The impact of BEPS on tax incentives in Asia Pacific

Many jurisdictions in the Asia Pacific region offer a range of tax incentives to attract foreign investment and to drive the development of local infrastructure. However, the introduction of a global minimum tax raises questions as to the future of such incentives.

A survey of the region shows a significant number of incentives below the global minimum tax rate. With the BEPS 2.0 reforms moving quickly, governments across the region will need to rapidly determine their policy responses to the measures, which can effectively neutralize their incentives even without domestic adoption of the rules.

Introduction

On 8 October 2021, the OECD Inclusive Framework ("IF") announced that it had reached majority agreement on the building blocks and key rates for a new global tax framework, which is currently supported by 136 out of 140 IF members.

The BEPS 2.0 rules are divided into two parts.

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The first part – Pillar One – involves the reallocation of taxable profits of multinational groups that have more than EUR20 billion in global turnover and profitability above 10 percent (measured as profits before tax, divided by revenue).

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The second part – Pillar Two – seeks to set a global minimum effective tax rate of 15 percent for multinationals. It is aimed at those with a global turnover of EUR750 million or more, but it is expected some countries will apply the rules without such a threshold.

Recent KPMG publications give a fuller explanation of the blueprint proposals for Pillar One and Pillar Two, the July 2021 IF statement and the 8 October 2021 statement.

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Impact of a global minimum tax rate on ASPAC tax incentives

The adoption of previous BEPS reforms across the ASPAC region has been historically been low. For the BEPS 2.0 measures, 16 out of the 17 members of the Inclusive Framework in the region have signed up to implement the reforms in due course (Sri Lanka did not sign up). However, this still leaves a number of countries that are not Inclusive Framework members in the region that are unlikely to adopt the reforms.

Notwithstanding this, it is important to note that Pillar Two is not like some of the other BEPS measures, where it simply won't affect a country or territory that chooses not to adopt it domestically. If a taxpayer is eligible for a tax incentive that results in an effective tax rate (ETR) below 15 percent, additional top up tax can become payable in another jurisdiction (typically at the ultimate parent company level). In other words, regardless of Pillar Two adoption by the subsidiary jurisdiction, there is an indirect impact for that jurisdiction as any tax incentive offered is neutralized at group level.

The global minimum tax rate is now fixed at 15 percent. The question then arises – how likely is it that a country or territory will continue offering generous tax concessions (at a cost to their tax revenue) if another can claw back that benefit (to benefit their tax revenue)?

In a survey conducted across KPMG firms in the region, it was found that there were more than 40 key tax incentive regimes across the ASPAC region that had the potential to be impacted by the Pillar Two measures, although once sector-specific variations of these incentives are factored in, the number grows considerably.

Tax holidays and special economic zones

At least 14 jurisdictions across the region offer tax holidays for certain industries, with the bulk in the manufacturing and power generation industries. In addition to this, entities that set up in special economic zones in at least nine countries can enjoy concessional tax rates. For both categories of incentives, the tax rate is typically nil for a fixed period of time (ranging from three years to 20 years, although most did not exceed 10 years), followed by a discounted rate for a further period.

With nil tax rates being offered, often to all of the taxable income of the incentivized company, the benefits of these types of incentives are most likely to be counteracted by Pillar Two.

Industry and activity-based tax incentives

At least seven jurisdictions offer activity-based or industry-based low tax rate incentives (including regional headquarters, treasury centers, intellectual property, global trading, financial services, shipping and aircraft leasing).

In most cases, the incentive rates sit between five and 10 percent and apply only to qualifying income of the incentivized company, so in practice the effective tax rates of those companies may be higher. Lower rate incentives may not survive in the wake of Pillar Two, but those sitting at the higher end might continue on.

R&D incentives and enhanced deductions

Several jurisdictions across the region offer R&D incentives or enhanced deductions for certain industries. This can be in the form of non-refundable tax credits, refundable tax credits, enhanced or accelerated deductions or grants.

Under the Blueprint paper released last year, grants and tax credits that are refundable within four years may be treated as income rather than a reduction to tax under Pillar Two, leading to a higher ETR compared to non-refundable tax credits or enhanced deductions. Notwithstanding this, jurisdictions with high headline corporate tax rates are likely to adopt a 'wait and see' approach before changing their R&D incentives, as their application to qualifying activities only will not necessarily pull the ETR of those entities below the global minimum tax rate.

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Exempt income classes

Various jurisdictions provide an exemption from tax for certain types of income, such as income from government bonds, debt securities and venture capital investments. In addition, territorial or semi-territorial regimes like Hong Kong (SAR) China, Singapore and Malaysia are exempt foreign sourced income and capital gains.

The Pillar Two impact will depend on whether such classes of income are proportionally high enough to drag the effective tax rate below 15 percent. For jurisdictions with headline or incentive tax rates close to this level, this is quite possible. Responses to the EU's blacklist / grey list may mean fewer exempt income classes going forward.

Headline tax rates

With a corporate tax rate of 12 percent, **Macau (SAR), China,** is the only jurisdiction in the region with a headline rate below 15 percent.

A summary of the types of tax incentives across the region is set out below (excludes incentives with a tax rate above 15 percent and those under repeal).

Country/Region/ Jurisdiction	Tax holiday	Special Economic Zone	Regional HQ/Tsy Centre/IP	Other mobile activities	Non-refundable R&D credits	Enhanced deductions	Exempt income
Australia*					●		
Bangladesh	●	●					
Brunei*	●						
Cambodia	●						
Mainland China*	●	●				●	●
Fiji	●	●					
Hong Kong (SAR)*			●	●		●	●
India*	●	●	●			●	●
Indonesia*	●	●					
Japan*					●		
Korea*					●		
Lao PDR	●						
Macau (SAR)						●	●
Malaysia*	●	●	●	●		●	●
Myanmar							
New Zealand*							●
Pakistan*	●	●		●			
PNG*		●				●	
Philippines	●	●	●			●	
Singapore*	●		●	●		●	●
Sri Lanka						●	
Taiwan		●			●	●	
Thailand*	●		●			●	
Vietnam*	●				●		

*Signed October 2021 IF agreement

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Mitigating factors

There are certain design features within the Pillar Two rules which should lessen the impact for some multinational groups.

Jurisdictional blending allows for the ETR to be calculated on an aggregated basis for all group entities in the same jurisdiction. Consequently, major market countries or territories, where multinationals may be more likely to have both non-incentivized entities (e.g. sales companies) and incentivized entities (e.g. manufacturing, R&D) may be able to more effectively continue to offer tax incentives post-Pillar Two, given the degree to which jurisdictional blending can 'protect' the value of these incentives.

In addition, the formulaic substance-based exclusion for a 10 percent return on payroll costs and 8 percent return on tangible assets (tapering to 5 percent over 10 years) may also reduce the impact, particularly for manufacturing operations with cost plus profits. However, the impact of the concession for higher profit operations may not be significant.

For Ultimate Parent Entities that benefit from incentive rates, the delay of the Undertaxed Payment Rule start date to 2024 is helpful. Groups with limited overseas operations will have an additional five years before it applies.

Potential policy responses

With the potential neutralization of their tax incentives under Pillar Two, some countries and territories in the region have already started to explore alternative options.

— It is likely the most generous tax incentives will be unwound, or else rates increased. Many jurisdictions will not feel inclined to keep no or low-rate tax incentives when another jurisdiction can claw back the benefit by way of top up tax. Multinational enterprises will have little desire to meet stringent incentive conditions (such as headcount or minimum investment amounts) if there are limited tax savings on a global basis. However, with the benefit of jurisdictional blending with higher rate income or entities, it may be that incentive rates of below a certain threshold (say, 10 percent) do not survive, but those at or above do.

— Some jurisdictions in the region are also exploring an alternative minimum tax concept for in-scope multinational groups. This would allow for incentives to be maintained for out-of-scope taxpayers, whilst ensuring that any top up tax to get to an ETR of 15 percent is collected locally rather than in another jurisdiction. Although running a two-tier tax system adds more complexity and could disincentivize growth, an alternative tax rate of 15 percent should still encourage foreign investment as it remains well below the headline corporate tax rate of most countries around the world. However, another issue to consider is that the Subject to Tax Rule (STTR) applies top up withholding for in-scope payments that are taxed at a nominal rate below 9 percent. An alternative minimum tax would typically apply at the entity level rather than the payment level, and so may still leave open an exposure under the STTR.

  As noted earlier, under the current proposal grants and qualifying refundable tax credits have less of a reduction to the ETR compared to non-refundable tax credits. This is likely to encourage the replacement of existing tax concessions with such alternative cash-based forms of incentives to encourage certain types of investment. However, there are challenges in designing these in a way that could provide a similar level of benefit to a tax incentive. In addition, there has been talk of a new mechanism within the Pillar Two rules to dissuade jurisdictions from replicating tax incentive outcomes through grants.

— Governments will also need to look at other alternative non-tax incentives, which might include things like payroll incentives or a reduction of regulatory burdens.

Some jurisdictions in the region may find themselves as net beneficiaries of the changes. Jurisdictions with multinational operations that tend to have a mix of incentivized entities and non-incentivized entities may benefit, as they can take advantage of jurisdictional blending to effectively retain their incentives. In contrast, jurisdictions with a higher proportion of single operation incentivized entities (such as manufacturing plant benefiting from a tax holiday) may be more adversely affected. Restructuring to centralize operations can enhance the advantages of jurisdictional blending.

One thing is clear: Governments need to respond quickly to these measures, as uncertainty can make medium- to long-term business planning very challenging and could dampen investment activity.

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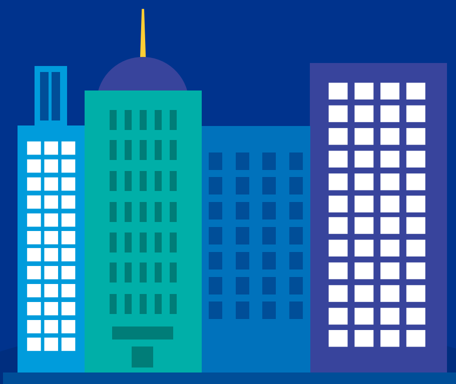
What should multinationals be thinking about?

With the expected release of the detailed rules in late November 2021, the pressure is on for quick adoption of the measures. The proposed timeline is for jurisdictions to legislate the measures domestically during the course of 2022, with a start date in 2023.

The timeline is looking to be even more compressed for US multinationals, with the US Green Book noting the US intends for the updated GILTI rules to be in effect for taxable years starting on or after 31 December 2021.



This leaves very little time for multinationals to work out how the measures may affect them and to re-assess their group structure, intellectual property holdings, financing arrangements and global supply chains given the potential neutralization of existing tax benefits in the next three to 18 months. It also leaves limited time for the system upgrades needed to capture the complicated data that will be needed to meet Pillar Two compliance requirements.

As there is no grandfathering of existing structures or transitional relief from Pillar Two for existing incentives, this can significantly increase the costs of longer-term investment commitments for immobile activities. The materiality of the impact will vary depending on profit margins in incentivised entities. Modeling of the impact and sensitivity analysis can help with early planning of how to respond.

With the main positions of the Inclusive Framework now agreed, submissions at the global level are now effectively confined to the details of the measures. However, participation in the design of local responses to the measures, particularly in terms of incentives, is likely to yield more results.

Talk to your local KPMG team or any of the listed contacts for support on impact assessments, scenario modeling, lobbying support, group structure planning and holistic data solutions.

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