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Michael C. Durst is an attorney who has written widely on transfer pricing, base erosion, and taxation in developing countries and served as director of the IRS advance pricing agreement program from 1994 to 1997. The author thanks John Bush, Stephen E. Shay, and Scott Wilkie for insightful comments on an earlier draft.

In this article, Durst explains how pillar 2 will reduce the use of profit shifting by multinational groups to lower effective tax rates while increasing the use of nontax incentives, a shift that could increase countries' overall social welfare provided that the nontax incentives receive proper political oversight.

The OECD's pillar 2 global minimum tax would prevent a multinational group from reducing its effective tax rate below 15 percent in any country in which an affiliate is subject to tax.[1] The global minimum tax is expected to result in profound changes to the tax planning of multinational groups around the world. For decades, affiliates of multinationals have routinely reduced their ETRs to very low levels in two ways:

- through base erosion and profit-shifting tax planning, which relies on long-standing defects in international tax laws, including the transfer pricing rules, to allow the shifting (stripping) of taxable income from affiliates operating around the world;[2] and
- by availing themselves of explicit tax incentives, like tax holidays and special economic zones, that countries frequently use to attract foreign direct investment.[3]

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[1] The pillar 2 global minimum tax is also known as the "GLOBE tax." A collection of official documents detailing the pillar 2 proposal is available at OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)" (last accessed Mar. 31, 2023). Citations to a number of commentaries on the pillar 2 proposal can be found in Leopoldo Parada, "Global Minimum Taxation: A Strategic Approach for Developing Countries," SSRN (2022). For an interesting political analysis of pillar 2, focusing on the topic of national sovereignty, see Scott Wilkie, "Pillar 2 — 'What's It All About?'" *Tax Notes Int'l* (forthcoming 2023).

[2] Base erosion and profit-shifting planning typically centers on the deduction by local affiliates of multinational enterprises of large payments to related companies based in zero- or low-tax countries, for items like management fees, royalties for the use of the group's technology, and interest on intragroup debt. After the payments, little taxable income is left in the local affiliate.

Income stripping of this kind is supposed to be controlled largely by the OECD's transactional net margin transfer pricing method (TNMM). The TNMM ostensibly uses statistical techniques, based on "comparables" identified from publicly available financial data, to determine "arm's-length ranges" and therefore set minimums on the amounts that local affiliates must retain after making payments to related parties. But the statistical method used under TNMM is typically flawed, owing primarily to the use of excessively small sample sizes of comparables. Therefore, arm's-length ranges determined under TNMM tend to be extremely wide, allowing for a great deal of profit shifting. For a history of BEPS, see Michael C. Durst, "Poverty, Tax Competition, and Base Erosion," *Tax Notes Int'l*, Mar. 19, 2018, p. 1189 (which is Chapter 2 of the author's book, *Taxing Multinational Business in Lower-Income Countries* (2019)). For discussion of the role of the TNMM in facilitating BEPS, see Durst, "It's Time to Reform Transfer Pricing Benchmarking," *Tax Notes Int'l*, June 6, 2022, p. 1271.

Intragroup interest payments are supposed to be controlled not primarily by transfer pricing methods like the TNMM but by special rules adopted by countries that limit the deduction of interest, such as by limiting interest deductions to a specified percentage of the taxpayer's income. *See* OECD/G-20, "BEPS Action 4: Limiting Base Erosion Interest Deductions and Other Financial Payments" (2015). Interest deduction limitations around the world today are of varying effectiveness in controlling income stripping.

[3] Countries offer a wide range of nontax, as well as tax-based, incentives to promote foreign direct investment. For a useful summary, see the descriptions provided by the Government of Nigeria, "Nigeria Investment Incentives" (last accessed Mar. 31, 2023).

The 15 percent minimum tax will reduce the appeal of both the implicit investment incentives made available by BEPS planning and the explicit tax-based incentives that countries provide through measures like tax holidays.[4]

Pressure of Tax Competition

The pillar 2 proposal can best be understood as an attempt to limit the pressures of tax competition on governments by reducing the extent to which all countries can lower their ETRs, even if they wish to do so.[5] The reduction of tax competition is intended to enable countries to reach a more desirable policy balance, regarding ETRs, than the balance that countries can achieve when faced by the pressures of today's level of tax competition.

In every country, there exists tension between the competing goals of raising government revenues and attracting foreign direct investment.[6] It seems to be accepted by most that progress toward either goal enhances social welfare. That is, most would agree that there are social benefits to a country from both raising revenue to fund a higher level of public services, and growing a country's economy through foreign investment.[7] There is, however, a trade-off between raising revenue and attracting foreign investment: Other things being equal, the higher the effective corporate tax rate in a country, the less likely companies are to locate investments there. In view of this trade-off, rational corporate tax policymaking can be seen as a process of balancing these two competing goals. Provided that the balance is determined through a legitimate and transparent political process, the balance reached can fairly be described as welfare-optimizing.

The pillar 2 minimum tax is based on the view that because of current levels of tax competition, countries have been unable to achieve ETRs that optimally balance between raising revenue and incentivizing investment. For example, a country might try raising its ETR by unilaterally curtailing the benefits from BEPS-style planning, or it might instead try reducing the tax benefits it is willing to offer through explicit tax subsidies like tax holidays and special economic zones. The country may well be constrained, however, from implementing either of these two policies by the expectation that other countries will continue to offer appealing implicit and explicit tax benefits to investors, gaining a competitive advantage in attracting investment. Especially in the developing world, fear of tax competition has tended to freeze ETRs at levels that almost certainly are lower than would be consistent with a desirable balance between investment and taxation. The global minimum tax is intended to dampen (but not eliminate) tax competition[8] so that countries can reach a more desirable balance between the competing goals of revenue-raising and attracting investment.

Nontax Incentives

It is sometimes suggested that the pillar 2 minimum tax is flawed because nothing in it constrains governments from replacing existing tax-based incentives with economically equivalent nontax incentives. Tax competition might simply be replaced by competition over the issuance of nontax incentives, leaving countries in essentially the same financial position as before the new minimum tax.[9]

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[4]Under a substance-based income exclusion (SBIE) rule, the pillar 2 proposal exempts from its coverage some tax-based incentives that are tied to investments in tangible property and in employment. In addition, taxpayers are permitted to receive certain "qualified refundable tax credits" without their ETRs being reduced for purposes of applying pillar 2. *See generally* Victoria Perry, "Pillar 2: Tax Competition in Low-Income Countries and the SBIE," Saïd Business School Working Paper 2022-24 (Dec. 2022).

[5]For a detailed analysis of pillar 2's effects on tax competition, see John Vella, Michael P. Devereux, and Heydon Wardell-Burrus, "Pillar 2's Impact on Tax Competition," SSRN (2022).

[6]For discussion of this trade-off, see Durst, "Poverty, Tax Competition, and Base Erosion," *supra* note 2.

[7]I use the word "most" because there are undoubtedly some who think that foreign direct investment actually reduces a country's well-being, such as through environmental damage; and there also are some, typically on the other side of the political spectrum, who view a corporate income tax to be inherently welfare-reducing, even at low rates. This article is based on the view that both foreign investment (with appropriate environmental, labor, and other protections) and corporate tax revenues are welfare-enhancing in themselves, although there is an often difficult trade-off between achieving the two goals.

[8]Peter A. Fischer and Christoph Eisenring, "OECD Negotiator Pascal Saint-Amans Wants to Limit Tax Competition," *Neue Zurcher Zeitung*, July 11, 2021 (interview with Pascal Saint-Amans): "The reform does not eliminate tax competition, but it does set multilaterally-agreed limitations on it."

[9]For general discussion of replacing tax-based with nontax incentives, see Noam Noked, "From Tax Competition to Subsidy Competition," 42(2) *U. Pa. J. Int'l Law* 447 (2020); and Parada, *supra* note 1.

It is indeed likely that at least some of the tax-based incentives rendered less effective by the new minimum tax will be replaced by nontax incentives. The replacement, however, is unlikely to be complete, or even nearly so. Today, a substantial portion of the corporate tax reduction enjoyed by companies derives not from explicit tax incentives like tax holidays, but instead from the tacit acceptance by governments of the defects in transfer pricing and other tax rules that make BEPS-style tax planning possible.

Governments have not explicitly endorsed BEPS-style planning, nor, as a general matter, have they attempted to set legal limits on the extent of its use. Governments instead have tacitly allowed BEPS planning to happen at volumes that exceed those a government would explicitly endorse through a considered lawmaking process.

Once the new pillar 2 minimum tax has rendered BEPS-style tax planning less available, governments will have the option to replace the lost implicit incentive by enacting nontax investment incentives like investment grants. Some substitution of this kind undoubtedly will occur, and to some extent the substitution will be motivated by an "incentives competition" similar to the tax competition that brought about the widespread toleration by governments of BEPS. It seems unlikely, however, that *all* the lost tax incentives from BEPS will be replaced by financially equivalent nontax incentives. The greater degree of political evaluation and control that is afforded nontax incentives (including control effected by international lenders like the World Bank and IMF) may well induce greater restraint on the allowance of those incentives than has been applied to the tacit allowance of BEPS.

Moreover, even if this expectation proves to be unfounded, and most or even all the BEPS planning's incentive effect is replaced dollar-for-dollar by nontax incentives, the net effect should be to increase social welfare. The substitution of incentives that have been subjected to explicit political evaluation, for BEPS-based tax incentives that receive virtually no political oversight, should result in a net augmentation of social welfare.[10]

Political Oversight

All this leads, finally, to an important point concerning political accountability in the granting of investment incentives. I have suggested in this article that the substitution of explicit incentives for the unlegislated, tacit incentive represented by BEPS will in itself represent an addition to social welfare. But this benefit can be realized only if countries actually submit their incentive-granting practices to rigorous political oversight. There is simply too much money involved in investment incentives, and too much opportunity for favoritism and corruption, to permit a country's oversight of investment incentives to operate ineffectively.

The implementation of the new global minimum tax should provide the impetus for review, in all countries, of the political oversight of investment incentives. Safeguards should be included to protect the decision-making process from rent-seeking. Finally, the approval process itself should be based on cost-benefit principles to ensure that a proposed incentive is not more generous than necessary to attract the desired investment, and that the social value of the investment justifies the cost of the proposed incentive. If pillar 2's elevation of the importance of nontax incentives helps stimulate more rigorous review of investment incentives around the world, its net welfare benefit will be substantially enhanced. ■

[10]The replacement of tax-based incentives by nontax incentives may also have welfare effects because of differences in the efficiency of the two kinds of incentives. *See generally* Noked, *supra* note 9, and Parada, *supra* note 1.