BUSINESS at OECD

March 11, 2022

To: The Chairs & Members of Working Party 11 on Aggressive Tax Avoidance (WP11)

c/o Pascal Saint-Amans, Grace Perez Navarro and Achim Pross
OECD Centre for Tax Policy and Administration (CTPA)

Dear Chairs and Members of WP11,

When we wrote to you on 6th January, noting three major structural issues with the Pillar Two Model Rules, we also noted that it might be necessary to write to you again, should other major issues emerge as business worked through the implications of the 20th December 2021 Pillar Two Model Rules[1]. *Business at OECD* (BIAC) members have now identified a further issue caused by a change in direction under the Model Rules that we believe may threaten the ultimate success of the Pillar Two project. We are aware this may be considered a "policy issue", but, nevertheless, given its potential impact, we did want to draw it to your attention, and suggest that it may need refinement or even change.

The issue relates to the effect of the UTPR, especially, in the UPE jurisdiction, when that UPE has availed itself of UPE country tax incentives and credits that are not qualified refundable credits as defined in the Model Rules. The result of this is that the use of the non-qualified tax incentives or tax credits – because they reduce covered taxes – may end up reducing the ETR of the UPE in its home country below 15%, even though for local tax purposes it may be well above 15%. This is turning out to be a political issue of some significance because it can – in effect – be characterized as other countries reaping the benefits of tax credits and incentives granted by the UPE jurisdiction.

We have especially been alerted by our members to three cases where this provision on non-qualified credits can have undesirable societal effects:

- **In the case of Research & Development incentives that are not qualified refundable credits**. Such incentives are a legitimate and favored means of promoting innovative and societally valuable activity that a country believes to be desirable – often where "market failure" (for reasons of risk, or other economic effects), means that private sector investment would not otherwise be made.[2]
- **In the case of "social" incentives.** These incentives, an example of which is the Low Income Housing Tax Credit in the U.S., encourage investment in socially desirable outcomes that, again, would not otherwise attract private investment because of lower returns on investment.
- **Finally, in the case of credits for renewable energy in relation to "green transition"**. Given the importance of this to such crucial EU initiatives as "Fit for 55", as well as to the critical question of energy security – and the crucial part renewable energy will play in that – this becomes an even more important issue in the EU and elsewhere.

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[1] *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)* ("Model Rules")

[2] A number of these regimes have been reviewed by the OECD Forum on Harmful Tax Practices and been found not to be harmful. (And in the case of R&D regimes, rarely even considered by the FHTP, because of the lack of base eroding potential – a consideration especially true in the UPE jurisdiction.)

Two arguments have been made against revisiting this issue. First, it is argued, that this result was clear two years ago from the Blueprint, when the Substance Based Income Exclusion was suggested as a proxy for individual credits. And second, that countries can move to qualified refundable credits to solve this issue. However, we think that neither of these arguments is currently completely persuasive.

- First, only in December with the publication of the Model Rules, did it become clear that the UTPR could be applied without any transactional link (i.e., payments) between the country of a subsidiary and the country of the UPE and thus without the explicit cap provided in the October 2020 Blueprint. What had previously been understood (including in the 8 October 2021 Agreement) to require a deductible payment in one country leading to an inclusion in the UPE country, no longer requires that link. The result is that any country with a subsidiary can impose the UTPR on a sub of the UPE entity, regardless of the lack of a link between payments and incentive regimes. Suddenly, what had been viewed as a BEPS measure against unfair tax competition, became a means of extraterritorial taxation. Put differently, a rule previously aimed at certain "unfair" incentive regimes, now applied indiscriminately to all incentive regimes, regardless of how beneficial they might be for social, economic and other legitimate policy reasons unless they are in the form of qualified refundable credits.

- Second, there are myriad reasons why countries cannot move *en masse* towards refundable credit regimes, including the potentially significant fiscal cost of that in early years. Furthermore, Pillar Two was not intended to force countries into adopting a certain type of credit.

We understand that the IF will not wish to exempt all credit and incentive regimes, and while we do not call into question the current treatment of qualified refundable credits in the Model Rules, we also believe that the current UTPR rules are so indiscriminate and "broad spectrum" as to restrict countries' legitimate societal interests in promoting certain types of beneficial activity.

We would urge you to consider how this issue might be addressed, otherwise we are concerned that it will inhibit the uniform adoption of Pillar Two rules, while also encouraging other countries to extraterritorially tax income that UPE countries have willingly and legitimately forgone.[3, 4]

We would of course, be happy to send you more details from our members, and to work with you on a satisfactory solution to this problem.

Sincerely,

Alan McLean
Chair, *Business at OECD* (BIAC)
Committee on Taxation and Fiscal Affairs

William H. Morris
Chair Emeritus

Cc: Hanni Rosenbaum, Executive Director, *Business at OECD* (BIAC)

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[3] A number of members have specifically drawn attention, in this regard, to make sure that any changes to the US BEAT rules are coordinated with the Pillar Two UTPR in order to keep a level playing field.

[4] The argument has also been made that the UPE country need not lose the revenue if it imposes a QDMTT. But this again misses the main point, namely that a country can still not give tax benefits in its home country to businesses for activities deemed to be societally important – and for which the formulaic SBIE is not adequate compensation.