TAX INCENTIVES AND INTERNATIONAL TAXATION

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INTRODUCTION

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ADDRESSING DRM

Through securing African taxing rights and implementation of the necessary administrative measures remains a critical issue if Africa is to achieve the Agenda 2023.

COVID-19 PANDEMIC

The Covid 19 Pandemic has exacerbated the DRM challenges by decimating many economies that were already struggling in creating meaningful economic growth measures.

GLOBAL TAX DEBATE

An opportunity to address two fundamental issues:-

- a) To redress the current imbalance in allocation of taxing rights between the source and residence states
- b) To address IFFs through artificial shifting of profits by some MNEs out of developing countries

TAX INCENTIVES TYPES & CATEGORIES

TYPES OF TAX INCENTIVES

Tax incentives granted by African countries include but not limited to:-

01 Reduction of tax rates

02 Special deductions

03 Capital deductions e.g investment deductions

04 Exemption from customs duties and VAT on importations;

05 Creation of preferential regimes (such as Export Processing Zones and Special Economic Zones)

06 Exemption of incomes

07 Tax holidays

CATEGORIES OF TAX INCENTIVES BY AFRICAN COUNTRIES

There are basically two categories of tax incentives granted to investors.

i). incentives that create timing differences between companies' financial statements, which declare profits according to international accounting standards and their taxable income, calculated based on domestic tax rules –e.g., accelerated depreciation.

- These do not reduce the total amount of taxes owed; they merely postpone them.
- They tend to be efficient in attracting investment
- They lower the cost of capital and so make less profitable investments viable

ii). Incentives that reduce or eliminate taxes paid on profits, often for a set period of time – e.g., tax holidays, preferential tax rates, tax credits, investment allowances, or exemptions.

- These incentives are considered less efficient than those in i) above.
- They are more likely to result in profit shifting.
- These are the ones targeted by the reform.

ARGUMENTS FOR AND AGAINST TAX INCENTIVES

ARGUMENTS FOR TAX INCENTIVES

- Attract investments;
- Transfers of know-how and technology
- Increased employment and improved workforce;
- Assistance in improving conditions in less-developed areas';
- Increased economic activity from related suppliers and consumers;
- Increased tax revenue from investor (after incentive expires)
- Increased economic growth

ARGUMENTS AGAINST TAX INCENTIVES

- Investors consider factors such as political stability and security, legal and regulatory environment and presence of large domestic market as critical to their investment decision. Tax incentives not even in the top 10 priorities
- Overgenerous or poorly designed;
- Give away tax revenues
- incentives are captured by politically connected firms and used as a merry-go-round for diverting public funds into political finance.
- Non-Tax losses due to incentives e.g.-”reported losses, mean reduced or minimal wages”

GLoBE RULES UNDER PILLAR TWO PROPOSAL AND IMPACT ON TAX INCENTIVES

SALIENT PROVISIONS OF PILLAR 2 PROPOSAL

- Two interlocking domestic rules (together the Global anti-Base Erosion Rules **(GloBE)** rules):

(i) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity; and

(ii) an Undertaxed Payments Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR.

- The minimum tax rate used for purposes of the IIR and UTPR will be **15%.**

- a treaty-based rule (the Subject to Tax Rule (STTR)) that allows source jurisdictions to impose limited source taxation on certain related party payments

- The taxing right on the payment under STTR will be limited to the difference between the minimum rate and the tax rate (in the jurisdiction of the payee). The minimum rate for the STTR will be 9%.

SALIENT PROVISIONS OF PILLAR 2 PROPOSAL

- The GloBE rules will apply to MNEs that meet the EUR 750 million in at least 2 out of the last 4 years.
- The GloBE rules will operate to impose a top-up tax using an effective tax rate test that is calculated on a jurisdictional basis and that uses a common definition of covered taxes and a tax base determined by reference to financial accounting income.

- The GloBE rules will have the status of a common approach. This means that IF members: - are not required to adopt the GloBE rules, but, if they choose to do so, they will implement and administer the rules in a way that is consistent with the outcomes provided for under Pillar Two.

- The GloBE rules provide for an exclusion for international shipping income.

- The GloBE rules provide for a formulaic substance carve-out.

GLoBE RULES UNDER PILLAR 2 PROPOSAL

1

The GloBE rules contains two interlocking rules, that is the Income Inclusion Rule (IIR) and the Undertaxed Payment Rule (UTPR).

2

As the IIR applies in priority of the UTPR, the Top-Up- Tax for each low-taxed constituent entity is allocated to the shareholder jurisdiction which will often be developed countries where in scope MNEs are headquartered.

3

This effectively implies that a source jurisdictions that may have granted the tax incentives creating the Top-Up Tax has given away their taxing rights to the residence jurisdictions.

PILLAR 2 IMPACT ON TAX INCENTIVES

- The GloBE rules under Pillar 2 will directly **impact the existing income tax incentive** regimes.

- The GloBE rules require that an in-scope MNE determines the **Effective Tax Rate** on a jurisdictional basis in order to establish whether certain jurisdictions can be deemed as Low-Tax Jurisdictions for the purposes of these rules.

- **Effective Tax Rate of MNE Group** for a Jurisdiction = $\dfrac{\text{Covered Taxes}}{\text{Net GloBE Income}}$

- In scope MNE Groups are those with **annual revenue of EUR 750 million or more** in the consolidated Accounts of Ultimate Parent Entity (UPE) in at least 2 of the 4 fiscal years immediately preceding the tested year.

PILLAR 2 IMPACT ON TAX INCENTIVES

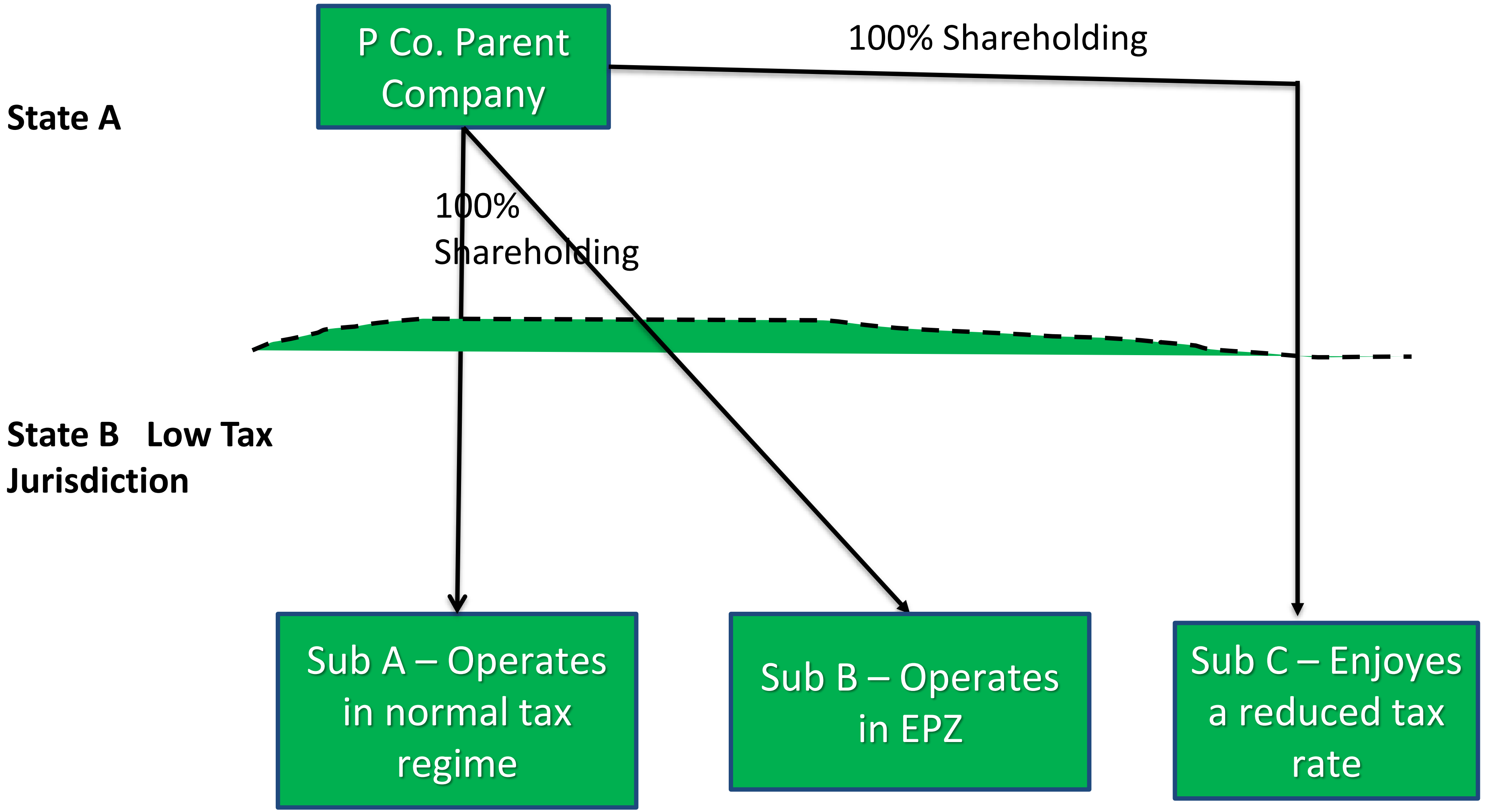
- Certain tax incentives e.g Tax Holidays, Reduced CIT Rates, Exemption of Income e.t.c will reduce (**if not make it Nil**) the **Taxes paid by an MNE Group** in a jurisdiction.

- This outcome may lead to an Effective Tax Rate (ETR) of a jurisdiction **being below the global Minimum Rate of 15%**, making a jurisdiction a Low-Tax-Jurisdiction for the purposes of the GloBE rule.

- **Assuming the Effective Tax Rate (ETR) of a jurisdiction was 5% after consideration of existing tax incentives, a Top-UP Tax Rate of 10% would be applied on the so-called Excess Profits of the jurisdiction.**

- Excess Profit = Net GloBE Income – Formulaic Substance Carve-out

PILLAR 2 IMPACT ON TAX INCENTIVES



- The incomes are blended and jurisdictional Top-Up tax computed.
- Assume State B Effective Tax Rate is determined as 5% and the Excess Profits was USD 2 Million.
- Top Up Tax of USD 200,000 would be allocated State A and taxed in the hands of P Co.

PROPOSED SOLUTIONS

DOMESTIC TAX POLICY REFORMS

01 **African countries can immediately reform the existing tax incentives** such that the constituent entities of in scope MNEs can pay a reasonable amount of income taxes and similar taxes (covered taxes).

02 African countries to **introduce a domestic minimum income** tax which will ensure that the constituent entities of in scope MNEs effectively pay taxes up to the agreed global minimum rate of 15%.

03 **ATAF** is the progress of **developing a Suggested Approach on the Domestic Minimum Tax** which may be implemented by countries to limit the impact of IIR.

04 Renegotiation and/or revision of existing investment contracts/treaties that may contain significant tax incentives

DOMESTIC TAX POLICY REFORMS

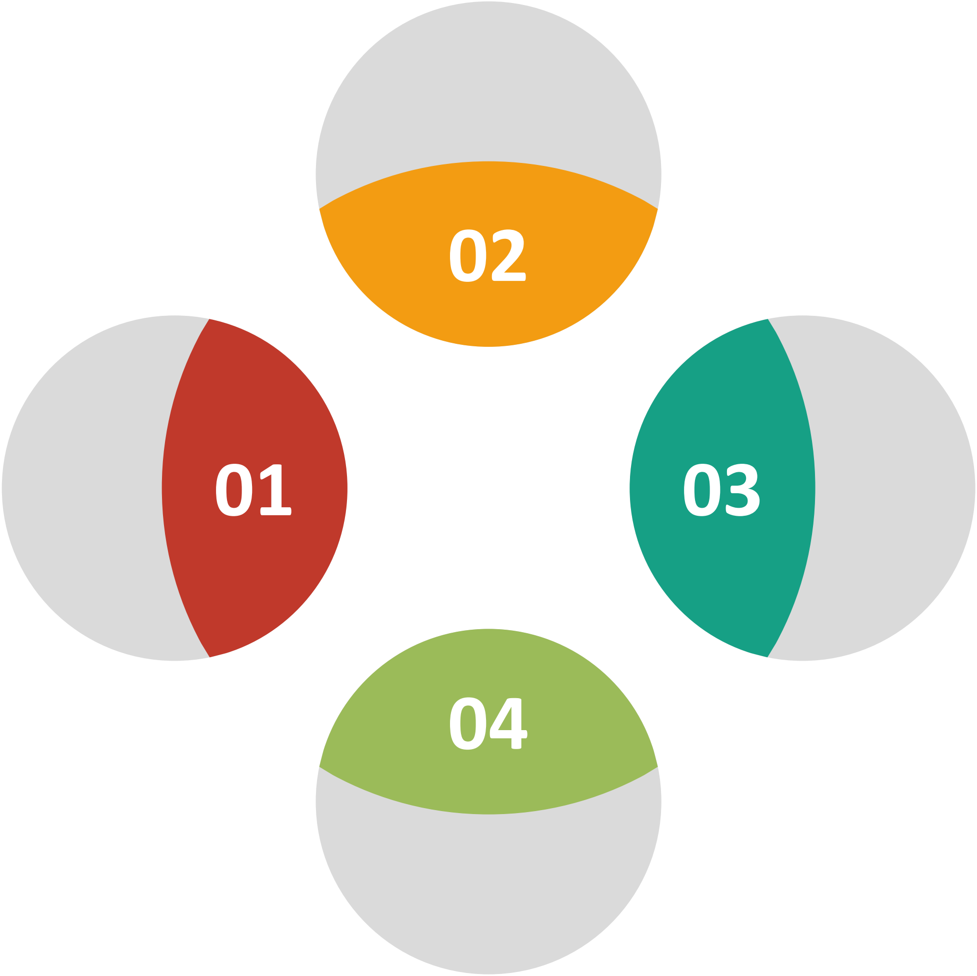
Possible reforms may include:-

Abolishing tax holidays or making adjustments thereto;	**Corporate tax adjustments to or near the global minimum rate of 15%.**
Reforms on exemption of income (some countries have regimes which exempt a significant part of a manufacturing activities income tax);	**Reforms on tax deductions (adjustments to the taxable income)**

These reforms should also take into account the Formulaic Substance Carve-out rule in the GloBE to attract real economic activities to support economic development in developing countries.

A substantial Formulaic carve-out reduces the Excess Profits and the Jurisdictional Top-Up-Tax to be reallocated.

EFFECTIVE PARTICIPATION IN STANDARD-SETTING



OECD Discssions

The Pillar 1 and Pillar 2 Global Tax Reforms are a product of intense negotiations at the OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS).

Pace of Discssions

The discussions have been extremely technical and fast paced making it challenging for many developing countries including African countries to effectively participate.

ATAF involvement

However, ATAF has been deeply involved in these technical discussions and has also provided guidance technical guidance to the African delegates participating in these meetings.

ATAF Focus

Despite the challenges of the pace of the discussions, ATAF continues to call upon more African countries to participate in these discussions.

ATAF'S ROLE

Participation	Support	Assistance	Guidance
ATAF will continue to participate in the remaining technical design of the Global Rules which is expected to be completed by June 2022 for the rules to be implemented in 2023.	ATAF will support countries to implement the rules but more importantly to implement the necessary reforms to ensure the rules, particularly the Pillar 2, do not have unfavourable impact on African countries.	Development of the Suggested Approach to Drafting the Domestic Minimum Income Tax legislation	Guidance on tax expenditure analysis and how to conduct the cost-benefit analysis of tax incentive Guidance on how to address the challenges of existing investment agreements that may contain significant tax incentives

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