Substance-based carve-outs

Main issues

1. What are substance-based carve-outs?

Under Pillar 2 of the OECD proposal, substance-based carve-outs consist of a reduction in the tax base on which the worldwide minimum tax (a priori 15%) will be applied. This reduction is determined based on two factors: employee compensation and tangible assets.

For instance: imagine a French multinational company, which earns profits of 100 in a tax-friendly jurisdiction, which taxes these profits at an effective rate of 5%. With a worldwide minimum tax of 15%, France would collect the multinational's tax deficit in that jurisdiction, i.e. :

$$100 * (15\% - 5\%) = 100 * 10\% = 10$$

Because of these profits of 100, the multinational would pay 5 taxes locally and 10 to France, the country of residence of its parent company. In total, the multinational pays 15 taxes and the effective rate is 15%.

In this example, we exclude substance-based carve-outs. Let's assume that in this jurisdiction, the multinational pay personnel costs of 100 and owns 100 tangible assets. The company will then be able to deduct a portion of these expenses and assets from the tax base that will be taxed by France in a complementary manner. According to the recent joint statement of the 132 members of the OECD/G20 Inclusive Framework, this share would be first at least 7.5%, then 5%.

Let's take 5% for example. The carve-outs would then be :

$$5\% * (\text{personnel costs} + \text{tangible assets}) = 5\% * (100 + 100) = 10$$

These carve-outs will then be deducted from the tax base on which the French surtax is applied. The multinational would therefore pay to the French tax authorities :

$$(100 - 10) * (15\% - 5\%) = 90 * 10\% = 9$$

The revenue generated by the worldwide minimum corporate tax is therefore reduced by the substance-based carve-outs.

2. Why is it that important to talk about those carve-outs?

Beyond the significant reduction in tax revenues that they generate, substance-based carve-outs may encourage multinationals to locate their employees and assets - in short, their real economic activity - in jurisdictions with convenient taxation. They may give rise to a new form of competition between states in which companies that benefit from advantageous tax treatments are protected from the global minimum tax by their investments.

This risk has already been identified for the GILTI tax, implemented by the United States in 2017. Indeed, in broad terms, this operates as a minimum tax on the profits of US multinationals and includes the equivalent of substance-based carve-outs up to 10% of tangible assets. Clausing, Saez and Zucman (2021) point this out; so does the Conseil d'Analyse Économique note.

3. How do the 130 signatory countries justify the exemption of carve-outs?

The inclusion or exclusion of substance-based carve-outs depends fundamentally on the objective of the global minimum corporate tax.

With substance-based carve-outs, the system can be used to combat artificial profit shifting: when a multinational relocates a substantial part of its profits to Bermuda without having any employees or tangible investments there, carve-outs do not apply and these profits are fully subject to the 15% minimum tax.

But substance-based carve-outs do not stop tax competition between states. For example, one can imagine a scenario in which special economic zones proliferate, with companies benefiting from very advantageous tax treatment in exchange for their tangible investments and the jobs they generate. The profits generated in this way would be at least partially "protected" from the global minimum tax by "substance-based carve-outs".

Therefore, from an economic point of view, carve-outs are justified by the desire to combat artificial transfers of profits as a priority (and almost exclusively that).