and the lives of people around the world, and this impact has only accelerated in the 21st century. These changes have brought with them challenges to the rules for taxing international business income, which have prevailed for more than a hundred years and resulted in Multinational Enterprises (MNEs) not paying their fair share of tax despite the huge profits many of these businesses have garnered as the world has become increasingly interconnected. The Organisation for Economic Co-operation and Development (OECD)/Group of Twenty (G20) Inclusive Framework on Base Erosion and Profit Shifting (BEPS) - the Inclusive Framework agreed on 8 October 2021 to the Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy. The Two-Pillar Solution will ensure that MNEs will be subject to a minimum tax rate of 15%, and will re-allocate profit of the largest and most profitable MNEs to countries worldwide.[1] Under these recommendations, *inter alia*, Pillar Two[2] consists of:

- two interlocking domestic rules (together the Global Anti-Base Erosion Rules (GloBE)):

(i) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity; and

(ii) an Undertaxed Payment Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR; and

- a treaty-based rule (the Subject to Tax Rule (STTR)) that allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The STTR will be creditable as a covered tax under the GloBE rules.

The GloBE rules will apply to MNEs that meet the EUR 750 million threshold as determined under BEPS Action 13 (country by country reporting). Countries are free to apply the IIR to MNEs headquartered in their country even if they do not meet the threshold. The GloBE rules will operate to impose a top-up tax using an effective tax rate test that is calculated on a jurisdictional basis and that uses a common definition of covered taxes and a tax base determined by reference to financial accounting income (with agreed adjustments consistent with the tax policy objectives of Pillar Two and mechanisms to address timing differences).

The IIR shall be incorporated in domestic laws of opting jurisdictions, and seems to have profound interaction with the Controlled Foreign Corporation (CFC) and tax-sparing provisions, as discussed in the following paragraphs.

CFC rules

CFC rules are designed to limit artificial deferral of tax by using offshore low taxed entities. These rules aim to disincentivize businesses from moving their income to low-tax jurisdictions, as it can still be subject to domestic tax, and thus protect the domestic tax base. The countries[3] which have CFC rules currently include Argentina, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, Chile, China, Colombia, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Indonesia, Ireland, Israel, Italy, Japan, Kazakhstan, Korea, Latvia, Lithuania, Luxembourg, Malta, Mauritius, Mexico, Netherlands, New Zealand, Norway, Pakistan, Peru, Poland, Portugal, Romania, Russia, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Turkey, United Kingdom and United States.

Pillar Two Blueprint on CFC and IIR interaction

The IIR operates by requiring a parent entity, in most cases, the Ultimate Parent Entity (UPE) to bring into account as income its proportionate share of the income of each Constituent Entity (CE) located in a low-tax jurisdiction in which it owns an equity interest. That income is then taxed in the parent entity's hands up to the GloBE minimum rate, after crediting any covered taxes (as defined for the purposes of the GloBE) on that income. In subjecting a domestic taxpayer to tax on its share of the foreign income of a controlled subsidiary, therefore, the IIR operates in a way that is closely comparable to a CFC rule and raises the same treaty questions as raised by CFC rules. Although there are a number of differences between the IIR and the CFC rules of many jurisdictions, since CFC regimes do not conflict with treaty obligations (though some countries do not conform to this view)[4], hence, for the same reasons, it can be concluded that an IIR along the lines envisaged under the GloBE is similarly compatible with the provisions of tax treaties that are generally based on the United Nations (UN) or OECD Model.[5]

CFC and IIR similarities: The IIR operates similarly to a CFC rule by requiring a parent company to bring into account and tax the profits of a subsidiary that are subject to an effective tax rate below the minimum rate. The operation of the IIR is, in some respects, based on traditional CFC rule principles and triggers an inclusion at the level of the shareholder where the income of a controlled foreign entity is taxed at below the effective minimum tax rate. For the purposes of calculating the Effective Tax Rate (ETR) under the GloBE rules, covered taxes *inter alia* include taxes paid in accordance with CFC rules provided that they are imposed on the income of the CFC that is attributed to shareholders in the parent jurisdiction. Such CFC taxes are assigned, where possible, to the jurisdiction in which the underlying income arises (i.e., to the jurisdiction of the CFC) and are excluded from the ETR computation if the underlying income is excluded. In subjecting a domestic taxpayer to tax on its share of the foreign income of a controlled subsidiary, therefore, the IIR operates in a way that is closely comparable to a CFC rule.

CFC and IIR dissimilarities: CFC rules typically do not apply to all the subsidiaries in an MNE Group and, when they do apply, they usually only capture certain types of low-tax passive income[6]. In contrast, the GloBE rules will apply to all the subsidiaries in the group and all types of income. Liability for the amount of top-up tax computed for a low taxed CE is allocated to the parent entity in proportion to the parent entity's equity interest in the income of that entity. The liability for the top-up tax usually falls on the UPE of the MNE Group. However, under certain circumstances, the GloBE rules are designed so that the liability for the top-up tax shifts to one or more other CEs of the MNE Group. This coordination of income inclusion rules among jurisdictions is part of the design of the GloBE rules, whereas CFC rules, though they may have tax credit rules designed to avoid double taxation, typically do not have this level of co-ordination. Also, in the case of CFC rules, the tax treatment of the income attributed to the controlling entity usually bears the same tax burden as other equivalent income and would not depend on the top-up tax, as happens with the IIR.

Interaction of CFC rule and IIR with certain treaty provisions under the UN and OECD Model Tax Convention (MTC) 2017

Interaction with Articles 7 and 10: A significant number of countries have adopted CFC provisions to address issues related to the use of foreign based companies. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. Since such legislation results in a State taxing its own residents, paragraph 3 of Article 1 confirms that it does not conflict with tax conventions like Articles 7 and 10.[7] Though, some countries hold a viewpoint that CFC provisions are contrary to the treaty provisions.[8] The purpose of paragraph 1 of Article 7 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. As confirmed by paragraph 3 of Article 1, the paragraph does not limit the right of a Contracting State to tax its own residents under CFC provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits.[9] Similarly, as confirmed by paragraph 3 of Article 1, paragraph 5 of Article 10 cannot be interpreted as preventing the State of residence of a taxpayer from taxing that taxpayer, pursuant to its controlled foreign company's legislation or other rules with similar effect, on profits which have not been distributed by a foreign company. Moreover, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules.[10] Also, the UN and OECD commentaries make it clear that even if a treaty does not have a saving clause, i.e., Article 1(3), it does not mean that a State is restricted from applying its CFC rule.[11]

Interaction of CFC and IIR with Article 9: Transfer pricing rules are intended to adjust the taxable profits of Associated Enterprises (AEs) to eliminate distortions arising whenever the prices or other conditions of transactions between those enterprises differ from what they would have been if the enterprises had been unrelated. Because CFC rules by definition address related parties (as the companies that are captured by such rules are controlled by another party), jurisdictions often also use these rules to combat the adjusted prices charged between related parties. In other words, CFC rules are seen as a way for a parent jurisdiction to capture income earned by a foreign subsidiary that may not have been earned had the original pricing of the income-creating asset been set correctly. CFC rules are thus often referred to as "backstops" to transfer pricing rules. That terminology, however, is misleading, in that CFC rules do not always complement transfer pricing rules. CFC rules may target the same income as transfer pricing rules in some situations, but it is unlikely that either CFC rules or transfer pricing rules in practice eliminate the need for the other set of rules. Instead, while CFC rules may capture some income that is not captured by transfer pricing rules (and vice versa), neither set of rules fully captures the income that the other set of rules intends to capture.[12] Transfer pricing rules, which generally rely on a facts and circumstances analysis and focus primarily on payments between related parties, do not remove the need for CFC rules. CFC rules are generally more mechanical and more targeted than transfer pricing rules, and many CFC rules automatically attribute certain categories of income that is more likely to be geographically mobile and therefore easy to shift into a low-tax foreign jurisdiction, regardless of whether the income was earned from a related party.[13]

CFC rules similar to transfer pricing regulations could possibly lead to economic double taxation among related parties. Consequently, specific rules which trigger economic double taxation among AEs need to be tested with Article 9. CFC rules reallocate the profits of the CFC to the shareholder. By doing so they are taxing the taxable base which has been allocated to another country on an arm's length basis. Thus, as they go beyond the boundaries of Article 9 they are restricted.[14] By applying the CFC rule, the State of the shareholder is unilaterally re-writing the accounts of AEs even though the transactions between such enterprises have taken place on normal open market commercial term (on an arm's length basis).[15] Similarly, a conflict may arise if the IIR makes income / profit re-allocations beyond arm's length allocations. However, given the understanding arising from the extant IIR rules, there may not be a case of double taxation as the State of the UPE taxes the low taxed income only up to the top-up rate (and not up to the domestic tax rate, which may be higher). That being said, double taxation may arise under IIR if the effective tax rate of a CE complies with the Arm's Length Principle (ALP) but is less than the minimum rate set at 15%.

UN and OECD MTC on Tax Sparing

By "tax-sparing" credit it is meant that a credit is granted by a country (generally a developed or capital-exporting country) in respect of tax not only actually paid, but actually forgone under the incentive legislation of another country (generally a developing or capital-importing country).[16] Factors in favour of tax-sparing regime include that it makes it more favourable to invest abroad, catalyses transfer of capital & technology, acts as a device to aid an emerging economy and ensures the exercise of a developing country's sovereignty by allowing it to effectively deploy a specific part of its domestic tax regime.

The rationale[17] for support of developed countries under their tax system to achieve the objective of introducing tax-sparing provisions by developing countries is *inter alia* explained below:

> *The effectiveness of the tax incentive measures introduced by most developing countries depends on the interrelationship between the tax systems of the developing countries and those of the capital-exporting countries from which the investment originates. It is of primary importance to developing countries to ensure that the tax incentive measures shall not be made ineffective by taxation in the capital-exporting countries using the foreign tax credit system. This undesirable result is to some extent avoided in bilateral treaties through a "tax-sparing" credit, by which a developed country grants a credit not only for the tax paid but also for the tax spared by incentive legislation in the developing country. It is also avoided by the exemp-tion method. Developing countries consider it necessary to underline their understanding that either the exemption method or the tax-sparing clause is, for these countries, a basic and fundamental aim in the negotiation of tax treaties. On the other hand, studies have shown that tax factors may not themselves be decisive in the process of investment decisions and, therefore, tax sparing may not be an appropriate policy.*

Factors[18] which prompt some countries to opine that tax sparing may not be an appropriate policy *inter alia* include:

◊ Tax-sparing provisions offer ample opportunities for tax planning and tax avoidance which undermines the tax bases of both the residence and source country.

- ◊ Investment decisions made by international investors resident in credit countries are rarely dependent upon or influenced by the existence or absence of tax-sparing provisions in tax treaties.
- ◊ While negotiating tax treaties, in return for tax-sparing provisions, some countries (developing) have to settle for certain concessions like lower withholding tax rates or stricter Permanent Establishment (PE) rules.

However, many members from both developed and developing coun-tries are of the view that tax-sparing credits should be included in treaties between developed and developing countries, where the developed country used the credit method.[19] On the other hand, the exemption method of providing relief for double taxation eliminates the undesirable effects of the residence country's taxes on the source country's tax incentive scheme.[20] The purpose of these provisions is to allow non-residents to obtain a foreign tax credit for the taxes that have been "spared" under the incentive programme of the source State or to ensure that these taxes will be taken into account for the purposes of applying certain conditions that may be attached to exemption systems.[21]

In general, tax-sparing clauses oblige the State of residence to provide relief for the taxes spared by the source State. The clauses are typically found in the relief provisions similar to Article 23A or 23B of the UN and OECD MTC. The question now is whether the State of residence, when applying its CFC rule or the IIR, shall provide relief to its own resident for taxes that have been spared by the other State (in the hands of a separate taxpayer)? As a start, it should be noted that the saving clause (corresponding to Article 1(3) of the UN and OECD MTC) contains an exception for Article 23. This would mean that the State enforcing the CFC rule / IIR will have to provide treaty benefits to its own residents for cases falling within the elimination of double taxation provisions. In the context of IIR, there may be a case when the UPE is taxed on the CEs' income and the spared tax is not considered as covered taxes for calculating the ETR of the CE.[22]

The OECD in its October 2021 statement has touched upon this issue by stating that the tax incentives provided to spur substantial economic activity will be accommodated through a carve-out. Overall, the GloBE rules will relieve pressure on developing countries to provide excessively generous tax incentives to attract foreign investment; while at the same time, there will be carve outs for activities with real substance.[23] It is important to remember that what we are talking about is a 15 per cent effective rate to be paid by multinationals, not the statutory rate set out in a country's tax laws. Many countries have reasonable corporate tax rates in their laws but most multinationals currently pay a lot less as a result of deductions, exemptions, loopholes, or tax avoidance strategies. As a result, even though 15 per cent may sound low to some, it is quite significant because we are talking about the rate actually paid. The minimum tax puts a floor on tax competition, and is expected to generate around $150 billion in additional global tax revenues.[24]

Viewpoint of some countries on Tax Sparing

Industrialized countries have a fairly restrictive policy on adopting tax-sparing provisions in tax treaties. On the outer end of the scale is the United States, which has a consistent policy of not adopting tax-sparing provisions in any of its double tax treaties. More recently, Norway has also taken the policy position of not adopting tax-sparing provisions in double tax treaties. The United Kingdom has seemingly adopted a more balanced position, and has concluded tax treaties with tax-sparing provisions as recently as in 2011. Developing countries tend to be proponents of tax sparing. On the outer end of this scale is the position of Brazil, that refuses to enter into tax treaties unless the treaty includes tax sparing. China has also been a strong proponent of tax sparing.[25]

From an African viewpoint,[26] IIR may compel countries to give up on tax incentive regimes as explained below:

An analysis gives the average corporate tax rate for Africa as 27.46%. Tax incentives, giveaways and loopholes result in a far lower effective tax rate for African countries. For instance, with a nominal tax rate of 30%, where the actual profit of an MNE could not be established, the Nigeria tax authorities, under its laws, subject such companies to a deemed profit taxation which results in an ETR of only 6%. This means that, as far as Nigeria is concerned, the difference between the proposed global minimum effective tax rate of 15% and the 6% ETR will be taxed by the country of residence of the MNE group using the IIR. This generates a situation for developing countries in which they have to shore up their ETR by overhauling their tax incentive regimes and retooling domestic legal framework for more effective taxation of MNEs to avoid losing a significant portion of their tax right/base to a developed country.

Overhauling of tax incentive regimes following introduction of IIR may have other implications as well. Interventions aimed at restructuring tax incentive regimes must cover domestic tax laws and tax related incentives within the context of International Investment Agreements (IIAs). These Agreements are usually fraught with stabilization clauses that guarantee a set standard of regulatory treatment to investments made pursuant to the Agreement. Some such clauses forbid the host nation from withdrawing certain incentives guaranteed under the IIA or otherwise established at the time of the investment. Though removing these kinds of tax incentives may be difficult, maintaining such boundaries may be less attractive to the MNEs if all IF members implement the IIR. This is because the MNEs will not benefit from the incentive since it would be taxed in its home jurisdiction.[27]

Under the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion & Profit Shifting (MLI), India has not included paragraph 3 of Article 7 while inserting Article 11 of the MLI in its tax treaties (refer to India's synthesised texts released)[28], which is equivalent to Article 1(3) of the UN and OECD MTC. A probable reason for the same is that India does not subscribe to Authorised OECD Approach (AoA) advocated by the OECD since it believes that the same is more suited for countries which are net exporters of capital and technology, thereby, implying that arm's length return in the source (developing) State may not be sufficient for taxation of a PE (in the market jurisdiction). A rationale for the same is that the business profits are a result of both supply as well as demand side factors and a Functions, Assets and Risk (FAR) based attribution ignores the contribution to business profits made by demand side factors such as access to marketplace, etc.[29] That being the case, ascribing returns based on CFC regulations would wean taxation to the State of residence rather than to the State of source. Perhaps that is why India has not introduced the CFC regulations as such. Also, as mentioned *supra*, some countries do not conform to the view that CFC regulations comply with Article 7(1) of the OECD MTC. That being the case, it may be an issue of conflict if IIR under Pillar Two is adopted by India or for that matter any country which does not have CFC provisions in place, though at the same time, it cannot be said that inclusion of CFC provisions is a *sine qua non* for adopting the Pillar Two provisions. India, like many developing countries, did not have CFC rules as they would have been at odds with the tax-sparing rules. Adoption of IIR (which is an extension of CFC rules) under Pillar Two is therefore going to create conflict with the tax-sparing rules, as demonstrated by the illustration below.

Illustration

Let us assume that a Company A under an MNE Group is located in Jurisdiction A which is a low-tax jurisdiction where corporate tax rate is Nil and there is another Company B under the same MNE Group which is located in Jurisdiction B where corporate tax rate is 25%. Jurisdiction B has tax-sparing rules in its domestic law which allow 100% tax exemption to certain eligible corporates and Company B complies with all requisite conditions so as to avail the tax exemption. The amount of top-up tax under IIR in respect of the CEs is constructed through an illustration hereunder so as to analyse its conflict with tax-sparing rules:

CE	Globe Income	Adjusted Covered Taxes	Jurisdictional ETR	Top-up Tax Percentage	Total Carveout*	Determination of Excess Profit	Determination of amount of Top-up Tax
Company A	100	0	0	15	17	83	12.45
Company B	100	0	0	15	23	77	11.55

Calculation of Substance-based Income Exclusion					
CE	Payroll expenses	Payroll carveout (at 10%)	Carrying value of tangible assets	Tangible assets carveout (at 8%)	Total Carveout*
Company A	50	5	150	12	17
Company B	150	15	100	8	23

The example above demonstrates that the taxes spared by Jurisdiction B are allocated to the UPE. The impact of payroll and tangible assets carveouts is limited to an extent, i.e., in their absence, the amount of top-up tax would have been 15, whereas, with carveouts, it is 11.55. The impact of carveouts will increase if the payroll expenses and carrying value of tangible assets in Company B are substantially higher and instead of 100% tax exemption, there is 50% tax exemption in Jurisdiction B, as demonstrated in the example given below:

CE	Globe Income	Adjusted Covered Taxes	Jurisdictional ETR	Top-up Tax Percentage	Total Carveout**	Determination of Excess Profit	Determination of amount of Top-up Tax
Company A	100	0	0	15	17	83	12.45
Company B	100	12.5	12.5	2.5	82	18	0.45

Calculation of Substance-based Income Exclusion					
CE	Payroll expenses	Payroll carveout (at 10%)	Carrying value of tangible assets	Tangible assets carveout (at 8%)	Total Carveout**
Company A	50	5	150	12	17
Company B	500	50	400	32	82

It is also to be noted that the higher carveout rates apply in the transition period of ten years, following which, the carveout rate will drop substantially to 5%. Notwithstanding the carveout rate and the quantum of payroll expenses and carrying value of tangible assets, the above illustration adequately demonstrates that taxes spared by the state of source are getting shifted to the state of UPE under the IIR. The IIR, therefore, impinges on tax sovereignty of developing countries which have introduced tax-sparing provisions.

Conclusion

The implementation of tax sparing can be viewed as a *quid pro quo* in exchange for the lowering of withholding tax rates at source or stricter PE rules that entail adopting a tax treaty. With tax-sparing benefits gone post the adoption of IIR under Pillar Two, it is unlikely that developing countries would be in a position to re-visit and re-set the already lowered withholding tax rates or re-negotiate the stricter PE rules in their tax treaties.

Specifically, from the perspective of developing countries, the adoption of GloBE implies losing tax incentives as a tax policy instrument to attract foreign direct investment. This is why every country involved, but especially developing countries, should undertake a thorough examination to determine whether such measures are convenient for their interests in the long run.[30]

The primary purpose of the OECD/G20 project on digitalisation was to shore up tax revenues of market jurisdictions to account for the contribution made by users in the market jurisdictions so as to compensate such jurisdictions for the revenue generated by them for the MNEs. On a bigger canvas and on taking into consideration the primary purpose of the OECD/G20 project, even if developing countries are ultimately the market for a variety of goods and services leading to generation of profits for the developed world, only a small portion of profits will get shared with them under the Two-Pillar Solution. The secondary purpose of the OECD/G20 project was to address remaining BEPS issues related to low-tax jurisdictions. Based on discussions above, it may be inferred that IIR under Pillar Two is not resulting in any tax advantage for the developing countries as it only ensures that taxes are paid in the parent jurisdiction of the MNEs. It may also happen that IIR would wean taxation to the state of residence at the expense of the state of source, which is disadvantageous for the developing countries. Added to that, adoption of IIR (which is akin to CFC rules) under Pillar Two is going to create conflict with various tax incentives and tax-sparing rules. In this light, since the primary and secondary purposes of the OECD/G20 project on digitalisation are not meeting the desired objectives, reluctance by a few countries to join the Two-Pillar Solution is absolutely valid. The only way to overcome this prejudice is for the developing economies to localise and to enhance cooperation amongst themselves. The developed world has been the biggest proponent of globalisation thus far, but with such partisan sharing of profits with market jurisdictions, the days of globalisation are set to get over and the developed world itself will be responsible for this predicament.

Endnotes:

[1] OECD, OECD/G20 Base Erosion and Profit Shifting Project, Brochure: "The Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy" (October 2021).

[2] OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, 8 October 2021.

[3] Refer to https://qdd.oecd.org/data/CFC/.ALL.

[4] Refer to paragraph 110 of commentary on Article 1 of the OECD Model Tax Convention on Income and on Capital (MTC) 2017. Also, refer to paras. 27.4 to 27.7 of the commentary on Article 1 of the OECD MTC 2014.

[5] Refer to the OECD Report on Pillar Two Blueprint (paras. 681 to 683) at https://www.oecd-ilibrary.org/docserver/abb4c3d1-en.pdf?expires=1638376619&id=id&accname=guest&checksum=36CFCF3C8BEF6501E0929069817D9A6C.

[6] Refer to Action 3: BEPS 2015 Final Report (para. 78), OECD/G20 Base Erosion and Profit Shifting Project at http://www.oecd.org/tax/beps-2015-final-reports.htm and Deloitte's "Policy options for domestic implementation of a global minimum corporate tax rate" at https://www.taxathand.com/article/20418/India/2021/Policy-options-for-domestic-implementation-of-a-global-minimum-corporate-tax-rate.

[7] UN Model Double Taxation Convention (DTC) 2017, para. 40 of commentary on Article 1 and OECD MTC 2017, para. 81 of commentary on Article 1.

[8] OECD MTC 2017, para. 110 of commentary on Article 1.

[9] UN Model DTC 2017, para. 8 of commentary on Article 7 and OECD MTC 2017, para. 14 of commentary on Article 7.

[10] UN Model DTC 2017, para. 16 of commentary on Article 10 and OECD MTC 2017, para. 37 of commentary on Article 10.

[11] OECD MTC 2017, para. 15 of commentary on Article 1.

[12] OECD, *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris), para. 8.

[13] Ibid., para. 9.

[14] Refer to V. Chand, A. Turina, K. Romanovska, "Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges", Working Paper (19 November 2021). Available from https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3967198.

[15] OECD MTC 2017, para. 2 of commentary on Article 9.

[16] UN Model DTC 2017, para. 10 of commentary on Article 23.

[17] Ibid., para. 4 of commentary on Article 23.

[18] Refer to *Tax Sparing – A Reconsideration* at https://www.oecd-ilibrary.org/taxation/tax-sparing_9789264162433-en.

[19] UN Model DTC 2017, para. 5 of commentary on Article 23.

[20] Ibid., para. 6 of commentary on Article 23.

[21] UN Model DTC 2017, para. 73 of commentary on Article 23 and OECD MTC 2017, para. 73 of commentary on Articles 23A and 23B.

[22] Refer to V. Chand, A. Turina, K. Romanovska, "Tax Treaty Obstacles in Implementing the Pillar Two Global Minimum Tax Rules and a Possible Solution for Eliminating the Various Challenges", Working Paper (19 November 2021). Available from https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3967198.

[23] OECD, OECD/G20 Base Erosion and Profit Shifting Project, Brochure: "The Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy" (October 2021).

[24] Refer to "How global corporate tax deal was struck, OECD official Grace Perez-Navarro recounts" at https://cfo.economictimes.indiatimes.com/news/how-global-corporate-tax-deal-was-struck-oecd-official-grace-perez-navarro-recounts/87010778.

[25] Kristian Reinert Haugland Nilsen, "The Concept of Tax Sparing: A General Analysis, and an Analysis and Assessment of the Various Features of Tax Sparing Provisions", Master Thesis, University of Oslo, 2013. Available from

https://www.jus.uio.no/ior/english/research/projects/global-tax-tranparency/publications/the-concept-of-tax-sparing.pdf.

[26] Refer to "What Does the G7 Proposal on Taxation of the Digitalised Economy Mean for African countries?" at https://afripoli.org/what-does-the-g7-proposal-on-taxation-of-the-digitalised-economy-mean-for-african-countries.

[27] Ibid.

[28] Refer to India's synthesised texts under the MLI at https://incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx.

[29] Refer to "Comments on the OECD Secretariat Proposal for a 'Unified Approach' under Pillar One" by South Centre at https://www.southcentre.int/wp-content/uploads/2019/11/OECD-Tax-Pillar-One-Comments-South-Centre-Tax-Initiative-v4.pdf.

[30] Refer to article by Aitor Navarro titled "Jurisdiction Not to Tax, Tax Sparing Clauses, and the OECD Minimum Taxation (GloBE) Proposal" at https://doi.org/10.2478/ntaxj-2021-0004.

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