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POLICY BRIEF

Inclusive Framework Agreement on the Global Minimum Tax:

Recommendations to address stabilized fiscal conditions

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Background

On October 8, 2021, 136 countries agreed to a *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (hereinafter referred to as the "statement").[1] The statement was an important step for the global initiative to address the tax challenges arising from a digitalized economy, led by the Organisation for Economic Co-operation and Development (OECD) since 2018. The reform includes two pillars. Pillar One creates a new taxing right for businesses selling goods and services digitally in countries where their users or consumers are physically located. Pillar Two ensures that all global profits of multinational companies are taxed at a minimum effective tax rate of 15%, beyond a carved-out amount of income equal to 5% of the company's total expenditure on employees and tangible assets. This note focuses on Pillar Two.

Pillar Two should achieve its aim indirectly by undermining the logic of tax competition. It does not require every country to raise their income tax rate above the globally agreed minimum. It creates four rules (known as the "GloBE rules") that allow countries to tax foreign income when that income is taxed under 15%, under certain conditions.

1. The **income inclusion rule** allows a home country to tax the income of the foreign branches and subsidiaries of a parent company in its jurisdiction if they do not pay the minimum effective tax rate in their host country(ies).
2. The **switch-over rule** complements the income inclusion rule by permitting the home country to tax on a worldwide basis (the "credit method") profits made by an overseas branch or from immovable property subject to less than the global minimum rate.

[1] The statement is available at 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.htm

3. The **undertaxed payments** rule gives host countries the right to tax payments made by multinational companies operating in their jurisdiction to foreign affiliates when these payments are not taxed at a minimum level. The rule will work by the home country either denying a deduction or imposing tax (including withholding tax) on the payment to the foreign affiliate.
4. The **subject to tax** rule will complement the undertaxed payments rule by disallowing reductions in the tax that a company pays in the host country because of its tax treaties, where the payment affected by the tax treaty is not subject to the minimum rate.

The outcome should make the most harmful tax practices ineffective: jurisdictions that reduce their effective tax rate below 15% through tax incentives would simply transfer tax revenue up to 15% to one or more jurisdictions that would collect the difference.

The OECD-G20 Inclusive Framework on BEPS members that agree to adopt the GloBE rules outlined in Pillar 2 will be required to implement and administer the rules in a way that is consistent with Pillar 2, including model legislation and a commentary approved by the Inclusive Framework. The model legislation is intended to give effect to the income inclusion rule and the undertaxed payment rule. It will be supplemented by a commentary that explains the purpose and operation of the rules, as well as the need for a switch-over rule in certain treaties. The subject to tax rule will be addressed separately through a multilateral instrument.

The Issue: Removing Stabilized Fiscal Conditions

Pillar Two will require many states, both within and outside of the Inclusive Framework, to review their domestic tax policy, designed in the absence of a global minimum tax. For instance, a country may choose to increase its headline corporate tax rate or remove tax incentives that leave companies paying less than the global minimum tax in its territory. This would, for example, include long-term tax holidays granted to large foreign investors.

However, some tax incentives may be locked in by fiscal stabilization clauses in domestic law or investment contracts with foreign investors. For instance, one West African country's investment code exempts eligible investors from all taxes, duties, and charges, except certain indirect taxes, for a period of 30 years. The investment code additionally states that investors will continue to receive the benefits listed regardless of any legislation enacted after publication of the Act that might mitigate or remove them. In another example, a neighbouring country recently concluded an investment contract for a large mining project that stabilizes the entire tax regime, including a 10-year tax holiday, for 25 years.[2]

"Fiscal stabilization" clauses are provisions that purport to limit or could be interpreted as limiting the ability of the government of the host jurisdiction to change the fiscal law applicable to an investor or investment in its territory or that requires economic compensation for enacting such changes in law. These clauses in domestic laws and contracts could make it difficult for governments to adapt their tax policy to the new reality of a global minimum tax

[2] Convention de base entre La République de Guinée et Winning Consortium Simandou SAU-SAU pour l'Exploitation du Mineral de Fer des Blocs I et II de Simandou. https://resourcecontracts.org/contract/ocds-591adf-9254500989/view#/pdf

without the risk of being sued in international arbitration. Historically, companies have been very protective of legal rights awarded under stabilization clauses. In addition, investment treaties with investor–state dispute settlement provisions may provide additional opportunities for companies to challenge any change in the host country's tax policy.

Few developed countries offer stabilization in their domestic law or investment contracts.[3] Therefore, the stabilization issue is primarily a problem for developing and emerging economies—the most vulnerable to tax competition. It also affects developing countries that have not signed up to the statement but have stabilized preferential tax arrangements for multinational companies headquartered in countries that have signed up. It is critical, therefore, that the Inclusive Framework find a solution to address stabilized tax incentives that could prevent developing countries from aligning their tax policy with a global minimum tax and forgoing vital tax revenues as a result.

This note provides recommendations on how the OECD could design the model legislation and commentaries to effectively address the issue of stabilized tax incentives. It builds on the International Institute for Sustainable Development's recent guidance to developing country governments on how to amend their tax incentives regimes to benefit from the minimum tax,[4] as well as contributions from the Intergovernmental Forum on Mining, Minerals, Metals, and Sustainable Development (IGF) on specific implementation issues of the global minimum tax in the mining sector.[5]

Recommendations to Address Stabilized Tax Incentives in Drafting the Model Legislation and Commentary

The OECD Secretariat is drafting model legislation to give effect to certain aspects of the GloBE rules. It will be accompanied by a commentary explaining the overall purpose of the rules.

First, the draft model legislation should indicate clearly that the global minimum tax applies to all investments irrespective of any tax rates or incentives that the domestic law, investment contracts, or investment treaties purport to stabilize and that would result in an effective tax rate that is below the global minimum rate.

In addition to adopting a strong statement in the model legislation, we recommend that the commentaries also address the following:

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[3] See Section 6 of International Finance Corporation. (2009, May). *Stabilization clauses and human rights: A research project conducted for IFC and the United Nations Special Representative of the Secretary-General on business and human rights.* https://www.ifc.org/wps/wcm/connect/0883d81a-e00a-4551-b2b9-46641e5a9bba/Stabilization%2BPaper.pdf?MOD=AJPERES&CACHEID=ROOTWORKSPACE-0883d81a-e00a-4551-b2b9-46641e5a9bba-jqeww2e

[4] Readhead, A., Lassourd, T., & Mann, H. (2021, June 24). The end of tax incentives: How will a global minimum tax affect tax incentives regimes in developing countries? *Investment Treaty News.* https://www.iisd.org/itn/en/2021/06/24/the-end-of-tax-incentives-how-will-a-global-minimum-tax-affect-tax-incentives-regimes-in-developing-countries/

[5] IGF. (2021). *Taxing the digital economy: Implications for mining.* https://www.igfmining.org/beps/current-topics/taxing-the-digital-economy-implications-for-mining/

1. Inclusive Framework members should state that measures adopted by states in good faith to adapt their tax law to the implementation of the GloBE rules, including establishing domestic effective tax rates at or above the global minimum tax level, are deemed to be in accordance with any investment treaty in force with a member of the Inclusive Framework that has also committed to implementing the GloBE rules.
2. Inclusive Framework members should clarify that they do not consider measures adopted by states in good faith to remove, unwind, or suspend provisions in their domestic laws or investment contracts to implement the GloBE rules or to adjust domestic tax rules to the global minimum tax as arbitrary, discriminatory, expropriatory, or otherwise in breach of international law, nor should they be considered a change in law constrained by fiscal stabilization provisions in domestic laws or investment contracts.
3. Members of the Inclusive Framework should avoid including fiscal stabilization provisions in investment contracts or domestic laws or concluding broad investment treaties with stabilizing impact to the extent that they could freeze or stabilize domestic effective tax rates under the global minimum tax level and prevent the modification of domestic tax rules required for the implementation of Pillar 2.
4. Multinational companies in the scope of the GloBE rules should be encouraged to state their support for an appropriate revision of stabilized provisions to allow all countries to adapt their tax policy to the global minimum tax. In this way, companies could lay the conditions under which they will not challenge measures to revise stabilized tax rates and incentives to bring all companies operating in its jurisdiction up to the minimum effective tax rate of 15%.

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