CFS
COMMITTEE ON FISCAL STUDIES

POLICY BRIEF NO. 4 OF 2022

IMPACT OF THE OECD INCLUSIVE FRAMEWORK'S PILLAR 2 ON DEVELOPING COUNTRIES: A FOCUS ON TAX INCENTIVES

John Bush, Michael Durst, and Michelle Mwaka Ogutu

Summary
This policy brief focuses on both the more general subject around BEPS and, in particular, on how the OECD Inclusive Framework's work on Pillar 2, a proposal for a global minimum tax, may affect developing countries. Developing countries are in critical need of tax revenue to meet their development goals and to fulfill the sustainable development goals (SDGs). We hope our comments will be of value to the United Nations Tax Committee (UNTC) when it turns its attention to the possible adoption of a minimum tax as a means of meeting developing countries' revenue goals.

Key words: BEPS, developing countries, global minimum tax, SDGs

Introduction

While the United Nations Tax Committee (UNTC) has called for comments on how it should address base erosion and profit shifting (BEPS), it has directed its recent attention mainly to an ongoing aspect of the tax community's work on the BEPS program, this being the consideration on how to tax the digital economy.

We focus here on both the more general BEPS subject and, in particular, on how the OECD Inclusive Framework's work on Pillar 2, a proposal for a global minimum tax, may affect developing countries. Developing countries are in critical need of tax revenue to meet their development goals and to fulfill the sustainable development goals (SDGs). We hope our comments will be of value to the UNTC when it turns its attention to the possible adoption of a minimum tax as a means of meeting developing countries' revenue goals. We address three questions:

1. How important are tax incentives that reduce minimum levels of corporate tax to the generation of foreign direct investment (FDI) in developing countries?
2. How will Pillar 2 affect the tax incentives that jurisdictions have adopted to encourage FDI?
3. What should the UN Subcommittee on BEPS do in response to Pillar 2?

To put the questions into context, we examine each of them with respect to tax incentives offered by Kenya. These tax incentives are common to many developing countries. We conclude by recommending that a model corporate minimum tax be adopted by the UNTC.

Pillar 2

Pillar 2 has three main pieces. The first is an income inclusion rule (IIR) that imposes a minimum tax on a Multinational Enterprise's (MNE) overseas activities. The

tax, a so-called "top-up" tax, is to be levied at the rate of 15% by the resident jurisdiction of a parent company of an MNE with respect to any jurisdiction where the combined activities of the MNE are taxed at a rate below 15% of the income reflected on its financial statements (so-called GloBE Income). It applies to MNEs having revenue in excess of 750 million Euros, but countries are free to apply it to smaller companies.

The second component of Pillar 2 focuses on undertaxed profits, known by the acronym as the UTPR. It is to be applied by a low taxed jurisdiction on the residual low taxed income where the IIR has no application. The UTPR operates by requiring the low taxed jurisdiction to deny the subsidiary of an MNE sufficient deductions to raise the tax on the subsidiary to 15%. The sum total of this top-up tax as calculated by all jurisdictions applying a UTPR is then to be distributed pro rata among these jurisdictions using an allocation formula based on tangible assets and the number of employees in each jurisdiction.

The final part of Pillar 2 is a qualified domestic minimum top-up tax (QDMTT) that any jurisdiction is free to apply on corporations engaged in business there. It has priority of application over the IIR and UTPR and will let the source country collect the same amount of tax that the resident jurisdiction would collect under an IIR. Effectively, this turns off the application of the IIR.[1]

For purposes of Pillar 2, two important adjustments are made to the calculation of the effective tax rate in a jurisdiction. The first is a substance-based income exclusion. The exclusion reduces the income going into the effective tax rate calculation. It is equal to 5% of eligible payroll costs and 5% of the carrying value of eligible tangible assets. The second is for qualified refundable tax credits. These credits, which can be claimed irrespective of whether there is sufficient tax to offset them against, are subtracted from taxes paid during the year and instead treated as income. Both of these adjustments give jurisdictions some leeway in the tax incentives they can offer businesses and still not suffer tax under the IIR or the UTPR.

Kenya's Tax Incentives

Tax incentives can be found in the law and in investment agreements entered into with foreign investors seeking to engage in business in a country. The incentives found in the law include tax holidays for a period of years, various forms of accelerated depreciation, generous use of losses, a variety of tax credits, and stabilization clauses that are designed to ensure that the benefits, once granted, cannot be reversed by a subsequent government action. The incentives in investment agreements,[2] typically not open to the public, largely match those found in the law.

The law in Kenya provides for several tax incentives. We focus on two notable ones. They are the incentives for special economic zones (SEZs) and export processing zones (EPZs). EPZs were established in 1990 under the Export Processing Zones Act[3] to attract FDI and turn Kenya into an export-based

[1] Pillar 2 also includes a subject to tax rule that permits source countries to impose a withholding tax at 9% on payments that are taxed below the minimum 15% rate in the jurisdiction where they are received. While important, this is outside of the scope of the discussion in this paper.

[2] Investment agreements should not be confused with bilateral investment treaties. Investment agreements are between private investors and the government while bilateral investment treaties are between two governments. Tax benefits are often found in the former and not so much in the latter.

[3] Export Processing Zones Act Cap 517 of 1990.

economy. Businesses that undertake activities consisting of the manufacture of goods for export are given a 10-year corporate tax holiday and a 25% rate for a further 10 years. The corporate tax rate outside of the zones is 30%. In addition, there is a 10-year withholding tax holiday on dividends and other remittances paid to non-resident parties, and a 100% deduction on new investment in the EPZs for buildings and machinery.

SPEZs were established under the Special Economic Zones Act in 2015[4] to encourage the development of designated types of business, such as agriculture and the provision of business services to regional headquarters, in certain geographic areas. They are considered outside of the customs area of Kenya and for businesses in the zone offer a reduced 10% tax rate for the first 10 years of operation and 15% for the next 10 years. Businesses also get a 150% investment deduction in certain of the zones. Withholding rates are reduced to 5% on third party foreign payments.

While the government argues that the SPZs and EPZs have created jobs and fostered exports, critics have argued that they instead waste tax revenue.[5]

In 2022, Kenya officially launched the Nairobi International Finance Centre created pursuant to legislation enacted in 2017. It is lauded by the government as creating an environment for innovation and new technologies, which will lure investors to inject new capital into Kenyan and regional businesses. The legislation creating the center did not include tax incentives.

However, the government has hinted that such tax incentives may be adopted in the future. In the case of other international finance centers, the tax incentives typically include reduced rates of corporate income tax and the elimination of withholding taxes on any of the payments made on financial instruments.[6]

The Three Questions

Question 1 – How important are tax incentives to the generation of foreign direct investment in developing countries?

A considerable amount of research has been done on whether tax incentives foster foreign investment above that which would have taken place without the incentives. Based on this research, no firm conclusion has been reached on this question.[7] The likely answer is that in some cases, tax incentives have a positive effect on attracting investment, but in many cases, they have no effect and amount to a waste of tax revenue.

The circumstances that warrant the use of tax incentives are situations where international trade costs are relatively low and capital is mobile.[8] Tax incentives are important, moreover, when production and

[4] Special Economic Zones Act[4] No. 16 of 2015.

[5] See ex's, Tax Justice Network Africa and ActionAid International, *Tax competition in East Africa: A race to the bottom?* (May 2012); J. Nyabiage, *KRA pays a price of tax incentives,* African Centre for Open Governance (2022).

[6] Nairobi International Financial Centre Act No. 25 (2017); see for a comment on the draft legislation, VIDC, EATGN, and Tax Justice Network Africa, *Nairobi International Finance Centre or Nairobi Tax Haven* (2017), available at: https://taxjusticeafrica.net/wp-content/uploads/2021/11/NIFC-Report-20172.pdf.

[7] While somewhat dated, see OECD, *Incentives for attracting foreign direct investment: An overview of OECD work* (2002); UN, *Tax Incentives and Foreign Direct Investment,* AST Advisory Studies No. 16 (2000).

[8] OECD, *Tax effects on Foreign Direct Investment,* Policy Brief, February 2008.

market conditions for competing locations for investment are relatively equal. In these cases, the incentives can make the difference on the margin in the investment decision.

Further, tax incentives are more important in some business sectors and in some countries than in others. For example, countries with major domestic markets can safely limit tax incentives in seeking most forms of FDI. FDI is also more important in efficiency seeking enterprises competing in global markets than resource seeking businesses such as mining or the production of petroleum.[9] Although somewhat counterintuitive, tax incentives tend to be less important when tax avoidance schemes are relatively easy to implement then in situations where this is not the case. In the former case, MNEs can create their own tax incentives and do not need a developing country to do this for them.[10]

Some research has been conducted on the effect of tax incentives specifically in Kenya. The studies used various statistical means to measure the impact of tax incentives on FDI. For the most part, the studies concluded that there was a correlation between FDI and the tax incentives in place in Kenya.[11] That said, a correlation between the amount of FDI and a tax incentive does not necessarily mean that the incentive caused the investment.

Question 2 – How will Pillar 2 affect the tax incentives that jurisdictions have adopted to encourage FDI?

The IIR and UTPR will have a direct impact on the tax incentives put in place to encourage FDI. Any decision to adopt a QDMTT as a reaction to these two rules will also have an impact on tax incentives.

First, the IIR will require the resident jurisdiction of an MNE to bring the effective tax rate on the operations of any subsidiary located in a jurisdiction with tax incentives up to the minimum tax rate of 15%. For example, take the hypothetical case of MNE Corp. A located in France that has Sub X, operating in Kenya in an EPZ. Sub X has an income tax holiday for its first 10 years of operation. It earns net income of 1,000,000 USD in a year and pays no income tax to Kenya. Under the IIR, France will levy a tax of 150,000 USD, eliminating the benefit of the 10-year tax holiday (although some of the benefit might be preserved under the "substance-based income exclusion, and the use of "refundable tax credits," as described immediately below). The same result will be reached under the UTPR in that the same amount of untaxed income will be required to be taxed by Kenya if it adopts Pillar 2. Some of this will be given back to Kenya under the formula allocation rule described previously. In either case, the tax benefit has effectively been wiped out. Of course, Kenya could adopt a QDMTT, but this too would eliminate the benefit of its EPZ.

The substance-based income exclusion may operate to save some, or all of the benefits of the tax incentives being offered by a

[9] IMF, *Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment,* (October 2015); OECD, *Corporate Tax Incentives for Foreign Direct Investment,* Tax Policy Studies, Report No. 4 (2015).

[10] IMF, *Options for Low Income Countries, supra.*

[11] See ex's, A. N. Mutisya, W. Muturi & I. Kemboi, *Effect of Tax Incentives on Foreign Direct Investment in Kenya*, International Journal of Business Management & Finance 3(2): 51-64 (2019); M. Gumo, *The Effect of Tax Incentives on Foreign Direct Investment in Kenya,* Research Project Submitted in Partial Fulfillment of the Requirement for the Award of the Degree of Master's of Science of Finance, University of Nairobi (2013), accessible at: http://erepository.uonbi.ac.ke/bitstream/handle/11295/58414/Gumo_The%20effect%20of%20tax%20incentives.pdf?sequence=3.

jurisdiction. Its benefit will only be significant in a jurisdiction where the operating subsidiary has substantial tangible assets and a significant number of employees. Thus, subsidiaries operating in tax havens having few tangible assets or employees will realize little benefit from the substance-based income carve out.

For example, a subsidiary located in Bermuda that owns intangibles on which it charges royalties will receive little or no benefit from this exclusion. The employment of refundable tax credits will also preserve some benefits. For these to be of use, a jurisdiction will need to remove tax holidays and substitute for them some form of a refundable tax credit that can be used against the tax otherwise due there. Typically, these credits have been used for research type expenditures and not given simply to reduce a rate of tax without a qualifying expenditure.

For Kenya, its SEZ and EPZ will likely lose a considerable part of their economic value if Pillar 2 moves forward, and it will render their continued use questionable. Some of its value will be preserved under the substance based income exclusion that Kenya will be entitled to, but the exact amount of the benefit that will be preserved is hard to estimate at this time. The type of tax benefits that may be bestowed on the Nairobi International Finance Centre likely would lose much of their value as well. It would, moreover, probably benefit little from the substance-based income exclusion since finance centers have not much in the way of tangible assets and often have only a moderate number of employees.

Question 3 – What should the UNTC do in response to Pillar 2?

Currently, predictions are hard to make on whether Pillar 2 will be adopted by enough jurisdictions to have a real impact. The U.S. has a form of an IIR rule, but its rule lacks some of the significant elements of the IIR. The EU and some other large, developed countries are contemplating adopting an IIR. If these countries do in fact move forward and adopt an IIR rule, Pillar 2 will come into effect (although a particular country may shield itself from its operation, somewhat, by choosing to enact a QDMTT or other form of a minimum tax).

What then should the UNTC on BEPS do about Pillar 2? Many developing countries have high corporate tax rates and depend heavily on corporate taxes as a major source of tax revenue. However, many of these countries also employ significance tax incentives with the view to attracting FDI. Historically, the UNTC has been careful to preserve the tax sovereignty of its member countries. For this reason, many of its policies leave its members free to adopt them or not.

Given this background, we suggest the following three-pronged agenda for the UNTC subcommittee on BEPS to follow.

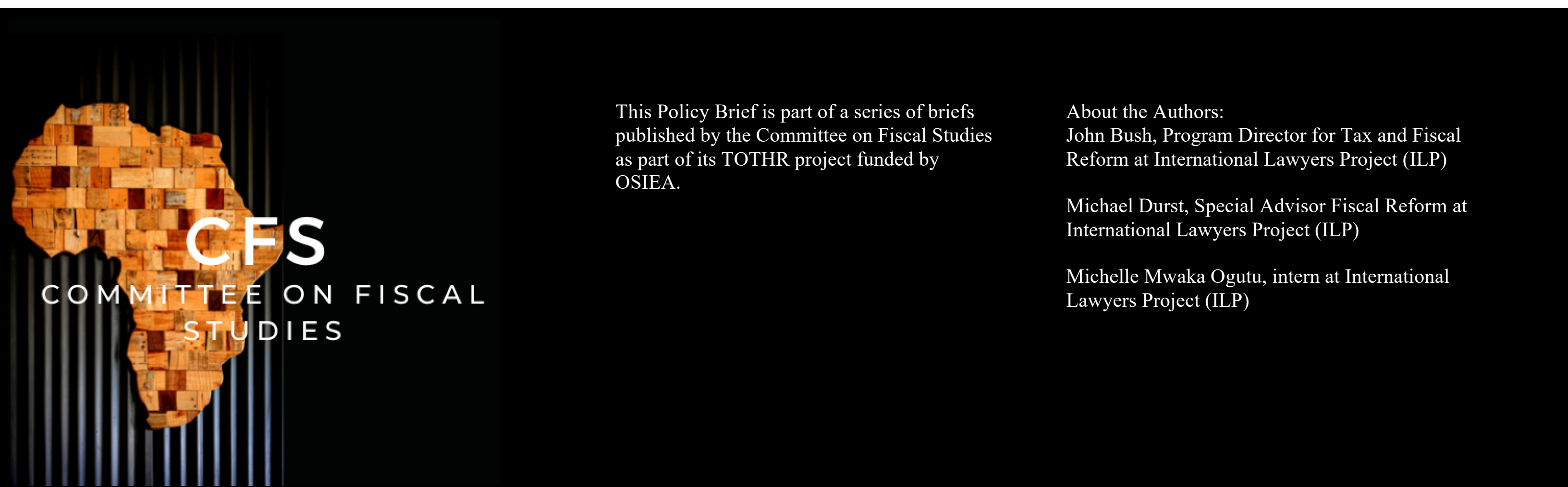
1. First, it should make clear the critical need for countries to maximize tax revenues to realize their development goals and to advance the SDGs; therefore, Pillar 2 should as a general matter be supported.

2. Second, it should recommend that any form of tax incentives be carefully weighed before being adopted considering the factors enumerated in this policy brief as to how effective they are likely to be. Further, the form of tax incentives should all have a substance-based exclusion. This could take the form of

the substance based carveout under Pillar 2 or some similar rule.

3. Third, the QDMTT has some real value to it. It can only be used in its present format if Pillar 2 is adopted as now articulated. Nevertheless, some form of a model minimum tax would be a useful addition to the international tax system.

While Pillar 2 may not move forward as presently fashioned, it creates an opportunity for the international tax community to consider the direction that the next generation of tax rules should take. One aspect of this is some form of a model minimum corporate tax. We advocate that one be adopted by the UNTC.



This Policy Brief is part of a series of briefs published by the Committee on Fiscal Studies as part of its TOTHR project funded by OSIEA.

About the Authors:
John Bush, Program Director for Tax and Fiscal Reform at International Lawyers Project (ILP)

Michael Durst, Special Advisor Fiscal Reform at International Lawyers Project (ILP)

Michelle Mwaka Ogutu, intern at International Lawyers Project (ILP)