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Taxation of Extractive Industries

Tax Incentives and the Global Minimum Tax in the Extractive Industries

Summary

This paper CRP.39 is presented to the Tax Committee at its Twenty-seventh Session for **discussion and review as a first read of the attached possible Committee guidance**. The comments, suggestions, and guidance will serve to improve the paper with the view to submitting a final draft of the attachment at the Twenty-eighth Session for approval.

Tax incentives in the Extractive Industries are used by almost all developing countries endowed in natural resources. The viability and value for money of such incentives have been examined in their various aspects in different recent publications. A whole chapter on the topic is published in the updated Handbook on Selected Issues for Taxation of the Extractive Industries, 2021.

This paper focuses on the potential impact on tax incentives in the Extractive Sector of Pillar 2 of the OECD and Inclusive Framework on BEPS' "Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy".

In examining the potential impact on tax incentives of this package, this note should not be read as making assumptions about the level of international take-up or otherwise of the approaches proposed as part of that BEPS project. That will become clearer over time as countries make their sovereign tax policy decisions. Some level of take-up of Pillar Two of the proposals for domestic legislation in participating countries will have consequences for other countries, while the proposed Pillar One multilateral convention requires a high level of take-up through ratification or similar processes to enter into force internationally and have a legal impact.

Resource-rich countries and foreign investors would be impacted by Pillar 2 in different ways. As a result, each country must assess the likely impact of Pillar 2 on its own tax revenue base. Various aspects and interaction between tax incentives and Pillar 2 are examined in this paper using practical examples to help explain some key concepts with possible options for countries to consider.

By default, Pillar 2 would create a pool of additional tax payable to jurisdictions that implement GloBE's rules. Resource-rich countries may want to ensure that any additional tax payable by multinational enterprises as a result of Pillar Two, which relates to profits made in their jurisdiction, is payable domestically. This may require changes to the domestic corporate tax laws applicable to extractive projects through a combination of one or more proposals on key issues examined in this paper. These issues include effective tax rate at 15% of the profit, considering the level of domestic effective minimum tax, and how any existing stability agreements can be amended if necessary.

Tax incentives and the global minimum tax in the extractive industries

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1. Introduction / Background

1.1 A brief introduction to Pillar Two

1. In October 2021, 138 members of the OECD/G20 Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS) agreed to a statement on the operational model of the Global Anti Base Erosion (GloBE) rules. The GloBE rules form part of a broader project by the OECD/G20 that builds on the 2013 project on Base Erosion and Profit Shifting. This work culminated in a proposed "two-pillar solution" aimed at addressing the tax challenges arising from the digitization of the economy, with the global minimum tax being the hallmark of Pillar Two.

2. Whilst the implementation of Pillar Two is not compulsory for all IF members, members of the IF may voluntarily choose to adopt the GloBE rules, and where such a choice is made, those electing members commit to administer and implement the model rules in a manner that is consistent with the overall aims of the framework. Members of the IF also agree to provide information to enable others to apply the GloBE rules if they wish to implement them.

3. In essence, the GloBE rules include an Income Inclusion Rule (IIR), which operates in a similar manner to the existing controlled foreign company rules, seeking to impose a minimum tax rate on the profits of companies controlled by multinationals. It is complemented by an Under Taxed Profit Rule (UTPR), which acts as backstop in cases where headquarters jurisdictions do not implement an IIR. There are however significant differences in practice, including the fact that the calculation of profit under the IIR and UTPR is based on the financial statements (with some adjustments) rather than on the taxable profit, as well as an exemption for a level of profit determined in relation to the amount of substance, as measured by employment and assets.

4. The impact of this on tax incentives is to impose a "top up tax" at the headquarters level where the effective rate of tax (ETR) in a subsidiary is below 15% of accounting profit. As such, tax incentives which lower the ETR below this level will be at least partially ineffective, as, where the rules apply, additional tax will be payable at the headquarters level.

5. This requires governments to rethink the type of tax incentives that they extend to companies covered by the GloBE rules. Countries face the prospect of their tax policies being affected by Pillar Two whether or not they are a part of the IF or endorse it, though the nature and extent of the effect can vary, especially depending on take-up internationally.

6. Pillar Two also includes a Subject to Tax Rule (STTR), which is a treaty-based rule that applies to intragroup payments (interest, royalties and a defined set of other payments) from source jurisdictions (i.e., the jurisdiction in which the income arises) that are subject to tax rates below 9% in the payee's jurisdiction of residence. The STTR allocates to the source country a limited and conditional taxing right to ensure a minimum level of taxation. The STTR takes priority over the GloBE rules. It is not discussed in detail in this paper except to the extent it interacts with the IIR.

7. The main body of this paper assumes a familiarity with the GloBE rules and Appendix A provides a brief overview as a recap.

1.2 Why is Pillar Two important to the extractives industries?

8. Whilst the extractive industries are expected to be mostly excluded from Pillar One, they are very much in scope of Pillar Two. These industries could be sensitive to the operation of Pillar Two, because of their economic characteristics, and the number and type of tax incentives that they benefit from.

9. Companies operating in the extractive sector are often subject to high sunk costs in the form of substantial capital inputs. These costs cannot be recouped when a project is unsuccessful. Significant investment in exploration and development is often sourced from the private sector. The long lead times from the initial investment to project start-up and profitability as well as the relatively long project lives, which can span beyond 30 years, expose the sector to economic risks (fluctuating commodity prices and volatility of demand) and adverse changes in the legal and regulatory framework. The cost of environmental responsibilities, including untimely decommissioning as well as reclamation activities, may further be identified as inherent factors that distinguish the sector.[1]

10. These characteristics of the sector are the rationale for certain differential tax treatments of extractive companies. In many jurisdictions, a special regime is applied to the extractive industries to balance domestic resource mobilization with the need to promote investment by partially reducing the high costs and project related risks. Companies in the sector are often afforded tax incentives to help them recoup their investment faster in successful projects. The most used tax incentives in the sector include longer loss carry forward rules, accelerated depreciation rules, preferential treatment of long-term capital gains, incentives that encourage local procurement, and, in some jurisdictions, tax holidays and reduced corporate income tax (CIT) rates.[2]

11. GloBE rules will potentially impact the effectiveness of many profit-based tax incentives that serve to lower a company's ETR. This invites countries to reconsider the type of incentives offered to companies, especially countries that use the extension of tax incentives as a leading investment promotion tool. Countries that continue to extend ETR reducing tax incentives to extractive companies covered by the rules may risk forgoing taxes for no benefit as those taxes would then be paid (through the operation of the IIR or UTPR) to tax authorities in the residence jurisdictions of multinational corporations, rendering the incentive ineffective or significantly diminished.[3]

12. However, the introduction of the GloBE rules will not affect all tax incentives.

- First, the GloBE rules will only apply to in-scope companies, i.e., with an annual turnover above €750 million.
- Second, the rules allow for a substance based carve out which excludes from the GloBE tax base a certain amount of income calculated by reference to a fixed return on assets and

[1] Committee of Experts on International Cooperation in Tax Matters; Nineteenth Session (2019), Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries.

[2] Committee of Experts on International Cooperation in Tax Matters; Nineteenth Session (2019), Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries.

[3] Supra note 8.

payroll expenses in each jurisdiction. As payroll and tangible assets constitute a significant portion of many extractive companies' financial activities, it is significant to the sector that tax incentives that reduce taxes on routine returns from investment in substantive activities will not trigger additional GloBE top-up tax. The use of payroll and tangible assets as indicators of substantive activities is justified on the basis that these factors are generally expected to be less mobile and less likely to lead to tax-induced distortions.

- Furthermore, not all tax incentives will have the same ETR reducing impacts and may continue to be extended to companies operating within the industry with moderate to lower risks of triggering a top up tax.

13. Finally, extractive industries benefit from "stabilized" fiscal regimes in many developing economies. Stability provisions are clauses in laws or contracts that either freeze in time the fiscal regime agreed at the outset, or require economic equilibrium where changes are made, can hinder future amendments to the fiscal regime. This might be a constraint for governments seeking to adapt their fiscal policy to the introduction of a global minimum tax, especially the case if the stability clause is picked up and made an enforceable treaty obligation by an investment agreement.

14. This paper explores the possible impacts of the GloBE rules on the taxation of the extractive industries. The paper assesses the impact of GloBE on the most used tax incentives within the sector, to assist policy makers in determining which incentives will remain effective investment promotion tools under the GloBE rules. The paper also considers the impact of stability clauses on the application of GloBE rules with specific attention on the interaction of the rules with subsisting stability agreements. The paper then offers some policy options for resource rich economies wishing to optimize their extractive revenue within the context of GloBE Pillar Two through changes to their domestic fiscal policy.

2 The impact of GloBE on extractive industries

2.1 Which companies / projects are affected (in-scope vs out of scope companies)?

15. The global minimum tax can apply to investments in countries that are not part of the Inclusive Framework, or which choose not to implement Pillar Two themselves. This would be the likely result of an IIR imposed in a shareholder jurisdiction, or a UTPR imposed.

16. It is important to note that not all investments will be subject to Pillar Two. For example, investors which do not meet the requisite annual group turnover threshold of €750m, some investment funds and equity accounted investments are generally not within the Scope of Pillar Two (apart from certain joint ventures and partially owned parent companies subject to specific rules). In considering the impact of Pillar Two, governments may want to start by identifying which investors in extractive projects in their countries are likely to be in scope. It is possible large MNEs may have certain investments out of scope, because equity accounted investments are outside of the scope of Pillar Two. For example, if a large extractive group has a minority interest in an extractive project that is equity accounted, without control, the profits from that investment will not be subject to the global minimum tax.

2.2 Which fiscal instruments commonly used in the extractive industries are considered "Covered Taxes", and which ones are not?

17. Different types of taxes have different treatment under Pillar Two. Certain taxes will not be 'Covered Taxes' i.e., not count towards the Pillar Two ETR calculation. This section reviews the "Covered Tax" definition of the GloBE rules and compares it with the typical fiscal instruments levied on extractive industries, as set out in the "fiscal take" chapter of the Handbook[4]. It draws conclusions on how fiscal regime design for extractive industries could be impacted by GloBE Rules.

18. Information required for the Pillar Two ETR to determine Covered Taxes will generally be sourced from MNE's financial statements. However, extractive companies not only report income taxes in country-by-country reports (CBCRs), but many also file so-called "payments-to-governments' annual reports" to stock exchange regulators in Canada, the European Union and the UK, which contain additional information on payments beyond corporate income taxes – some of them Covered Taxes.

19. Generally, taxes on income, profits, and distributions are Covered Taxes for Pillar Two purposes (e.g., corporate income tax payments recorded in the financial accounts are Covered Taxes). In contrast, a tax imposed on gross income, revenue, or another basis may not qualify as a Covered Tax under the GloBE Rules (e.g., a royalty based on production or gross revenue). The definition of Covered Tax is broader than simply income taxes. In determining whether a Tax is a Covered Tax, the focus is on the underlying character of the tax.

20. The table below shows whether commonly used fiscal instruments in the extractive industries are likely to qualify for Covered Taxes for Pillar Two purposes. They include bonus payments, royalties, income taxes, resource rent taxes, state equity, and indirect payments, fees and duties.

[4] Source: UN Handbook on Taxation of the Extractive Industries,2018; pp 364-366

Mechanism	**Description**	**Covered tax: yes/no**	**Notes**
Signature bonus	Up-front payment for acquiring exploration rights	No	1
Production Bonus	Fixed payment on achieving certain cumulative production or production rate	No	1
Royalties	Specific (amount per unit of volume produced)	No	2
	Ad-valorem (percentage of product value)	No	2
	Ad-valorem progressive with price	No	2
	Ad-valorem progressive with production	No	2
	Ad-valorem progressive with operating ratio/profit	No	2
	Profits based royalty	Yes	2
State, provincial, and/or local CIT	Rate of corporate income tax at the state, provincial, or local level in addition to federal level	Yes	3
Variable income tax	CIT where the tax rates increase with the ratio of taxable income to revenue, between an upper and lower bound	Yes	4
Resource rent	Cash flow with accumulation rate/uplift. Can be assessed before or after CIT	Yes	5
	Cash flow with limited uplift on losses (UK) (Surcharge tax on cash flow)	Yes	5
Windfall taxes	Profits based	Yes	6

Other additional income taxes	Other profit taxation mechanisms that do not fall under any of the categories above	Yes	7
Production sharing	Under production sharing agreements – commonly used in the oil & gas industry – a contractor shares its profits with government after deducting an amount equal to its capital and operational costs. The profits can be split on a fixed share of production basis or a sliding scale basis (e.g., the government's share of profit increases as total cumulative production increases).	Depends	8
State participation	Free equity: government receives percentage of dividends without payment of any costs	No	9
	Carried equity: government contributions met by investor and recovered from dividends with interest	No	9
Social investments/ infrastructure	Resource companies build infrastructure or make other social investments (hospitals, schools, etc.) or other payments in kind	No	10
Indirect taxes	Custom duties, payroll taxes, stamp duties and other input taxes	No	11
Controlled Foreign Company Taxes	Taxes paid in shareholder countries in relation to profits in the source country.	Yes	12
Pillar One tax	Pillar One Tax under the GloBE Rules	Yes	13
Withholding tax	Withholding tax on dividend, interest	Yes	14
"STTR" Tax	Tax arising under the "Subject to Tax Rule"	Yes	15

Notes

(1) Signature and production bonus are single lump-sum payments triggered by events, which can be legislated, negotiable or biddable. They are not charged based on income or profits and are not qualified as Covered Taxes for GloBE Model Rules purposes under Article 4.2.1.

(2) Royalties imposed on a fixed basis or on the quantity, volume or value of the resources extracted rather than on net income or profits would not be treated as Covered Taxes under Article 4.2.1 (a) unless they are imposed in lieu of generally applicable income taxes. However, royalties paid on net profit where some relevant costs are deducted from income could fall within the

definition of Covered Tax as its tax base is net profit under Article 4.2.1 (a). Whilst not determinative, royalties that are recorded as income tax in the accounts would be more likely to be a Covered Tax, whereas royalties recorded as an expense before tax would less likely be a Covered Tax.

(3) State, provincial, and/or local corporate income taxes charged based on net income would likely be treated as Covered Taxes under Article 4.2.1 (a).

(4) Variable income tax is a profit-based tax and is treated Covered Tax under Article 4.2.1 (a).

(5) If the resource rent tax is a profit-related tax, which is based on net income (i.e., gross revenue from the resource development minus certain expenses incurred in connection with deriving the income), it should be treated as Covered Tax under Article 4.2.1 (a).

(6) If windfall taxes are imposed on profits, they should be treated as Covered Tax irrespective of whether they are in addition to a generally applicable income tax under Article 4.2.1 (a).

(7) Other additional income taxes could be treated as Covered Taxes if they fall within the definition of Covered Taxes under Article 4.2.1.

(8) Under a production sharing agreement, payments made to the Government could be a mixture of profit related payments (corporate income taxes, resource rent etc.) or payments subject to production levels (e.g., production bonus, royalties). Some countries (Egypt and Trinidad for example) have the concept where the Government takes an amount of the production of the oil or gas rather than receiving tax (and a cash payment for the tax). This is often known as “tax barrels” (as the Government get oil instead of cash for its tax). In simplistic terms this is accounted for as a double entry for the company as debit tax, credit turnover. On this basis “tax barrels” would be treated as a Covered Tax under Article 4.2.1 (a) and (c) as it is included in the income tax of the company’s Income Statement, and it is a payment in kind made to the government as a substitute for a generally applicable income tax.

Where the payment made to the government is taxed on a profit basis or is included, it is more likely to be treated as Covered Tax under Article 4.2.1. However, if the payment made to the government is not profit-related tax or is not tax in lieu of a generally applicable income tax under Article 4.2.1, it is unlikely to be treated as Covered Tax. It should be considered on a case-by-case basis to determine if the definition of Covered Taxes is met under Article 4.2.1.

(9) Under a state participation agreement, the host government could receive corporation income tax, withholding taxes, or distribution of profits generated from an extractive entity due to their free, carried or paid equity interest. Covered Taxes include taxes on a distribution of profits under Article 4.2.1 (a) and taxes on distributed profits imposed under an Eligible Distribution Tax System are Covered Taxes under Article 4.2.1 (b). However, if the payment made to the government does not have any underlying characteristics of taxes, it is unlikely to be treated as Covered Tax for Pillar Two purposes. E.g., providing the government a free carried equity stake with rights to dividends would not be considered a Covered Tax. It should be considered on a case-by-case basis to determine if the definition of Covered Taxes is met under Article 4.2.1.

(10) Social investment / infrastructure are contributions made by resource companies to resource-holding countries, which do not qualify as Taxes for Pillar Two purposes.

(11) Indirect taxes do not generally fall within the definition of Covered Tax as they are imposed on transactional basis rather than on income or equity basis and are not taxes in lieu of an income tax under Article 4.2.1. However, it will always be necessary to check the precise nature of the tax to draw conclusions e.g., the HMRC has confirmed the US Federal Excise Tax will be treated as Covered Taxes for Pillar Two purposes.

(12) For the purposes of the IIR, a Controlled Foreign Company ("CFC") Tax is Covered Tax as under Article 4.2.1 (a) as it is based on a share of part, or all of the income earned by the CFC. The CFC Tax incurred by a Constituent Entity's owners are allocated to the Constituent Entity under Article 4.3.2(c), subject to the limitations on the "push-down" of Taxes under Article 4.3.3. Importantly, under a QDMTT, CFC taxes incurred by the Constituent Entity's owners are not eligible to be included as a covered tax if the DMTT is to be "qualifying". This is a key intended distinction between the calculation of top-up tax under an IIR and a QDMTT.

(13) Tax on net income of a Constituent Entity under Amount A of Pillar One would be treated as a Covered Tax under the GloBE Rules as a tax with respect to income or profits under Article 4.2.1 (a). The Pillar One tax should be allocated to the Constituent Entity that takes into account the income associated with such tax for calculating its GloBE Income or Losses.

(14) Withholding taxes on interest, dividends would be treated as Covered Taxes provided such taxes are imposed in substitution for a generally applicable income tax. Importantly, for the purpose of determining the ETR under Pillar Two, dividend withholding tax is allocated to the Constituent Entity making the distribution under Article 4.3.1 (e). Whereas interest withholding taxes are allocated to the Constituent Entity incurring those taxes (i.e., the entity that receives the interest income).

(15) The Subject to Tax Rule ("STTR") is a treaty-based rule that applies to intragroup payments (interest, royalties and a defined set of other payments) from source jurisdictions (i.e., the jurisdiction in which the income arises) that are subject to tax rates below 9% in the payee's jurisdiction of residence. The STTR takes priority over the GloBE Rules and is creditable as a covered tax.

2.3 Which incentives commonly used in the extractive industries are affected, or not, by GloBE?

21. This section analyzes the likelihood that domestically implemented GloBE rules would affect the tax incentives commonly offered to extractive industries. General remarks on the interaction between GloBE rules and tax incentives are provided in Appendix A2. While the GloBE rules treat different categories of tax incentives seemingly in the same way, the analysis will be divided between profit-based and cost-based incentives. A summary of the assessment is provided in the table below. Incentives may exist even in domestic law or stability agreements which will impact how and whether they are able to be revised in response to Pillar Two - this is discussed in Section 2.4 and 3, further below.

22. Incentives that create a permanent tax reduction (i.e., a permanent difference between accounting profits and taxable profits, sometimes referred to as a "book-tax difference") will likely be more affected than incentives that create timing differences between recognition of accounting and taxable profits, e.g., accelerating deductions ahead of accounting expenses that defer the tax payment into the future (i.e., creating a timing

difference between accounting profits and taxable profits). Nevertheless, the actual impact of GloBE on a specific incentive depends on several other factors, such as the scope limitations, the magnitude of the benefit, the weight of its tax base on the GloBE income, and the particularities of the MNE and its group in the relevant jurisdiction (e.g., the jurisdictional blending and SBIE mitigation effects).

23. These incentives can be provided separately or as part of an export processing zone (EPZ), which is an industrial zone that provides companies with special incentives to attract (mostly foreign) investment for export production. Under these zones, countries usually offer a variety of tax incentives, such as tax holidays, duty-free export and import, value-added tax (VAT) incentives, and free repatriation of profits.[5]

24. The impact of the GloBE rules on EPZs depends on which incentives are offered to companies granted the EPZ status. Nevertheless, many of the incentives that are generally granted under EPZs, such as duty-free export and import and VAT incentives will not be affected by GloBE as they relate to taxes that are not treated as covered taxes for its purposes.

Profit-based incentives

25. Income or profit-based incentives generally reduce the tax liability once the project is profitable, for example through exemptions or reduced tax rates. They usually provide a permanent difference between the tax that would have been paid on those profits without the incentive and that with the incentive, as the reduction in the amount of tax paid is not reversed over time.[6] Common types of profit-based incentives offered to extractive industries are corporate income tax holidays, withholding tax relief on income remitted abroad, or a combination of incentives under export processing zones.

i. Income tax holiday

26. An income tax holiday is a temporary reduction or an elimination of taxes. In the extractive sector, the duration of such a tax-free period can vary from one year to the full term of the project and can take many forms, ranging from a complete tax exemption to a reduced rate, or a combination of the two.[7]

27. The impact of GloBE on a tax incentive depends on whether or not a specific adjustment is prescribed in the rules to neutralize its effect on the GloBE ETR. Based on this rationale, income tax holidays which reduce the tax rate below 15% in any income year are likely to be affected by the application of GloBE as they will be treated as a reduction of covered taxes, and no adjustment is prescribed to ensure a neutral effect on the ETR. In other words, while the availability of the tax holiday will not increase the covered taxes (the numerator of the ETR), the corresponding untaxed income is not excluded from the GloBE income (the denominator). This will result in the MNE having a lower ETR in that jurisdiction, making such an incentive more likely to become ineffective due to the top-up tax trigger. However, the degree of the impact depends on the magnitude of the tax holiday benefit. For instance, a tax holiday that provides a total exemption should be more affected than one that offers a partial exemption (e.g., a rate of at least 15% with

[5] Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, pp. 17-18. Also, Readhead. A, *Tax incentives in mining: minimizing risks to revenue*. IGF-OECD (2018), p. 32.

[6] Committee of Experts on International Cooperation in Tax Matters; Nineteenth Session (2019), Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, p. 15.

[7] Ibid., p. 16.

limited permanent benefits provided). In addition, it also depends "on the length of relief and the treatment of other tax provisions such as depreciation allowances during the period of the holiday."[8] It also depends on whether any profits are generated in the initial income tax holiday, and how much.

28. Importantly, an exception to this is an income tax holiday granted to income from international shipping, which is excluded from the GloBE income computation. Thus, incentives such as tax holidays offered to international shipping activities will remain unaffected by the GloBE rules.

ii. Withholding taxes on income remitted abroad

29. Another income-based tax incentive commonly used in the extractive sector is a withholding tax (WHT) relief in respect of outbound passive payments, including services, interest, royalties, management fees, and shareholder dividends.[9] Such relief usually takes the form of an exemption or a reduced WHT rate. The impact of GloBE on WHT incentives varies in relation to the nature of the relevant income to which it applies to.

- WHT on interest, royalties, and services

30. Withholding taxes on interest, services, and royalties are attributed to the recipient entity's jurisdiction for the purpose of calculating the GloBE ETR. Thus, whether such incentives are impacted by the GloBE rules will depend on the tax profile of recipient entities. For in scope MNEs, it can be assumed that profits on such payments will be taxed at a minimum rate of 15%, and thus, provided WHT imposed does not exceed 15% of **profits** generated by relevant activities, excess taxation should not arise. As with all incentives, if the provision of relief against WHT leads only to additional tax payable upon receipt, the incentive will be ineffective and therefore such incentives should be carefully considered. Conversely, a high withholding tax is likely to give rise to excess taxation, as the tax imposed on the gross payment may well exceed the minimum tax paid on the net profit of the recipient.

STTR Tax

31. Importantly, intragroup payments for services, interest and royalties (as well as certain other defined categories of income) may be captured by the STTR, which would be akin to WHT. Accordingly, where relief from withholding tax has already been granted on payments covered by STTR, the value of the incentive will be eroded in a similar way to WHT on interest royalties and services (up to a maximum possible tax cost of 9% on the gross income).

[8] Ibid., para. 14.

[9] Committee of Experts on International Cooperation in Tax Matters; Nineteenth Session (2019), Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, pp. 16 and 17. Also, Readhead. A., *Tax incentives in mining: minimizing risks to revenue*. IGF-OECD (2018), p. 25.

● Dividend WHT

32. Withholding tax on non-portfolio dividends is attributed to the source (i.e., the "dividend paying") jurisdiction for the purpose of calculating the ETR. The rationale behind this is that such tax represents a new or additional tax on the income of the distributing entity that has been included in the GloBE[10] That is, as the underlying income from which the dividends are paid was included in the distributing entity's GloBE income, any tax paid on such dividends should be assigned to the tax jurisdiction of the constituent entity that originally earned the underlying income for the GloBE purposes.[11] Therefore, while WHT on dividend distributions is a legal liability (and tax expense) of the recipient shareholder, it is included in the covered taxes of the distributing entity, i.e. the constituent entity that distributed the underlying income.

33. The impact of GloBE on WHT exemptions or reductions on such dividends depends on the ETR for the distributing entity's jurisdiction. In broad terms, where the ETR is already above 15%, a dividend WHT exemption would not be impacted, but where the underlying ETR is below 15%, a dividend WHT exemption may be partially or totally offset by the top-up tax levy.

Cost-based incentives

34. Cost-based incentives are widely offered across resource-rich jurisdictions. This category of incentives allows taxpayers to recoup their investment faster through special deductions from their taxable income or directly from the amount of taxes to be paid and defer tax payments to later stages in a project's life, thus not reducing cash flows to companies in the initial years.[12]

35. The most common types of cost-based incentives offered to extractive industries are investment allowances and credits, accelerated depreciation and loss carry forward.

i. Accelerated depreciation, immediate expensing, and loss carry forward

36. Some of the most common types of tax incentives offered throughout the world, for the extractive sector and beyond, are accelerated depreciation and immediate expensing of business assets. Accelerated depreciation allows the cost of an asset to be written off at a faster rate than the accounting rate of depreciation. Immediate expensing allows the entire cost of an asset to be deducted for tax purposes in the first year of investment. As both allow investors to deduct the cost of assets over a shorter period for tax purposes compared to accounting purposes, these regimes lower the taxable profits of firms for the years they apply, leading to a deferral of taxation to later stages in a project's life and thus a timing benefit. As such, they are extremely important to capital-intensive sectors such as the extractive industries. These are commonly referred to as "timing differences" because the tax rules allow for tax deductions at different

[10] Commentary on the GloBE Model Rules, *Article 4.1.3.*, para. 11.

[11] Commentary on the GloBE Model Rules, *Article 4.3.2.*, paras 60-61.

[12] Committee of Experts on International Cooperation in Tax Matters; Nineteenth Session (2019), Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, p. 18. Also, Readhead. A, *Tax incentives in mining: minimizing risks to revenue*. IGF-OECD (2018), p. 28.

points to time to when amounts are recognized as expenses for accounting purposes. This may either provide for deductions in advance of accounting expenses (e.g., immediate expensing of capital items), or accounting expenses may arise before amounts are deductible for tax purposes ((e.g., rehabilitation and decommissioning costs are expensed over the life or a project but may only be deducted when expenses are incurred towards the end of the project life). In broad terms, these differences lead to the same amount of taxable profit brought to account as accounting profit that is recognized, albeit over different periods of time.

37. Given that GloBE relies on financial accounts to arrive at the tax base, they do not take into account the more beneficial tax treatment of depreciation, where the timing benefits of incentives like accelerated depreciation and immediate expensing could lead to distortions in the ETR calculation. As these incentives simply create a timing or ‘temporary’ difference, where the payment of the tax is not reduced but deferred into the future, failing to address them under GloBE would lead to over-taxation, especially for capital-intensive businesses such as in the extractives sector. Recognizing this, GloBE prescribes certain adjustments to the ETR calculation to avoid the imposition of the top-up tax as a result of timing differences between financial accounting and domestic tax recognition of income and expenses.

38. Notably, the GloBE rules incorporate deferral tax accounting adjustments in the calculation of covered taxes. If the income is recognized for GloBE purposes before it is for domestic tax purposes (e.g., as a result of accelerated depreciation and immediate expensing), GloBE allows the deferred tax liability accrued in the financial accounts at the minimum rate to be added in the adjusted covered taxes computation, neutralizing the timing difference effect in the ETR calculation. In other words, these deferred taxes are included as a Covered Tax at the minimum rate, meaning that, in principle, these incentives would not be affected by the GloBE rules.

39. However, the application of the deferred tax accounting approach under GloBE is subject to a limitation that may render such incentives affected in certain circumstances, namely, the recapture rule. That is, if taxation is deferred for more than five subsequent fiscal years, a recapturing mechanism may apply for GloBE purposes requiring the deferred tax liability to be reversed. This means that the MNE has to recalculate the amount of covered taxes for the year when the deferred tax liability was originally credited under GloBE, regularizing the amount of top-up tax that should have been paid if no adjustment had been made for the timing difference. Accordingly, GloBE only allows a deferral for a maximum period of five years, where if the book-tax difference is not reverted within this period, the top-up tax needs to be recaptured.

40. The five-year recapture rule has some exceptions, however, where no top-up tax will be recaptured even if the deferred tax liability is not reversed within the period. The Recapture Exception Accrual Rule (REAR) set out in Article 4.4.5 includes a broad list of categories of deferred tax liabilities that do not need to be monitored for recapture. The list includes, for example, cost recovery allowances on tangible assets, which means that tax incentives providing for immediate expensing or accelerated cost recovery of tangible assets are unaffected by the GloBE Rules, even if the temporary difference they create is not reversed within five years. For the purposes of GloBE, tangible assets not only consist of assets classified as property, plant, and equipment or stockpiles for financial accounting purposes, but also include natural resources, such as mineral deposits, timber, oil and gas reserves, and exploration and evaluation assets.

Timing differences in relation to de-commissioning and rehabilitation expenses, research and development, foreign exchange gains and losses, and fair value accounting on unrealized net gains are also allowed under REAR.

41. Therefore, REAR is expected to bring significant benefits apply extensively to the extractive sector, which will still be able to enjoy largely used tax incentives, such as accelerated depreciation and immediate expensing in relation to tangible assets, as these remain unaffected by the GloBE rules.[13] In addition, REAR applies to the cost of a license or similar arrangement from the government, such as a lease or concession for the exploitation of natural resources, where this entails significant investment in tangible assets, as well as to de-commissioning and remediation expenses. These exceptions can also avoid unintended outcomes of denying a GloBE deduction for these costs to natural resource extractive businesses.[14]

42. On the other hand, those incentives directed at assets other than tangible assets that create a temporary difference lasting more than five years are likely to be affected by the GloBE rules, as no REAR applies to them. This may be the case, for example, with long-lived intangibles.

43. It is also relevant to note that, even in the case where a deferred tax liability adjustment is allowed under GloBE (and no recapture applies), if the rate applicable on the income that will be taxed at a later stage is below 15%, the incentive may still be affected by GloBE. This is because the deferred tax arising from timing differences is only recognized in the ETR at the minimum rate. In case the tax rate applicable is below 15%, the tax amount will have to be paid in the year when the income is recognized in the financial accounts, meaning that the deferral would not be applicable for GloBE purposes. Thus, even in relation to cases where recapture would not be needed in relation to incentives for immediate expensing or accelerated asset cost recovery, these may still be affected by the top-up tax if the tax rate applicable is below 15%.

44. The same deferred tax accounting adjustment applies in relation to deferred tax assets on timing differences including those arising from loss carry-forward regimes, also widely used by extractive industries. A loss may occur for tax purposes where deductible expenses exceed taxable income for the period, for which domestic tax rules may permit taxpayers to carry forward such loss until it has been completely offset against future tax liabilities.

45. This mechanism also creates timing differences between tax and financial accounts, where GloBE allows deferred tax adjustments to be taken into account when calculating the MNE's covered taxes. That is, the amount of covered taxes will be reduced in the year in which the deferred tax asset is recognized and will subsequently be increased as the loss is utilized, neutralizing the effect of the deferred tax asset on the ETR. Thus, loss carry-forward regimes generally remain unaffected by the GloBE Rules. Deferred tax accounting that relates to carry-forward tax credits, such as foreign tax credits, is not allowable under the GloBE rules and can give rise to top up tax.

[13] OECD (2022). *Tax incentives and the Global Minimum Corporate Tax: Reconsidering tax incentives after the GloBE rules,* para. 62.
[14] Article 4.4.5. (b) and (d) of the GloBE Model Rules and Commentary on the GloBE Model Rules, *Article 4.4.5.*, paras 96 and 98-101.

ii. Investment allowances and credits

46. Investment allowances and credits are tax reliefs based on the capital expenditure on qualifying investments, providing benefits beyond the value of depreciation of an asset. The impact of GloBE on these incentives differs depending on certain factors.

47. In relation to investment allowances, the GloBE's impact will depend on whether they give companies the right to deduct up to or more than 100% of the value of the acquisition cost or depreciation expense of the asset to which it relates. That is, enhanced investment allowances, such as a capital allowance uplift, which entitle the taxpayer to deduct an amount that exceeds the actual expenditure incurred, are likely to be affected by the top-up tax levy.

48. As described by the OECD, if, for example, the "taxpayer is entitled to depreciate 120% of the acquisition cost of the asset, then the additional 20% is considered a tax allowance", which may be affected by the GloBE rules provided the ETR for the jurisdiction is below 15%. This is because such enhanced investment allowances will reduce the covered taxes (numerator) in the GloBE ETR calculation, where no specific adjustment is made to this nor to the GloBE income (denominator) to neutralize their effects, thereby contributing to the reduction of the ETR and potentially being offset if the ETR falls below 15%.

49. In addition, under the GloBE rules, a special situation related to the grant of super or enhanced deductions may give rise to a top-up tax even where the MNE group has no GloBE income in a jurisdiction. This can occur where a permanent book-tax difference arises as the domestic tax rules allow, for example, a deduction that is in excess of economic cost, i.e., in excess of the amount that would be allowed for financial accounting purposes, and that is not reversed over time. In this situation, the local tax loss will be greater than the loss recognized for the GloBE purposes, resulting in an excess benefit. To address this, Article 4.1.5 imposes an additional current top-up tax on the excess benefit in the year in which the permanent difference is created at the minimum rate. Thus, such an additional current top-up tax will only arise in a year when the tax loss is greater than the loss recognized for GloBE purposes and the additional tax loss results from a permanent difference. This may have an impact on how countries may grant deductions in excess of the economic cost of assets, because even where the company has a loss for GloBE purposes, the top-up tax may be charged on the excess benefit created.

50. Nevertheless, while enhanced investment allowances are more likely affected as they create a permanent reduction of taxes that will not reverse in a future period (i.e., a permanent difference), an allowance giving the right to a deduction of up to 100% of the actual cost of the investment will not give rise to additional tax liability under GloBE (provided the REAR applies). This is because the latter only leads to a timing benefit, since the deduction for tax purposes occurs in advance of when they would be recognized for accounting purposes, resulting in a deferral of taxation into the future. As indicated above in relation to accelerated depreciation and immediate expensing, the GloBE rules prescribe certain adjustments to the ETR calculation to reflect and neutralize the effects of GloBE on certain timing differences created by incentives that only defer the tax payment into the future. Therefore, as long as the investment allowance produces the same effect as an immediate expensing, where the amount allowed to be written off in advance does not exceed the actual cost of the investment, the same deferred tax

adjustments prescribed in the GloBE rules apply to them, and such incentive will not give rise to a top-up tax if a moderate tax rate is applied and no recapture is required.

51. Also commonly offered to the extractive sector, investment credits allow a reduction to the amount of tax payable, rather than the taxable income, by a portion of the taxpayer's investment expenditure in the first year. That is, a tax credit allows a percentage of the investment to directly reduce the amount of taxes to be paid in a certain period, where if the taxes owed are lower than the taxpayer's entitlement to a tax credit, resulting in a negative tax liability, such negative balance can be paid back to the investor by the tax authority, carried forward to offset future tax liabilities or expire.

52. The impact of GloBE on tax credits depends primarily on whether they are qualified refundable or non-qualified refundable credits and, subordinately, on whether they can be transferable at a marketable price. This is because, first, the GloBE rules provide for an adjustment for "Qualified Refundable Tax Credit" (QRTC) in the GloBE ETR, making it generally less affected by the rules. That is, GloBE follows general financial accounting standards by treating refundable tax credits as income rather than a reduction in the firm's tax expense, as is the case with grants. Thus, the rules adjust the GloBE income for QRTC, where the credit will be treated as income for the purposes of the ETR computation, rather than a reduction in covered taxes in the year such entitlement accrues.

53. A QRTC under GloBE is a credit that is refundable within four years from the date when the conditions for it are met, and is either payable as cash or cash equivalent. Where the QRTC is recorded in the firm's financial accounts as a reduction to current tax expense in the year it is refunded, an adjustment will be made to add the amount of credit to the adjusted covered taxes, in addition to including such amount to the GloBE income.

54. All other refundable credits (i.e., refundable for more than four years) are deemed "Non-Qualified Refundable Tax Credits" (non-QRTCs) for the purposes of GloBE. In principle, non-QRTCs and non-refundable tax credits will be excluded from the computation of GloBE income and be treated as a reduction to adjusted covered taxes.

55. However, if it is a transferable tax credit, even in those cases where the tax credit does not qualify as a QRTC (i.e., a non-refundable or a non-QRTC), it can still qualify as a "Marketable Transferable Tax Credit" (MTTC) and be treated as income for the purposes of the ETR computation, in a similar way to QRTCs. To qualify as a MTTC, the credit must be a tax credit that can be used by the credit holder to reduce its liability for a covered tax in the jurisdiction that issued the credit and that meets both the legal transferability standard and the marketability standard in the hands of the holder (the originator or the purchaser of the tax credit). Broadly, the legal transferability standard is met if the credit can be transferred by the originator or purchaser to an unrelated party. The marketability standard is met if the credit is transferred by the originator or from the purchaser at a price of at least 80% of the net present value of the credit (the "Marketable Price Floor").

56. If the tax credit does not meet the refundability criteria (to qualify as a QRTC) or the transferability criteria (to be considered a MTTC), it will then be treated as a reduction of covered taxes for the purposes of GloBE. This will be the case for credits that are "Non-Marketable Transferable Tax Credits" (non-MTTCs), i.e., those that are transferable but not considered as MTTCs, or "Other Tax Credits" (OTCs), which are non-refundable and non-transferable tax credits that can only be used to offset the originator's liability for a covered tax. Although all instances may reduce the ETR below 15%, i.e., QRTCs and MTTCs by increasing GloBE income and non-MTTCs and OTCs by reducing covered taxes, the QRTCs and MTTCs are expected to be less affected by GloBE. In this context, jurisdictions may wish to revisit their tax credit regimes to align them to the QRTC and MTTC definitions under GloBE. Nevertheless, it is relevant to note that countries opting to offer such an incentive will need to make a payment (in cash or in cash equivalent) to investors within four years if the credit exceeds the tax liability, amounts of which can be significant. Such a requirement can make this instrument a less viable option, especially for developing and emerging economies.

iii. <u>Customs duty reductions or exemptions</u>

57. Customs or import duty relief is also commonly offered to the extractive sector. A custom duty relief is offered to grant investors in the sector the right to import goods such as equipment, plant, fuel, construction material, etc. duty-free.[15]

58. Since, in general, import tax or customs duty is levied on the value of the imported goods, it may not qualify as a covered tax under GloBE. This is because, as noted above, the definition of covered taxes under the GloBE rules includes (broadly) income-based taxes,[16] and the import tax is a tax based on the value of the good rather than on a measure of income. In addition, the "in lieu" test set out in the rules to regard a tax as a tax imposed in lieu of a generally applicable CIT may not be satisfied to include custom duties as covered taxes for the purposes of GloBE.[17]

59. Therefore, given that the tax itself may not be treated as a covered tax, any custom duty or import tax relief will not be affected by the GloBE rules.

iv. <u>VAT exemptions on imports</u>

60. resource-rich countries exempt imported inputs used in oil and gas operations from VAT. This approach is particularly due to the difficulties they encounter in refunding the VAT paid on inputs by export-oriented extractive industries, which do not pay VAT on exports, therefore eliminating or reducing the common issue arising from the imposition of VAT with immediate refund.[18]

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[15] Committee of Experts on International Cooperation in Tax Matters; Nineteenth Session (2019), Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries p. 19. Also, Readhead. A., *Tax incentives in mining: minimizing risks to revenue*. IGF-OECD (2018), p. 35.

[16] Article 4.2.1 of the GloBE Model Rules. Also, Commentary on the GloBE Model Rules, *Article 4.2.1*, para. 25.

[17] Article 4.2.1(c) of the GloBE Model Rules. Also, Commentary on the GloBE Model Rules, *Article 4.2.1*, paras 31-32.

[18] Committee of Experts on International Cooperation in Tax Matters; Nineteenth Session (2019), Update of the

61. VAT is expressly excluded from the definition of covered taxes in the GloBE rules as it is a tax "calculated by reference to the consideration for a defined supply and are not Taxes on the net income or equity of a taxpayer".[19] Thus, while the effectiveness of adopting an exemption for VAT may be questionable, any incentive offered under the VAT regime will not be affected by the top-up tax as it will not be accounted for in the ETR calculation.

v. Production royalty-based incentives

62. In the extractive sector, royalties are an "obligatory payment made by the operator of the extraction project to the country as a compensation for the extraction rights."[20] They are usually calculated as a percentage of the gross volume or value of the production and/or by reference to the type, quantity, and quality of the extracted mineral resource. Royalties are due once production has commenced, rather than when the project is profitable as with profit-based taxes and are usually charged at a constant rate. As such, they impose a fixed cost on the investor, typically irrespective of profitability.

63. With the aim of reducing the burden on the project during the initial phase until sunk costs are recovered, encouraging new entrants, and preventing early termination of production as the natural resource approaches depletion, governments offer certain production royalty-based incentives.[21] These are generally provided by:

(i) royalty holiday, reducing or eliminating the amount of royalties to be paid for a period;
(ii) royalty deferral, extending or deferring the payment into the future; and
(iii) sliding scale, where the applicable rate varies depending on sales, production, price or costs.

64. As noted above, production royalties may not be regarded as covered taxes, as they are imposed on the gross volume or value of the production ("ad valorem") rather than on net income or profits. As the Commentary to the GloBE rules explains "natural resource levies closely linked to extractions (for example, those that are imposed on a fixed basis or on the quantity, volume or value of the resources extracted rather than on net income or profits) would not be treated as Covered Taxes except where these levies satisfy the "in lieu of" test described below in connection with paragraph (c) of Article 4.2.1."[22]

65. In this context, unless royalties are imposed on net profit, where some relevant costs are deducted from income, they will not be included in the computation of covered taxes for GloBE purposes. Therefore, incentives granted to production royalties, which are charged "ad valorem"

Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, p. 20.

[19] Commentary on the GloBE Model Rules, *Article 4.2.1*, para. 36a.

[20] Handbook on Taxation of the Extractive Industries, p. 475.

[21] Committee of Experts on International Cooperation in Tax Matters; Nineteenth Session (2019), Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, p. 21. Also, Readhead. A., *Tax incentives in mining: minimizing risks to revenue*. IGF-OECD (2018), p. 39.

[22]

and not in lieu of generally applicable income taxes, are not affected by the GloBE rules application.

66. Where royalties are imposed on profits similar to an income tax, they may be impacted by the GloBE rules.

Nature	**Type**	**Intensity of effect**
Profit-based incentives	Income Tax holiday	More likely
	Withholding taxes on income remitted abroad	
	Interest and royalties	More likely (to impact recipient jurisdiction, not source state)
	Dividends	More likely (to impact source state)
	Export processing zone (EPZ)	Depends
Cost-based incentives	Accelerated depreciation and immediate expensing (including rehabilitation and remediation (decommissioning) costs	
	Tangible assets and resource rights	Unaffected
	Short-lived intangible-assets	Less likely
	Other intangible assets	More likely
	Loss carry forward	Unaffected
	Investment allowances	
	More than 100% of actual cost	More likely
	100% or less than actual cost	Less likely
	Investment credits	
	Qualified refundable credits	Less likely
	Marketable transferable tax credits	Less likely
	Other tax credits (non-refundable and non-transferable)	More likely
	Customs duty reductions or exemptions	Unaffected

	VAT exemptions on imports	Unaffected
	Production royalty-based incentives	Unaffected

Note: "More likely" means that the incentive has a strong potential to bring the ETR below 15% (because it is not regulated by the GloBE rules) and as such is more likely to be offset by the top-up tax levy. Should the ETR in the jurisdiction be above 15%, there is still a chance that these incentives will remain effective.

2.4 What could be the impact of stability provisions and what options are available to governments in relation to existing stability agreements?

67. As a consequence of GloBE rules, source countries may consider changes to domestic tax policy to ensure any additional top-up tax payable by MNEs in respect of activity in those countries, is paid in those source countries rather than in shareholder jurisdictions. For developing economies, this requires consideration of the applicable fiscal terms that govern operations in their jurisdiction and their interaction with the GloBE rules, including the implications where there are stabilized agreements. Under many stabilization agreements, changes to domestic tax legislation will not typically apply to the stabilized projects/entities, or will only apply if they do not increase the overall tax burden.

68. We analyze stabilized Extractive Industries (EI) agreements in two categories:

i. In most cases, EI companies' ETR will be higher than 15%, or companies will be out of the scope of Pillar Two (i.e., junior companies and mid-cap). There will be no impact on those agreements.

ii. In-scope companies with jurisdiction-level GloBE ETR below 15% will be subject to the GloBE rules, typically in the form of an IIR imposed by countries in which the parent company or intermediate shareholders are located, regardless of stabilization provisions in host jurisdictions. In this case, an existing stabilized agreement focused on host taxation is unlikely to cover the top-up tax paid by the parent and the ETR will increase leading to the natural incentive for the host jurisdiction to raise taxes by an equivalent amount to ensure tax remains in the host jurisdiction. However, because the tax regime applicable in the host jurisdiction has been stabilized, any imposition of additional local taxes in the host jurisdiction in response to the GloBE rules is not possible without mutual agreement. While changes to the existing arrangements should be feasible, several commercial and legal issues need to be considered as stabilization provisions operate within existing legal regimes, and they are likely to cover a range of issues beyond taxation.

69. This section considers whether there are practical ways to amend tax stabilization provisions while reducing complexity for governments and investors. An important consideration will be ensuring that any additional tax paid locally is in fact a Covered Tax which is taken into account for the purposes of the GloBE rules.

Pillar Two Interaction with Existing Stabilized agreements

70. Any changes to domestic tax policy will need to take into consideration stabilized agreements. In this regard, the term 'stabilized agreement' is used to refer to any agreement that sets the tax regime for a project and limits the application of changes in domestic tax law to the project. This may be done in several ways:

- The agreement may 'freeze' taxation law in force at a particular date so that future changes to domestic law are not applicable to the investment.
- The agreement may set out the tax regime in relation to the project (in a manner that differs from the general domestic tax regime).
- The agreement may provide for equalization of the value-sharing arrangements, or compensation to be paid to an investor where there are changes to the taxation regime.
- In some cases, the agreement may provide for a combination of the above.

71. The common feature of such an arrangement is that it is not generally possible to amend the fiscal regime for a project simply through changes to the general domestic tax rules. Importantly, stabilized agreements in relation to taxation are generally part of a wider framework of agreements governing project investment. These agreements cover a wide range of commercial matters beyond taxation, e.g., the legal regime governing the project and construction, state participation where relevant and dispute resolution. These agreements may be documented in the form of investment agreements, production sharing contracts, conventions and framework agreements (among others).

72. To the extent the GloBE rules result in additional top-up tax payable in relation to projects (usually at the level of the parent company or intermediate companies, under an IIR), host governments will likely have an objective to ensure that tax is instead paid locally. In many cases investors may share a similar objective to the host country. That is a preference to pay additional tax in the source jurisdiction of operations, if the GloBE rules would otherwise result in additional top-up tax being paid in a shareholder jurisdiction.

73. Where mutually agreed between the parties, it may be possible to amend the tax regime for projects that are governed by stabilized agreements. Three potential approaches and issues to consider are set out below.

1. Amend tax clauses of existing stabilized agreements.
2. Implement a side agreement outside the stabilized agreement.
3. Unilateral acknowledgement by a company to pay Pillar Two tax locally.

Option 1 – Amend Tax Clauses of Stabilized agreements

74. Amending stabilized agreements through mutual agreement would involve a renegotiation of tax clauses embedded within stabilized agreements. This approach would provide a number of benefits:

- This would provide the highest degree of certainty to governments and investors in relation to the tax regime for the project.
- Modifications to the stabilized agreement would enshrine the way corporate tax rules apply regardless of the evolution of the GloBE rules and how they are actually implemented by the relevant shareholder country. This would ensure stability and certainty for both parties – as the government would not be dependent on drafting of the GloBE rules by shareholder countries, ongoing progression on the interpretation of the GloBE rules (including subsequent releases of administrative guidance by the OECD), or whether Pillar Two tax is payable by new investors. Different investors can have different Pillar Two outcomes and there can be different outcomes for jointly owned projects – linking local tax payments to different investor positions would be extremely challenging and potentially lead to inequitable outcomes depending on the characteristics of an investor.
- This approach enables the tailoring of arrangements for specific projects to meet government and investor objectives. This may include for example, removing corporate tax holidays or other

incentives that are ineffective under the GloBE rules, and replacing them with a higher corporate tax rate along with more effective tax incentives such as accelerated tax depreciation or immediate expensing (a timing difference that is allowed under the GloBE rules under the REAR) or reductions in customs duties, royalties or VAT (no impact on outcomes under the GloBE rules as they are not treated as Covered Taxes). If agreed, it would be possible to neutralize the effect of top-up tax arising under the GloBE rules for investors while also benefiting local governments, by changing the mix of taxation applicable to the project; or the timing of tax collections for governments.

- Many tax incentives operate with the effect of minimizing tax payments during the earlier stages of operations e.g., a corporate tax holiday during the first [10] years of operation. Replacing these incentives which are likely to give rise to top-up tax are expected to bring forward tax revenues for host jurisdictions.
- Under this approach as noted above, the government is in direct control of its tax revenue rather than subject to OECD proposals; disputes would be resolved directly between investors and the government rather than through another jurisdiction's view of the application of the GloBE rules.
- Where stabilized agreements are published, and ratified by Parliaments, this provides transparency in relation to the tax regime for the project and provides the highest level of certainty for investors.

75. It is acknowledged that opening tax clauses within stabilized agreements may be complex and risky for governments and investors, given the potential to trigger renegotiation of issues wider than tax. In addition, renegotiation can take many months. One way to address this complexity would be to provide the option of a simplified approach for importing a simplified domestic minimum tax into stabilized agreements.

Option 2 – Side Agreement

76. Instead of directly amending a stabilized agreement through mutual agreement between investors and host government, a side agreement may be entered into. A side agreement generally comprises an agreement outside of the stabilized agreement that has the effect of amending certain clauses of the original agreement. Similarly, an investor may agree to 'waive' certain clauses in the stabilized agreement, enabling a host government to introduce new fiscal terms in response to the GloBE rules.

77. This approach may reduce the complexity and limit the scope of amendments that can be made to the existing stabilized agreement, thus limiting risks associated with opening wider issues outside of the tax regime for a project. In these circumstances, investors are likely to insist on clarity of what is being agreed to and on dispute resolution processes in the event of disagreement as to the interpretation of the rules that apply as a result of a side agreement or waiver. Where this approach is adopted, it will be necessary to ensure the existing stabilization clauses and applicable laws permit variation, and that the agreement relates only to tax.

78. As for option 1, an alternative would be to provide pro-forma agreements or interpretative guidelines to be followed when implementing a side agreement.

Option 3 – Unilateral acknowledgement by taxpayers

79. Another option would be for an investor to acknowledge that any top-up tax imposed in the parent or shareholder jurisdiction is paid locally. On its face, this approach may seem simple to implement and thus may be attractive to investors and host governments. However, the approach raises a number of practical

challenges which are ultimately expected to undermine the stability of the tax regime and therefore make this approach unsustainable.

80. The practical challenges associated with unilaterally agreeing to pay top-up tax in the host jurisdiction include:

- To avoid double taxation, a tax must be a Covered Tax for the purposes of the GloBE rules.[23] To constitute a Covered Tax for the purposes of the GloBE rules, the payment must be a *"compulsory unrequited payment to a General Government."* It is unlikely that an acknowledgement by an investor to pay top up tax locally will be treated as a Covered Tax as it is not a compulsory unrequited payment. This is important, as if it is not a Covered Tax, double taxation will arise as the investor will still have a primary obligation to remit top-up tax to the tax authority in the shareholder jurisdiction.
- Even if the payment does count as a Covered Tax, top-up tax could still be payable in the shareholder jurisdiction to the extent the original liability has been sheltered by the SBIE. That is, the inclusion of the original top-up tax liability as a Covered Tax will not produce an ETR of 15% where the SBIE has been applied (and the host jurisdiction otherwise has no Covered Taxes i.e., an ETR of 0%). Revenue collections would be subject to changes or removal of GloBE rules in the shareholder jurisdiction(s)
- Revenue collections would be dependent on whether the investor, or any future investors in the project, are subject to top-up tax – for example due to revenue thresholds or other exclusions. Additional complexity would arise where there are two or more investors in a project which have different outcomes under the GloBE rules.[24]
- Enforceability of such arrangements may be a concern for tax authorities. For example, a host government may not be protected if the company decides to revoke its unilateral election (e.g., following a sale of shares to a new investor). Dispute resolution processes may be a concern for investors.
- There may be complexity in identifying the relevant top-up taxpayer in relation to the local jurisdiction. This may not necessarily be the investor's ultimate parent company is based (e.g., where there are partially-owned entities within the upstream structure or where Pillar Two tax is levied under the UTPR or Subject to Tax Rule). The arrangement would need to be robust enough to deal with this, including flexibility to adapt to future change in the Pillar Two taxpayer, e.g., as a result of upstream ownership changes or the late implementation of Pillar Two in a relevant jurisdiction.

81. While it may be beneficial to amend tax regimes for projects that are subject to stabilization provisions due to the global endorsement of the GloBE rules, it is important to ensure certainty in respect to taxation and other commercial aspects governing an extractive investment.

[23]

[24] The risk of investors having different outcomes under Pillar Two is elevated where they have unrelated upstream investment structures that are governed by GloBE rules implemented in different jurisdictions. While the OECD Inclusive Framework countries have committed to a consistent and coordinated implementation of the GloBE rules in principle, it remains to be seen whether this will happen in practice. There is already evidence of possible departures from the model rules seen in some host jurisdictions proposed legislation for implementing Pillar Two. Despite the best efforts for consistent implementation, it is foreseeable that departures from the model rules will increase with time as their interpretation and application is tested in practice and disputes arise.

Tax policy responses

2.5 What are the possible domestic policy responses of resource-rich countries?

82. Where countries project that the implementation of GloBE will result in the imposition of a top-up tax in another jurisdiction, either through the mechanics of the IIR or UTPR, they may consider enacting domestic policy responses that serve to preserve their primary taxing rights. Various domestic policy responses will be available to resource-rich countries subject to some potential legal barriers within their domestic or international legislative regime that may serve to limit the scope of reforms. These legal risks include, in particular, the constraining effects of stabilization clauses discussed above.

83. Resources rich countries will not be impacted by GloBE in a uniform manner and so the proposed responses and their varying complexity will need to be weighed against any projected revenue losses, as well as other domestic fiscal priorities. Some reforms may be carried out in parallel as well. Each country will accordingly need to determine which policy reforms best meet its national interest and which are most practicable within its administrative capacity constraints. Where a resource rich country establishes that it hosts only a few constituent entities (with predictably low profits) of in-scope MNEs within its jurisdiction, or that the constituent entities, on the whole, are subject to an ETR higher than 15%, maintaining the status quo may be the easiest course of action, as there is no or little revenue loss at stake currently and there can be considerable complexity in introducing new tax provisions. Such countries may still wish to reflect on the effectiveness, use, and mix of tax incentives that they avail to companies operating in the sector.

84. This section considers the most viable policy responses for resource rich countries. Given the extensive use of tax incentives as an investment promotion tool, a key response is likely to be the revision of the tax incentives regime and specific consideration of stabilization provisions if applicable (as discussed above). Countries may also implement broader reforms that ensure that any possible top-up taxes are retained domestically, such as by implementing a Domestic Minimum Tax (DMT). A QDMTT is one version of DMT that is consistent with GloBE rules and would only apply to MNEs that are in scope of the GloBE rules[25], beyond the extractive industries. A QDMTT would qualify for the QDMTT Safe Harbor (discussed further below). A country may also choose to adopt these two domestic measures in a concurrent manner particularly in light of the complexities of unwinding the tax incentive regime applied to extractive companies. This section considers the impact of these two response measures in turn.

85. For projects that have existing stabilization agreements, this section should be considered in conjunction with Section 3 - in other words, the first step would be to consider which revisions to existing tax incentives are possible under stabilized agreements, and which revisions require amendments of the stabilized agreements.

2.6 Review the use of tax incentives

86. Given that the GloBE rules are likely to nullify some of the benefits that investors derived from the use of some types of tax incentives, it is recommended that countries review the effectiveness of the existing set of tax incentives, with a view to considering optimizing their use in the new environment. The chapter 5 in the Handbook (2021) on Tax Incentives sets out how to evaluate tax incentives and can

[25] Alternatively, based on the latest Technical Guidance released by the OECD on 2 February 2023, an implementing jurisdiction has flexibility to expand the application of their QDMTT to a broader scope than the GloBE rules.

be used in this regard. This review will need to take into account the nuances of the GloBE rules, including the fact that the Substance Based Income Exclusion will result in some profits not being subject to the top up to 15%. Furthermore, some international tax considerations may further impact the overall effectiveness of tax incentives granted to the industry under the GloBE rules. These considerations include the impact of taxes imposed by other jurisdictions on in-scope MNEs.

87. The governance structure of the extractive industries may serve to complicate the evaluation of tax incentives within the sector. Although good practice suggests tax incentives should be provided for in general tax legislation, in practice, tax incentives can be located in the following sources:

1. Corporate income tax laws
2. Investment promotion laws
3. Sector-specific laws (petroleum, mining, agriculture, fisheries, forestry, manufacturing, telecoms, etc.)
4. Laws governing special economic zones.
5. Special statutory provisions or decrees
6. Bilateral investment treaties (BITs)
7. Investment agreements, including concession agreements or production-sharing contracts for extractive industries (including stabilized agreements as discussed above)
8. Free Trade Agreements - regional or inter-regional
9. Ad hoc government acts (e.g., decrees)

88. Where countries decide to adhere to Pillar Two, they may consider amending certain tax incentives which are less effective in light of GloBE. Firstly a map-out of the exact source of tax incentives for in-scope MNE’s will be necessary. They will then need to assess the legal constraints that may impede the withdrawal of impacted tax incentives with special attention to the stabilization provisions whose risks have been assessed above. Countries will then have to ensure that the reform process is carried out in a comprehensive and consistent manner by amending the tax incentive regime in both the domestic and international sources that have been identified above. Whilst reviewing tax incentives is the most targeted manner to retain domestically any possible top up tax, depending on a country's legislative framework, it may prove to be a time and resource consuming exercise. The risks of opening up contracts in order to renegotiate the extension of tax incentives must also be balanced against the overall revenue implications of exploring other options of domestic revenue retention under the GloBE rules.

89. Rather than entirely unwind the use of tax incentives, countries may seek to revisit the mix of tax incentives granted to extractive companies. As the GloBE ETR reducing impacts of tax incentives vary, countries and companies may wish to replace profit-based tax incentives with measures such as certain tax deferrals and investment allowances, for example. Given the capital-intensive nature of extractive projects, cost-based tax incentives such as these have been found to be more appropriate relief measures. Care should be taken to ensure that any resulting incentives represent value for money to the country, as discussed more widely in the chapter in the handbook.

90. Reviewing tax incentives may be carried out in parallel with other response measures such as the adoption of a broader domestic tax or a qualified domestic tax which may be implemented sooner.

2.7 Adopt a Qualified Domestic Minimum Top-Up Tax (QDMTT)

91. The GloBE rules provide specific treatment where a jurisdiction introduces a QDMTT. This response measure is, however, not industry specific and must be implemented across all industries. Applying a QDMTT to extractive companies only could be perceived to be inherently discriminatory in nature and open a country to various domestic and international challenges. It would also mean the regime does not meet the scoping requirements under the GloBE rules, causing the DMT to not be recognized as having a "qualified" status. [26]

92. A country has the choice to:

- introduce a Qualified Domestic Minimum Top-up Tax (QDMTT) to ensure that the "top up tax" is paid locally rather than at the headquarters level. This can be achieved through either a "strict" QDMTT that meets the safe harbor requirements and switches off the headquarters;
- implement a "relaxed" QDMTT that operates as a credit against any IIR payable.

93. Adopting a QDMTT as prescribed by the OECD has the advantage of aligning with the top-up taxes that would be collected under IIR or UTPR. A QDMTT further presents a targeted response to the GloBE model rules and so it will not impact out of scope companies, which may be an important consideration for host countries. It also ensures that the benefit of the substance can be provided to investors, without leading to additional top up tax in shareholder jurisdictions (as discussed further below).

94. On the other hand, a QDMTT essentially requires implementation of rules and administration that mirror Pillar Two and would therefore be complex to administer and would require significant additional capacity for many countries' tax authorities.

95. It is also important to note that a QDMTT will rank before controlled foreign company (CFC) taxes. In February and July 2023, the OECD published further guidance on the design of a recognized QDMTT towards assisting countries in establishing if their domestic minimum tax is qualified. The 2023 guidance provides further insights into the scope and nature of QDMTTs, including that it can be more restrictive in scope than the GloBE rules in order to preserve consistency with local tax rules. Countries are further not compelled to provide adjustments to the computation of a QDMTT that are not consistent with the domestic tax system. The application of a QDMTT may be extended to constituent entities whose UPE is located in a country but fall outside the revenue scope of the GloBE rules. It can even apply to purely domestic companies. While this paper is not intended to cover in detail every aspect involved in a QDMTT achieving qualified status, the main considerations for a host country are outlined below. The requirements are described in detail in the GloBE rules and the 2023 guidance. Because it is an evolving process, further guidance from the OECD and the IF is still anticipated on various aspects related to administering QDMTTs.

96. The GloBE rules currently define a QDMTT as a domestic minimum tax which presents the following characteristics:

[26] OECD (2023), Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), OECD/G20 Inclusive Framework on BEPS, OECD, Paris. www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillar-two.pdf.

1. Determines the excess profits of Constituent Entities located in the country (domestic excess profits) in a manner that is equivalent to the GloBE rules.

2. Increases the domestic tax liability with respect to domestic excess profits to the minimum rate for the country and Constituent Entities for a fiscal year.

3. Is implemented and administered in a way that is consistent with the GloBE rules and the commentary, so long as the adopting country does not provide any benefits that are related to such rules.

<u>GloBE Rules</u>

98. In order to qualify for the safe-harbor, a QDMTT should follow the architecture set out in the OECD's model rules as closely as possible. In order for a DMT to be a QDMTT (i.e., achieve "qualified status, an implementing country will need to use substantially similar methods to the model rules towards calculating the ETR of in-scope companies as well as any resulting top-up tax. Each jurisdiction will invariably have to customize a QDMTT to its local circumstances, which the IF recognizes. However, any deviation from the model rules will need to be justifiable within the context of the domestic tax system and will need to result in outcomes consistent with the purpose of the rules.

99. An assessment of the viability of a QDMTT will need to be conducted in a case-by-case manner, taking into account existing outcomes under a country's domestic law. There are however two principles guiding the qualification of a QDMTT:

a. The minimum tax must be consistent with the design of the GloBE Rules; and

b. The minimum tax must provide for outcomes that are consistent with the GloBE Rules.

100. Despite the stated benefits of applying a QDMTT, such adoption is likely to be a burdensome undertaking, particularly within the context of limited tax administration and enforcement capacities. Countries may opt to first monitor the extent to which top-up taxes attributable to entities within their country are enforced elsewhere; then, only in the event of significant revenue loss, decide to adopt a QDMTT. This "wait and see" approach will however rely on efficient information sharing processes and may present less legal and revenue certainty for governments.

101. A country's QDMTT will not exist in a vacuum. The qualification of a minimum tax as a QDMTT depends on its interaction with the existing tax system and whether it achieves outcomes consistent with the GloBE Framework. Therefore, if a country extends tax incentives that undercut the aims of GloBE, it will not be considered a valid QDMTT. A country that for example transfers back Qualified Domestic Minimum Top-Up Taxes as subsidies to taxpayers, or refundable credits will thus expose itself to the external mechanics of GloBE such as the IIR or UTPR to the extent that the tax incentives it returns to companies to undercut the QDMTT. Further, incentives or subsidies introduced by a country that are designed to compensate for the introduction of a QDMTT will result in the DMT not meeting qualifying status.

102. The IF has further developed a multilateral review process that will amongst other things assess whether the domestic minimum tax that a country administers, produces outcomes that are consistent with the GloBE rules and particularly if it should be treated as a QDMTT. In July 2023 the IF published further administrative guidance, including examples, to clarify the interpretation and operation of the OECD model rules. Appendix A3 provides further guidance on the QDMTT Safe Harbor.

<u>QDMTTs and substance based carve-out</u>

103. Although a QDMTT is not compelled to include a substance-based carve-out, if the aim is to mirror the impact of IIR and UTPR, then countries may wish to provide investors with the benefit of the SBIE. The model rules restrict any such carve-out to the substance factors set out in the model rules, such that they may not go beyond the scope of exclusions for only tangible assets and payroll. The QDMTT could however provide for an applicable percentage lower than the GloBE rules and a country may decide not to adopt any transitional allowances in the percentages of the carve-out. To ensure functional equivalence the applicable percentage of the carve-out may not go above the percentages provided for in the rules.

104. Given the high level of investment in tangible assets for developing economies, the quantum of the substance based carve out is likely to be significant and most relevant where corporate tax rates are 15% or lower. For a $1billion capital investment, the carve-out would be equal to $10.5m for a single year ($1billion asset base x 7.5% x 15%). As noted, the benefit of providing this carve out needs to be weighed against the complexity of administering a QDMTT for tax authorities and companies. For DMTs that do not qualify as QDMTTs, the value of the carve-out would be partially eroded.

2.8 Adopt a Simplified Domestic Minimum Tax

105. To preserve domestically any possible top up taxes, a country may also adopt a domestic minimum tax (DMT) that achieves the same objectives as a qualified minimum tax but is simpler to design and implement. Like the QDMTT, this tax would need to be levied at a minimum rate of at least 15%. However, to ensure the credibility of a domestic tax in foreign jurisdictions, countries will need to ensure that it is recognized as a covered tax. Under the GloBE rules, a covered tax is defined as “any tax on an entity’s income or profits (including a tax on distributed profits), and includes any taxes imposed in lieu of a generally applicable income tax[27].” The tax must further be compulsory and unreciprocated. This threshold is easier to meet than the onerous threshold of a QDMTT, which may make this approach a more viable option for countries with limited administrative resources.

106. A domestic minimum tax can thus be implemented in various ways. This tax could apply broadly to all large corporate taxpayers, to all domestic MNE’s or, similar to a QDMTT, be designed to apply only if a domestic constituent's entity would be liable for a top up tax in another jurisdiction under the GloBE framework. The main difference between a simplified domestic minimum tax and a GloBE compliant QDMTT is that, if the low taxed constituent entity is not anticipated to be liable for a top-up tax in a foreign jurisdiction, it will not be subject to a QDMTT. However, the application of a simplified domestic minimum tax will not necessarily depend on the application of GloBE in other jurisdictions. A simplified domestic minimum tax thus risks increasing the tax liability of all MNE’s operating in a jurisdiction indiscriminately.

107. The risk of a simplified domestic minimum tax resulting in the double taxation of a constituent entity will depend on whether it is recognized as an Adjusted Covered Tax in the calculation of the MNE’s overall ETR. As long as it is based on the profits of local branches of MNEs, it should qualify as a Covered Tax. Where it is not so considered a covered tax, for example if the simplified domestic tax is based on

[27] Organisation for Economic Co-operation and Development. (2021). *FAQs on model GloBE rules.* p. 3. https://www. oecd.org/tax/beps/pillar-two-model-GloBE-rules-faqs.pdf

companies' gross revenue, it may risk adding an additional tax burden to a company that continues to face a GloBE top-up tax in another jurisdiction.

108. In theory, a DMT could enable countries to design a DMT that reduced the potential application of top up taxes but did so in a way that was significantly less burdensome than a QDMTT. However, care is needed to ensure that such a tax would qualify as both a Covered Tax for the GloBE purposes and as creditable tax for treaty obligations.

2.9 Conclusion

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[28] Organisation for Economic Co-operation and Development. (2021). *FAQs on model GloBE rules.* p. 3. https://www. oecd.org/tax/beps/pillar-two-model-GloBE-rules-faqs.pdf

APPENDICES

Appendix A: Introduction to Pillar Two / GloBE

1. At their core, the GloBE rules are a series of complementary rules, designed to ensure that all MNEs with a total group annual revenue above €750 million pay a minimum tax of 15% of profits in every jurisdiction in which they operate. This is achieved by creating a "top-up tax" that is applied to the profits of an MNE (above a substance based safe harbor) to bring the total taxes paid to the minimum of 15% of accounting profit.

A.1. Key Concepts

2. The primary operative mechanism of the GloBE rules is the Income inclusion Rule (IIR) which is backstopped by the Undertaxed Profits Rule (UTPR), formally known as the Undertaxed Payments Rule. Affected countries may preclude the application of the IIR and UTPR by implementing a Qualified Domestic Minimum Top-up Tax (QDMTT), which will capture domestically any additional tax revenue stemming from the application of the GloBE rules. The function of the QDMTT as a domestic response measure is strengthened by the fact that it ranks ahead of Controlled Foreign Corporation (CFC) taxes, while IIR and UTPR do not.

<u>The Effective Tax Rate</u>

3. The starting point towards establishing the applicability of the GloBE rules to a multinational company is to ascertain the effective tax rate (ETR) for in scope constituent entities in each jurisdiction. This calculation makes use of the financial accounting net income or loss of a constituent entity for a financial year. The ETR itself is the ratio of a multinational group's taxes paid or that are due on GloBE income in a specific jurisdiction, divided by the multinational's GloBE income from that jurisdiction. Differences between the taxable income as it is calculated under GloBE and domestic rules are accommodated in this calculation through relevant adjustments. Some shareholder-level taxes imposed through CFC regimes will also be accounted for.

4. Effectively, a jurisdiction's ETR is calculated by dividing the sum of the adjusted covered taxes by the net GloBE income of that jurisdiction.

Jurisdiction ETR = Adjusted covered taxes/Net GloBE income

<u>Covered Taxes</u>

5. Under the GloBE rules, covered taxes are the taxes that are considered towards calculating the effective tax rate of a multinational group. Covered taxes include the income taxes (both current and deferred tax expense) reflected in the Constituent Entity's financial statements. However, the rules allow for some adjustments[29]. The GloBE rules consider taxes withheld on payments of income such as interest, royalties, and services as covered taxes of the recipient entity. Taxes withheld on distributions are considered

[29] The financial statement is the unconsolidated statement of the Constituent Entity. If the Constituent Entity engages in non-arm's length transactions with other multinational group members, the unconsolidated financial statement must be adjusted to reflect arm's length transactions. Because the multinational group's consolidated financial statements eliminate intercompany transactions, the unconsolidated financial statement used in GloBE is unlikely in most countries to have previously been reviewed under the arm's-length standard.

covered taxes of the entity distributing the earnings as well as certain shareholder-level taxes on undistributed earnings of a subsidiary as if paid by the subsidiary and not the shareholder. It can accordingly be understood that the computation of a constituent entity ETR is ascertained through a combination of its domestic corporate income taxes as reflected in the financial statements (including taxes withheld on income payments to it) as well as taxes paid on distributions and deemed distributions of its earnings by both direct and indirect shareholders.

The Income Inclusion Rule (IIR)

6. The IIR is a rule that entitles the residence country of a parent or intermediary holding company to impose a "top-up" tax, where the constituent entities of a multinational group in that jurisdiction are subject to an ETR below 15% in the source jurisdiction. The top-up tax is levied only on the "excess profit" for a jurisdiction. Excess profit is broadly defined as the GloBE profit less the Substance Based Income Exclusion (SBIE) discussed further below.

Example 1:

7. Country A offers a range of tax incentives including tax holidays and reduced rates to extractive companies as an investment promotion tool. Extractive company X which is a constituent entity of an MNE group[30] has an ETR determined under GloBE rules of 8% in Country A. Through the IIR, Country B, which adopts GloBE and is the country of residence of extractive company X's parent entity, is entitled to collect the difference between 15%, the global minimum tax rate, and 8% of the ETR applied in Country A. Country B imposes 7% tax on the excess profits (the profit after applying the SBIE) of company X from company X's parent entity.

The Qualified Domestic Minimum Top Up Tax

8. The QDMTT is a domestic minimum tax that preserves the first right of taxation for the source country. This preservation of taxing rights is achieved by a QDMTT tax being creditable against an IIR or UTPR or alternatively if the QDMTT meets the QDMTT safe harbor requirements, by deeming the IIR or UTPR top up tax to be zero. The OECD has released initial guidance on the features of a domestic minimum tax (DMT) that will make it eligible for qualifying status. However, the final status of a DMT as qualifying is determined by a peer review of the IF.

Example 2:

9. Country A offers a range of tax incentives to extractive companies as an investment promotion tool. These incentives bring the GloBE ETR of company X, which is a constituent entity of an MNE, to 8%. Subject to guidance under development, some specific QDMTTs may preclude the application of the IIR and UTPR by the country of residence of the parent or other constituent entities within the MNE group. Alternatively, a QDMTT will be creditable against an IIR or UTPR. The QDMTT in effect entitles Country A to collect the difference between 15% and 8% domestically thereby ensuring that company X is still taxed at a minimum rate of 15%. Thus, preserving the first right of taxation to Country A (the source country).

[30] with a total group revenue above EUR 750 million.

Undertaxed Profits Rule

10. The operation of the Undertaxed Profits Rule (UTPR) is a “back stop” to the application of the IIR. Its application is triggered only where an in-scope multinational group constituent entities are not liable for an ETR of at least 15% and further, the Ultimate Parent Entity’s jurisdiction does not implement an IIR or to the extent that the IIR is not implemented in intermediate parent jurisdictions. In practical terms, the UTPR is designed to adjust the income or similar mechanism of one or more Constituent Entities to produce a tax equivalent to the top-up tax amount that was calculated but not collected in respect of a low-taxed Constituent Entity elsewhere in the group. This includes scenarios in which the ultimate parent entity is itself a low-taxed Constituent Entity. Where more than one jurisdiction hosting a Constituent Entity of the MNE group adopts a UTPR, each of the countries is designated a portion of the top-up tax amount according to an allocation key based on the number of employees and net assets.

Example 3:

11. Country A applies an ETR of 4% to extractive company X which is a constituent entity of an MNE. Country A does not adopt a QDMTT. The residence country (Country B) of the MNE’s parent entity does not adopt GloBE entirely; however, the MNE has another constituent entity in country C that is taxed above 15% and is resident in a country that adopts GloBE. The UTPR allows the resident country of company C to collect UTPR tax based on the difference between 15% and 4% applied to company X’s excess profits.

Substance Based Income Exclusion (SBIE)

12. The SBIE (also referred to as the ‘substance based carve-out’) excludes a portion of income derived from tangible investment and payroll in the source country from the computation of any possible top-up tax. The SBIE effectively reduces the impact of GloBE on in-scope low taxed constituent entities that have ‘substance-based’ income, meaning that where a constituent entity has specified assets or payroll expenses, the amount of possible top-up tax is reduced by this exclusion.

13. The SBIE permits countries to “continue to offer tax incentives that reduce taxes on routine returns from investment on substantive activities[31],” without triggering the application, or reducing the impact, of the GloBE rules. Initially, the SBIE has been set at 8% and 10%, respectively, of the carrying value of tangible assets and payroll costs. But it will drop to 5% following a transition period of 10 years.

14. By making a special provision for taxpayers with a high payroll and tangible assets such as the extractive industries, the SBIE makes it permissible for countries to continue to extend some ETR reducing tax incentives to extractive companies without risking tax revenue loss to countries implementing the IIR or the UTPR. The SBIE itself was crafted to promote substance-based activities in jurisdictions where MNEs make substantial income, by providing more favorable tax conditions for countries with high payroll and tangible assets.

Dividends

15. It is important to note that, for GloBE purposes, the dividend income and any tax imposed on it may be removed from the recipient’s ETR calculation. Dividends will be excluded from the recipient’s GloBE

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

income if they qualify as "excluded dividends" under Article 3.2.1(b), i.e. if "paid on shares or other equity interests where (i) the MNE Group holds 10% or more of the Ownership Interests in the issuer or (ii) the Constituent Entity has held full economic ownership of the Ownership Interest for a period of 12 months or more."[32] In addition, any tax paid in respect of such excluded dividends is removed from the recipient's covered taxes pursuant to Article 4.3.1(a) of the GloBE Rules.[33] This mechanism not only avoids double-counting of the same income and tax but also ensures that the ETR in the recipient's jurisdiction is not affected by the inclusion of the dividend income without the corresponding addition of the tax imposed on it, which is attributed to another (source) jurisdiction in accordance with the GloBE Rules.

Conclusion

16. Broadly, the GloBE rules aim to eliminate tax competition by creating a pool of top-up taxes that may be collected by countries where an ETR of 15% is not applied. To preserve first taxing rights and override the default order of the application of the GloBE rules, a country may seek to increase the applicable rate of tax at source, for example by adopting a QDMTT that meets the safe harbor and deems and IIR or UTPR top up tax to be zero. In recognition of the fact that companies often hold tangible assets and substantial payrolls in the countries in which they operate, a substance based carve out has been included within the architecture of the rules. This carve-out allows companies to continue to benefit from ETR reducing tax incentives to the extent of the carve-out rate which will be 8% for payroll taxes and 10% for tangible assets for a transitional period.

17. In December 2022, the OECD released guidance documents on the implementation of GloBE rules that addressed the contemplated safe harbors mechanisms aimed to lessen the compliance burden on companies towards calculating their Pillar Two obligations. A guidance note was also released on additional mechanisms to facilitate the consistent and coordinated adoption of the rules, although the OECD recognizes that interpretation or application differences could still arise between countries depending on domestic adoption measures. The tax certainty mechanisms presently being contemplated include the introduction of a multilateral review process that will be used to assess the viability of a country's application of the GloBE rules, a tax authority referral mechanism that will address rule clarification questions, common risk assessment, and compliance mechanisms that are similar to the OECD International Compliance Assurance Programme (ICAP) and finally binding certainty mechanisms such as bilateral and multilateral advance pricing arrangements (APAs).

A.2. How incentives are affected by GloBE

18. While neither the GloBE rules nor the Commentary explicitly prohibit countries to adopt tax incentives or reduced CIT rates, it is expected that the global minimum tax will have a profound impact on their use,[34] as the extent to which the incentive reduces the ETR below 15%, rendering that element of the incentives ineffective.

19. Nevertheless, not all income-related tax incentives are affected, just as not all are affected by GloBE to the same extent. The impact assessment depends on several different factors involving not only the type and design of the incentive but also the CIT system in the jurisdiction offering it and the specificities

[32] Commentary on the GloBE Model Rules, *Article 3.2.*, para. 36.

[33] Commentary on the GloBE Model Rules, *Article 4.1.3*, para. 8 and 11.

[34] UNCTAD (2022) and Ferreira Liotti, B., Ndubai, J. W., Maina, R. W., Lazarov, I., & Owens, J. (2022). The treatment of tax incentives under Pillar Two. *Transnational Corporations Journal, 2*(2).

and circumstances of the affected MNE, such as its type, activities undertaken, and level of the substance in the relevant jurisdiction.[35]

20. Only "in-scope" incentives will potentially be affected by the top-up tax. This means that, first, only incentives granted in relation to covered taxes, which are essentially income-related taxes, are likely to be affected.

21. The GloBE Rules provide for limited exceptions to its application according to the size, type, and activities undertaken by the MNE group, and for certain types of income earned by in-scope MNEs in the jurisdiction. Thus, only (income-related) incentives granted to MNE groups and income streams falling within the scope of GloBE will likely be affected. Incentives granted to all other out-of-scope situations, such as in relation to taxes that are not included in the GloBE's covered taxes definition, or income-related incentives granted to entities belonging to an MNE group below the €750m threshold, excluded entities and excluded income, will not be affected.

22. A tax incentive will modify the GloBE ETR unless the GloBE rules expressly prescribe specific adjustments to the GloBE ETR to neutralize the impact.[36] This is broadly the case where the incentive gives rise to a timing benefit, rather than a permanent one. In contrast, where an incentive is in-scope, but no specific adjustment is prescribed by the GloBE rules, then it will generally result in a reduction in covered taxes (the numerator of the ETR) with no corresponding exclusion will be done in the GloBE income (the denominator), and hence lower the ETR.

23. The degree of the impact depends on two factors: the magnitude of the tax benefit and the weight of the tax base to which the incentive applies in group's (i.e., on whether the incentivized income is proportionally high enough in the computation of the total GloBE Income in the jurisdiction to bring the ETR below 15%).[37]

24. Notwithstanding this, certain circumstances and specificities of the particular MNE and its group in a jurisdiction may mitigate or reduce the actual effect of the GloBE on some potentially affected incentives:

- First, the GloBE rules provide for a jurisdictional blending calculation of the ETR, whereby the "[ETR] of the MNE Group for a jurisdiction is equal to the sum of the Adjusted Covered Taxes of each Constituent Entity located in the jurisdiction divided by the Net GloBE Income of the jurisdiction for the Fiscal Year".[38] This means that the ETR for the jurisdiction is not computed on a single-entity basis, but is based on ETR resulting from aggregating the GloBE profit of all group entities in a particular jurisdiction.[39] Such jurisdictional blending may reduce the effect of the GloBE rules on a tax incentive as the calculation will blend low-tax with high-tax income, which may limit the overall effect on the ETR. Thus, for example, an incentive granted to an entity may not be or be less affected if, in the same jurisdiction, there is at least another group entity earning high-tax income, or if the same entity has earned other higher-tax income therein. This is likely to be the

[35] OECD (2022). *Tax incentives and the Global Minimum Corporate Tax: Reconsidering tax incentives after the GloBE rules*, mentions that the impact will depend on a three-tiered framework: the jurisdiction level, the entity level and the incentive level.

[36] UNCTAD (2022), p. 136.

[37] As explained in UNCTAD (2022), especially in Figure III.17 at p. 136.

[38] Article 5.1. of the GloBE Model Rules.

[39] Commentary on the GloBE Model Rules, *Article 5.1.1*, para. 4.

case where the incentive is granted to a specific category of income or expenditure rather than being broadly applicable.[40]

- The top-up tax will be levied on profits in excess of the Substance Based Income Exclusion (SBIE), which is the amount of GloBE Income remaining after the exclusion of a "routine return", proxied by payroll and tangible assets costs, in the jurisdiction. Accordingly, the SBIE can have a mitigation effect on the impact of GloBE on tax incentives offered by a jurisdiction depending on the degree of "economic substance" the MNEs have therein due to the nature of their activities. MNEs that rely on substantive activities are likely to benefit the most from the SBIE, meaning that incentives granted to these companies may be less affected by the GloBE rules. Moreover, incentives that have substance requirements in line with the Rules, may similarly benefit from the SBIE and be less affected.

25. Some of the most common types of tax incentives offered throughout the world, for the extractive sector and beyond, are accelerated depreciation and immediate expensing of business assets. Accelerated depreciation allows the cost of an asset to be written off at a faster (or "accelerated") rate than the accounting rate of depreciation. Immediate expensing allows the entire cost of an asset to be deducted for tax purposes in the first year of investment. As both allow investors to deduct the cost of assets over a shorter period for tax purposes compared to accounting purposes, these regimes lower the taxable profits of firms for the years they apply, leading to a deferral of taxation to later stages in a project's life and thus a timing benefit. As such, they are extremely important to capital-intensive sectors such as the extractive industries. These are commonly referred to as "timing differences" because the tax rules allow for tax deductions at different points to time to when amounts are recognized as expenses for accounting purposes.

26. Such timing differences are not always incentive in nature as some accounting expenses can only be deducted for tax purpose when incurred (e.g., rehabilitation and decommissioning costs are expensed over the life or a project but may only be deducted when expenses are incurred towards the end of the project life). In broad terms, these differences lead to the same amount of taxable profit brought to account as accounting profit that is recognized, albeit over different periods of time.

27. Given that GloBE relies on financial accounts to arrive at the tax base, and financial accounts will tend to match the tax benefit to the period in which the underlying expenses is recognized ("deferred tax accounting"), the GloBE rules do not reverse the more beneficial tax treatment of depreciation, where the timing benefits of incentives like accelerated depreciation and immediate expensing could lead to distortions in the ETR calculation. As these incentives simply create a timing or 'temporary' difference, where the payment of the tax is not reduced but deferred into the future, failing to address them under GloBE would lead to over-taxation, especially for capital-intensive businesses such as in the extractives sector.

28. Deferred tax accounting allows the deferred tax liability accrued in the financial accounts to be included at the minimum rate in the adjusted covered taxes computation, retaining the benefit of the timing difference.

29. However, the application of the deferred tax accounting approach under GloBE is subject to a limitation that may render such incentives affected in certain circumstances, namely, the recapture rule. That is, if taxation is deferred for more than five subsequent fiscal years, a recapturing mechanism may

[40] OECD (2022). *Tax incentives and the Global Minimum Corporate Tax: Reconsidering tax incentives after the GloBE rules*, para. 48.

apply for GloBE purposes requiring the deferred tax liability to be reversed.[41] This means that the MNE has to recalculate the amount of covered taxes for the year when the deferred tax liability was originally credited under GloBE, regularizing the amount of top-up tax that should have been paid if no adjustment had been made for the timing difference. Accordingly, GloBE only allows a deferral for a maximum period of five years, where if the book-tax difference is not reverted within this period, the top-up tax needs to be recaptured.

30. The five-year recapture rule has some exceptions, however, where no top-up tax will be recaptured even if the deferred tax liability is not reversed within the period. The Recapture Exception Accrual Rule (REAR) includes a list of categories of deferred tax liabilities that do not need to be monitored for recapture. The list includes, for example, cost recovery allowances on tangible assets, which means that tax incentives providing for immediate expensing or accelerated cost recovery of tangible assets are unaffected by the GloBE rules, even if the temporary difference they create is not reversed within five years. For the purposes of GloBE, tangible assets not only consist of assets classified as property, plant, and equipment or stockpiles for financial accounting purposes, but also include natural resources, such as mineral deposits, timber, oil and gas reserves, and exploration and evaluation assets.[42] Timing differences in relation to de-commissioning and rehabilitation expenses, research and development, foreign exchange gains and losses, and fair value accounting on unrealized net gains are also allowed under the REAR.

31. On the other hand, those incentives directed at assets other than tangible assets that create a temporary difference lasting more than five years are likely to be affected by the GloBE rules, as no REAR applies to them.[43] This may be the case, for example, with long-lived intangibles.

32. It is also relevant to note that, even in the case where a deferred tax liability adjustment is allowed under GloBE (and no recapture applies), if the rate applicable on the income that will be taxed at a later stage is below 15%, the incentive may still be affected by GloBE.[44] This is because the deferred tax arising from timing differences is only recognized in the ETR at the minimum rate. In case the tax rate applicable is below 15%, the tax amount will have to be paid in the year when the income is recognized in the financial accounts, meaning that the deferral would not be applicable for GloBE purposes. Thus, even in relation to cases where recapture would not be needed in relation to incentives for immediate expensing or accelerated asset cost recovery, these may still be affected by the top-up tax if the tax rate applicable is below 15%.

33. The same deferred tax accounting adjustment applies in relation to deferred tax assets on timing differences including those arising from loss carry-forward regimes, also widely used by extractive industries. A loss may occur for tax purposes where deductible expenses exceed taxable income for the period, for which domestic tax rules may permit taxpayers to carry forward such loss until it has been completely offset against future tax liabilities.

34. This mechanism also creates timing differences between tax and financial accounts, where GloBE allows deferred tax adjustments to be taken into account when calculating the MNE's covered taxes. That is, the amount of covered taxes will be reduced in the year in which the deferred tax asset is recognized and will subsequently be increased as the loss is utilized, neutralizing the effect of the deferred tax asset

[41] Article 4.4.4. of the GloBE Model Rules.

[42] Commentary on the GloBE Model Rules, *Article 4.4.5.*, paras 93-94.

[43] OECD (2022). *Tax incentives and the Global Minimum Corporate Tax: Reconsidering tax incentives after the GloBE rules,* para. 61.

[44] Article 4.4.1. of the GloBE Model Rules.

on the ETR. Thus, loss carry-forward regimes generally remain unaffected by the GloBE rules. Deferred tax accounting that relates to carry-forward tax credits, such as foreign tax credits, is not allowable under the GloBE rules and can give rise to top up tax.

A.3. Subject to Tax Rule ("STTR")

35. In July 2023, the OECD released model treaty provision and associated commentary on the STTR. In broad terms, the STTR allows jurisdictions to impose limited additional taxation on certain cross-border payments between connected companies where the recipient is subject to a nominal corporate income tax rate below 9%. The STTR applies to interest, royalties and a specified list of other payments, including all intra-group service payments. Where the STTR applies, the payor jurisdiction can impose additional tax on the gross amount of Covered Income up to 9% of the income. This 9% figure is reduced by (a) the nominal tax rate in the recipient jurisdiction and (b) any existing taxing right of the payor jurisdiction under the applicable tax treaty.

36. The STTR does not itself impose a tax obligation but allows jurisdictions to impose a tax where they otherwise would be unable to do so under the other provisions of the treaty. Where no bilateral income tax treaty applies, source jurisdictions are already able to impose tax on these payments and the STTR has no work to do. For the same reason, the STTR does not apply to a category of Covered Income (for example, interest or royalties) where the source state can already impose an amount of tax that is greater than the STTR rate of 9% on the relevant category under another treaty provision.

37. A multilateral instrument will facilitate the implementation of the STTR. That multilateral instrument will, with respect to all tax treaties it covers, amend treaties and include the STTR. Alternatively, the STTR can be implemented into relevant tax treaties individually via bilateral negotiations.

38. Where the STTR applies, the payor jurisdiction can impose additional tax on the gross payment up to 9% of the income. This 9% figure is reduced by (a) the nominal tax rate in the recipient jurisdiction (factoring preferential tax adjustments) and (b) any existing taxing right of the payor jurisdiction under the applicable tax treaty.23 The STTR takes priority over the GloBE Rules (including QDMTT) and is creditable as a covered tax.

39. Importantly, the STTR will only have effect through the amendment of tax treaties via a multilateral instrument or through bilateral negotiations. Members of the Inclusive Framework that apply nominal corporate income tax rates below 9% to any category of income impacted by the STTR have committed to implement the STTR into their bilateral treaties with Inclusive Framework members that are considered as developing economies when requested to do so.

40. The STTR may have limited effect in practice if the introduction of the GloBE rules results in affected countries increasing their nominal corporate tax rates to at least 915% and/or removing preferential tax adjustments that could cause the effective tax rate to be below 915%. However, the STTR will still apply to low taxed countries that do not increase their nominal corporate tax rate.

A.4. QDMTT Safe Harbor

41. IF members have observed that the requirement to undertake separate Top-up Tax calculations in respect of the same jurisdiction under the GloBE rules (under an IIR or UTPR) and the QDMTT rules will result in increased compliance costs for MNE Groups and administrative burdens for tax authorities. The QDMTT Safe Harbor is intended to provide a practical solution to address this issue. Where an MNE Group qualifies for the QDMTT Safe Harbor, the application of the GloBE rules in other jurisdictions

(under an IIR or UTPR) is effectively switched off, thereby avoiding the need to undertake a second calculation under those rules.

42. Inherently, the QDMTT Safe Harbor represents a significant compliance saving for companies as the Pillar Two compliance in respect to the host jurisdiction is effectively halved. In this respect, given the increasing compliance burden imposed on MNEs from the GloBE rules (along with other international tax developments), the ability for tax administrations to present a tax regime which mitigates burdensome compliance requirements has growing importance for investors.

43. A host country may also be interested in introducing a QDMTT that qualifies for the QDMTT Safe Harbor as this is the only means of definitively ensuring that shareholder jurisdictions will not be collecting any residual top up tax in relation to the host jurisdiction under the IIR or UTPR.

44. However, to address potential integrity risks from switching off the IIR/UTPR in relation to a host jurisdiction, a QDMTT must meet an additional set of three standards to qualify for the safe harbor. The broad description of these standards are as follows:

1. The QDMTT Accounting Standard – requires a QDMTT to be computed based on the accounting standard of the UPE or the financial accounting standard permitted in the host jurisdiction to subject to certain conditions; and

2. The Consistency Standard – requires the QDMTT computations to be the same as the computations required under the GloBE rules, except where the QDMTT commentary explicitly requires the QDMTT to depart from the GloBE rules[61] or the Inclusive Framework decides that an optional variation still meets the standard[62]. The standard applies the same principles in determining whether a DMT achieves “qualified” status (discussed above); and

3. The Administration Standard – requires the QDMTT jurisdiction to meet the requirements of an on-going monitoring process, to ensure that the information collection and reporting requirements are consistent with the equivalent requirements under the GloBE rules and the approach set-out in the GloBE Information Return.

45. In the context of a country with possibly limited tax administration and enforcement capacities, the ability to comply with the Administration Standard is a relevant consideration. However, where a country has decided it is necessary to have a QDMTT and thus already establish the necessary capacity building infrastructure to administer the regime, there may not be any additional steps needed to meet the Administration Standard.

46. The IF envisions the development of a multilateral review process that will assess the DMT that a country administers. Firstly, in terms of whether the DMT can be considered a QDMTT. Secondly, in terms of whether the QDMTT meets the standards of the QDMTT Safe Harbor. In principle, the QDMTT should meet both standards where the jurisdiction computes its QDMTT using the same rules as applicable to calculating an IIR under the GloBE rules (excluding the mandatory variations).

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