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The Two-Pillar Reform in International Taxation of Multinational Corporations: Challenges and Policy Recommendations[1]

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The Two-Pillar Reform in International Taxation of Multinational Corporations: Challenges and Policy Recommendations

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Abstract

The international tax system currently in place, designed over a century ago, is struggling to address the challenges of the modern economy. While in the past it was relatively easy to define where income was generated and where business activity took place, today's digital and global economy presents new challenges arising from the fact that business activity occurs largely in the virtual space, without the need for physical presence, fundamentally different from the world for which the international tax rules were originally designed. In this paper, we aim to contribute to the understanding of current trends in international taxation and their impact on Israel by outlining key issues in the design and trajectory of the contemporary international tax system. In particular, we present and analyze the emerging reform in international taxation led by the Organization for Economic Cooperation and Development (OECD), known as the "Two-Pillar Reform," assuming it progresses on the basis of its current status. This is against the backdrop of the critical intersection between the Two-Pillar Reform and Israel's system of tax incentives and investment policy.

136 member countries signed the Statement on the Two-Pillar Reform in 2021 as part of the OECD's Inclusive Framework (as did 147 countries by 2024). The two pillars of the reform focus on different yet complementary aspects of the development of the international tax system over the past few decades and are intended to address tax shortcomings emblematic of the digital age of the global economy. Against this backdrop, the first pillar centers on taxing large and highly profitable multinational corporations. It creates a new taxing right, transferring part of the profit generated by these corporations to the target countries or market where goods and services are provided or where the final consumer is located. In this way, the first pillar expands the tax bite of target countries or market, allowing them to increase their tax collection. The economic impact of the first pillar is expected to be small in most countries and also, accordingly, in Israel. In contrast, the second pillar establishes a global mechanism for effective minimum taxation of multinational corporations at the rate of 15 percent. Thus, the second pillar targets the phenomenon of profit shifting and base erosion that has greatly intensified in recent decades by setting a limit to international tax competition. The scope of the second pillar is broader than that of the first pillar, it applies to a larger number of companies, and may accordingly have a more significant effect on the global economy in general and the Israeli economy in particular.

Specifically, we analyze the impact of the Two-Pillar Reform on the tax incentives system and the policy required to maintain Israel's appeal to foreign investments in the new international taxation and economic reality. In this context, three main scenarios regarding the implications of the Two-Pillar Reform for Israel's policy are outlined and discussed,

from which it emerges that the reform poses unique challenges as well as opportunities, especially in the field of tax incentives and investments. The challenges are the required changes in the tax system, resulting from the emerging reform, and their potential consequences for corporate incentives to invest in Israel. The opportunities, on the other hand, include the potential to increase revenue collection alongside possibly cutting back on the provision of tax benefits in light of declining international tax competition and increasing international tax cooperation.

Our recommendations include examining the corporate tax-incentive system to identify which incentives should be maintained, which should be canceled, and which should be converted into grants or benefits external to the corporate-tax system, in order to protect Israel's comparative advantage in attracting international investments/corporations. Furthermore, in light of the expected reduced capacity to attract international investments/corporations by means of tax benefits, we also recommend examining alternative investment incentives that comply with the rules of the reform, such as tax credits that turn into grants and regulatory simplification. These incentives should target companies that contribute significantly to the Israeli economy, such as investments that generate considerably more value than is reflected in corporate profits ("positive externalities"), or those that are particularly important to the economy, and have the capacity to relocate from Israel. More importantly, and more than ever, in light of the reform, it is essential to improve fundamental factors, such as education and other infrastructure, in order to strengthen Israel's position as an international business center. These steps will support Israel's economic growth and fiscal resilience.

רפורמת שני הנדבכים במיסוי בינלאומי של חברות רב-לאומית: אתגרים והמלצות מדיניות

שגית לוינר ויהודה פורת

תקציר

מערכת המיסוי הבינלאומית הנוכחית, שעוצבה לפני למעלה ממאה שנה, מתקשה להתמודד עם אתגרי הכלכלה המודרנית. בעוד שבעבר ניתן היה להגדיר בקלות יחסית היכן נוצרה הכנסה והיכן בוצעה פעילות עסקית, הכלכלה הדיגיטלית והגלובלית של ימינו מציבה אתגרים חדשים הנובעים מכך שפעילות עסקית מתרחשת ברובה במרחב וירטואלי, ללא צורך בנוכחות פיזית, באופן שונה מהותית מהעולם שבעבורו עוצבו במקור כללי המיסוי הבינלאומי. נייר זה נועד לתרום להבנת המגמות הנוכחיות במיסוי בינלאומי והשפעתן על מדינת ישראל, על ידי פריסת סוגיות מרכזיות בעיצוב מערכת המס הבינלאומי העכשווית ומגמת התפתחותה. במיוחד, הנייר מציג ומנתח את הרפורמה המתגבשת במיסוי בינלאומי שבהובלת הארגון לשיתוף פעולה ולפיתוח כלכלי (ה-OECD), המכונה "רפורמת שני הנדבכים", בהנחה שהיא תתקדם ו/או תתבסס על מתכונתה הנוכחית. זאת, על רקע נקודת ההשקה שבין הרפורמה למערכת תמריצי המס ומדיניות ההשקעות במדינה.

ההצהרה על הסכמה לגבי רפורמת שני הנדבכים נחתמה בשנת 2021 על ידי 136 מדינות חברות במסגרת המכילה של ה-OECD. שני נדבכי הרפורמה עוסקים בצדדים שונים אך משלימים הנוגעים להתפתחות מערכת המס הבינלאומית במרוצת השנים, ונועדו לתקן פרצות שנפערו בה בעידן הדיגיטלי של הכלכלה הגלובלית. על רקע זה, הנדבך הראשון מתרכז במיסוי חברות רב-לאומיות גדולות ורווחיות במיוחד. הוא יוצר זכות מיסוי חדשה, המעבירה חלק מהרווחים העסקיים המופקים על ידי אותן חברות גדולות ורווחיות במיוחד למדינות יעד או שוק להן ניתנו סחורות ו/או שירותים או בהן נמצא הצרכן הסופי. באופן זה מרחיב הנדבך הראשון את נתח המס של מדינות היעד או שוק (market destinations), ומאפשר להן לגבות מסים על יותר הכנסות. השפעתו של הנדבך הראשון על הכלכלה הגלובלית צפויה, ברוב המדינות, להיות קטנה, ובהתאם גם על הכלכלה הישראלית. לעומת זאת, הנדבך השני קובע מנגנון גלובלי למיסוי מינימלי אפקטיבי של חברות רב-לאומיות בשיעור של 15%. בכך מתמקד הנדבך השני בתופעת הסטת הרווחים ושחיקת בסיס המס שהתגברה מאוד בעשורים האחרונים, על ידי הצבת גבול לתחרות המס הבינלאומית. היקפו של הנדבך השני רחב מזה של הנדבך הראשון, הוא חל על חלק גדול יותר מהחברות, ועשוי להשפיע באופן משמעותי יותר על הכלכלה העולמית בכלל ועל כלכלת ישראל בפרט.

הניתוח בנייר מתייחס במיוחד להשפעות רפורמת שני הנדבכים על מערכת תמריצי המס ועל המדיניות הנדרשת על מנת לשמר את האטרקטיביות של מדינת ישראל להשקעות זרות במציאות המיסויית-כלכלית החדשה. בהקשר זה, פורס הנייר שלושה תרחישים מרכזיים להשלכות מדיניות של הרפורמה על ישראל, מהם עולה כי הרפורמה מציבה אתגרים כמו גם הזדמנויות לישראל, במיוחד בתחום תמריצי המס וההשקעות. האתגרים הם הצורך שהרפורמה מחייבת לשינויים במערכת המס, שכתוצאה מהם תמריצי חברות להשקיע בישראל עלולים להיפגע. ההזדמנויות הן האפשרות להגדלת היקף גביית המסים בארץ אל מול פוטנציאל צימצום השימוש בהטבות מס על רקע מגמת הירידה בתחרות המס הבינלאומית והגברת שיתוף הפעולה המדיני-כלכלי.

המלצות הנייר כוללות בחינה של מערכת תמריצי המס לחברות על מנת לזהות אלו מהתמריצים רצוי לשמר, אלו לבטל, ואלו כדאי להמיר במענקים או בהטבות שלא באמצעות מס החברות, על מנת לשמר את יתרונה היחסי של מדינת ישראל במשיכת השקעות/פירמות בינלאומיות. לנוכח הירידה בפוטנציאל משיכת ההשקעות באמצעות הטבות מס, אנו ממליצים לבחון תמריצים חלופיים שעומדים בכללי הרפורמה, כגון זיכויי מס ההופכים למענקים ופישוט רגולטורי, ולמקד אותן בחברות שמניבות תועלת מיוחדת למשק: השקעות היוצרות ערך רחב יותר ממה שבא לידי ביטוי ברווחי החברה ("השפעות חיצוניות חיוביות"), או שהן בעלות ערך גבוה למשק ושיש לחברות המשקיעות יכולת לעזוב את ישראל. חשוב מכך, ויותר מתמיד, לאור הרפורמה יש לשפר גורמי יסוד כגון חינוך ותשתיות אחרות, על מנת לחזק את מעמדה של ישראל כמרכז עסקי בינלאומי. צעדים אלו יתמכו בצמיחתה הכלכלית של ישראל ובחסינותה הפיסקלית.

Contents

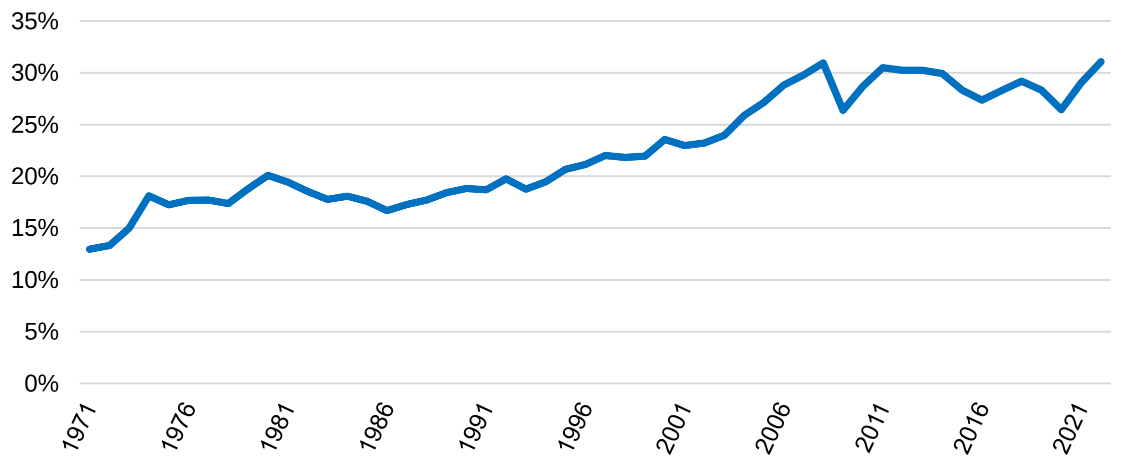
Initials	**Concept**	**Explanation**
	Adjusted Covered Taxes	Reform-relevant tax payments, including taxes on distributed earnings and additional adjustments; for a breakdown, see Appendix 2.
BEPS	Base Erosion and Profit Shifting	Shifting of profits from country to country by multinational entities shift in order to minimize their total tax burden; The conventional term for international action to mitigate the phenomenon.
CbCR	Country-by-country reporting	Detailed reportage by multinational entities of income, profits, and taxes in each country of operations.
ETR	Effective tax rate	The ratio of adjusted covered taxes to adjusted profits.
GloBE	Global Anti-Base Erosion	A mechanism that assures 15 percent minimum effective global taxation of multinational entities.
	GloBE income	Net profit/loss according to the IFRS rules plus tax expenses and additional adjustments.
IIR	Income-inclusion rule	A rule in Pillar Two that shifts the right to top-up taxation higher up on the ownership chain.
MNE	Multinational entity	A corporation that operates in several countries by means of subsidiaries, permanent establishments, branches, or partnerships.
	Nexus	The legal relation between an individual/a company and a country that entitles that country to tax its income.
	Non-qualified refundable tax credit	See Appendix 2.
	Permanent establishment	A permanent place of business through which a company manages some of its business, including branches, offices, and plants.
P1	Pillar One	Taxation of large multinational entities' excess profits and special profits.
P2	Pillar Two	Global minimum effective taxation of large multinational entities.
QDMTT	Qualified domestic minimum top-up tax	A minimum effective top-up tax on domestic profits.
	Qualified refundable tax credit	See Appendix 2.

STTR	Subject-to-tax rule	A mechanism that allows developing countries to tax at source certain kinds of international payments that are taxed at a nominal rate of less than 9 percent.
SBIE	Substance-based income exclusion	See Appendix 2.
	Top-up tax	The extra tax that a multinational entity will be asked to pay in order to pay at a minimum effective global rate of 15 percent
UPE	Ultimate Parent Entity	The entity that sits at the top of a multinational entity's ownership chain.
UTPR	Undertaxed profits rule	A backup mechanism for the implementation of global minimum effective taxation of multinational entities when the IIR and QDMTT rules are nonexistent or only partly applied; part of Pillar Two.

1. Introduction

International corporate taxation is one of most discussed topics in the field of economic policy. It has major implications for the apportionment of tax revenue among countries, global economic competition, and firms' investment decisions. Despite its great importance and in contrast to areas such as international trade, which the World Trade Organization (WTO) monitors and regulates, no single global body today is empowered to regulate international taxation generally and corporate international taxation particularly.[1] The current system of international taxation took shape in the early twentieth century, in a world much different from today's. At that time, most international trade was conducted in goods (physically) and exports accounted for only 7 percent of global output. The global economy has undergone far-reaching changes since then: global trade in goods and services has grown forty-fold from its 1950s level, climbing from 12.7 percent of global output in 1970 to 31.1 percent in 2022 (Figure 1).[2]

Figure 1: Total global exports as a percentage of global GDP 1970-2022



Source: World Bank

Not only has the extent of global trade changed over the years; so has its composition. From predominance of goods in global trade in 1982 (81.3 percent of total exports) as opposed to services (18.7 percent), the share of services escalated steadily to 25.3 percent

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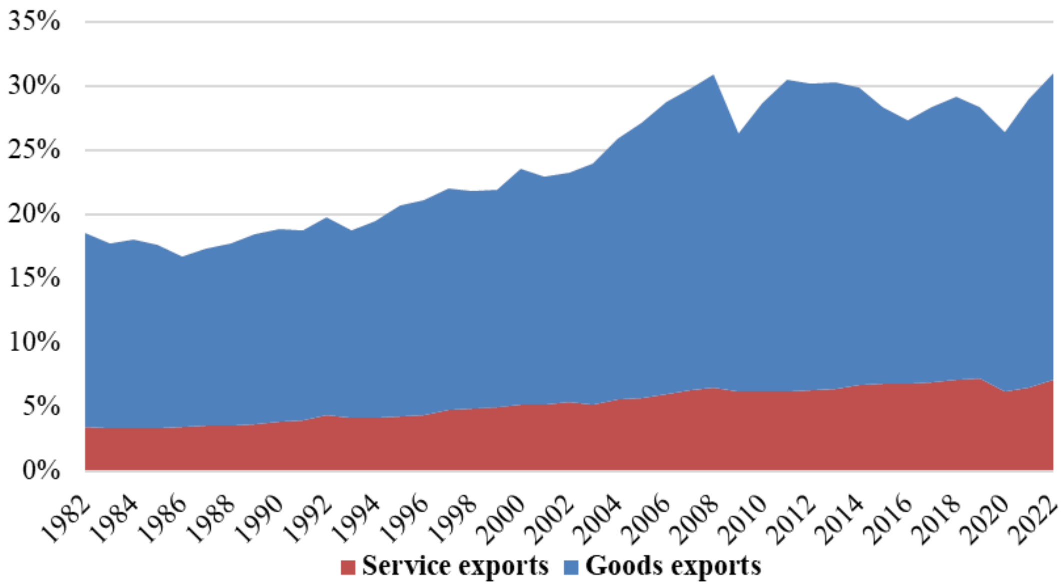
[1] For a literature review, see, for example, Avi-Yonah (2007); for an empirical study, see Ash & Marian (2019).

[2] WTO, Evolution of Trade under the WTO: Handy Statistics, https://www.wto.org/english/res_e/statis_e/trade_evolution_e/evolution_trade_wto_e.htm#fnt-1 (last accessed on January 12, 2025).

in 2019 before slumping to 22.8 percent in 2022 due to the Covid crisis (Figure 2). This change reflects the rapid transition to a digital economy, in which services such as software, digital content, cloud services, and on-line advertising, increasingly sold by multinational entities (MNEs), account for a growing share of global economic activity, and emphasize the increasing importance of online trade as an integral and leading slice of the global economy.

Figure 2: Global exports of goods and services* as a percentage of global GDP, 1982-2022



* The World Bank has been reporting data according to this division since 1982.
Source: World Bank.

While the global economy and, particularly, global trade have changed momentously over the years, the international taxation system has stagnated as corporate taxation is still based on two key principles that were born more than a century ago[3]:

1. **Country nexus**—an MNE is liable to taxation in a given country insofar as it has a sizable physical presence ("permanent establishment") there[4];

3 Zachariadis (2019), p. 5.
4 See Sections 5 (Permanent Establishment), 7 (Business Profits), and 9 (Associated Enterprises) of the OECD model convention, available at https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_g2g972ee-en#page62, and the same section numbers, respectively, in the UN model convention, available at https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf.

2. **Market price**—transactions among associated entities (for example, a subsidiary of the same MNE) should take place in prices similar to those set in transactions between unassociated parties (arms-length pricing).

These principles, tailored to a world of trade in goods and physical presence, become challenging in an era of heightened trade in services, particularly digital ones. The growing power of large multinational technology companies that have a "winner-take-all" edge in digital markets[5] allows these firms to operate and profit immensely in countries where they lack the physical presence that international taxation traditionally requires. Furthermore, an adequate reference point for a "market price" is especially difficult to define today when unique digital assets such as intellectual property, a typical feature of the digital economy, are in play. Consequently, multinational tech companies can quite easily shift profits to countries that tax them at a lower total rate, often using their existing multinational corporate structure and international taxation arrangements. As a result, countries engage in increasingly intensive economic competition in an attempt to lure business activity and investments by means of the mechanisms available to them, chiefly by lowering their rates of corporate tax. This dynamic, in turn, is subjecting many countries to protracted tax-base erosion. According to various estimates, tax revenue lost to international base erosion and profit shifting (BEPS) ranges from 4 percent to 10 percent of global corporate-tax revenue.

With these processes in mind, the OECD member states and the G20 launched the BEPS Project in 2013. The project was begun in order to counter the ongoing assault against tax-base integrity occasioned by tax planning that exploits loopholes, contradictions, and mismatches among different countries' domestic tax rules. It led to a practical plan composed of fifteen measures, starting with tackling the challenges of digitalization of the economy.[6] This first step led, after about a decade of intensive international work, to the Two-Pillar Solution, aka the Two Pillar Reform. Its creation was set against the background of the Covid crisis at the beginning of the 2020s, which deepened the need for international tax-system reform due to accelerated digitization of the global economy and an upswing in international activity susceptible to profit shifting.[7] Concurrently, the increase in

5 Autor et al. (2020); cf. Frank & Cook (1996) (who give a broader analysis of the "winner-take-all" paradigm).

6 For a detailed account of the fifteen steps, see OECD (2013); for a concise overview in Hebrew, see Chief Economist (2020).

7 Perry et al. (2021).

government debt due to the Covid crisis further intensified governments' need to shore up their tax-revenues.

The reform was formulated in its final version in the course of 2021 and has been approved in principle by most countries worldwide, including Israel, and by most wealthy countries. In this document, we present and analyze this reform of international taxation, which is composed, as stated, of two main pillars:

1. **Pillar One** deals mainly with reallocation of some of the profits of the largest and most profitable MNEs to countries in which the same MNEs operate (target countries or markets);
2. **Pillar Two** focuses on a 15 percent global minimum effective corporate tax rate.

The United States, the residence state of many MNEs, backed the international-taxation reform during the term of the Biden Administration. However, given the first Trump Administration's opposition to the reform, the USA may slow the reform and/or demand an additional review now that Donald Trump has been elected to a second term. One of the first orders that President Trump signed when he reentered the White House, for example, establishes that the international-taxation reform shall not be applied in the United States and that countermeasures will be implemented against countries that apply tax rules that discriminate against American firms.[8]

This document presents the details of the Two Pillar Reform, analyzes the reform, reviews progress in applying it in various countries, and estimates its implications for the Israeli economy, all on the assumption that the reform will move ahead as currently formulated. The analysis relates in particular to effects on the tax-incentive system and the policy that Israel should adopt to maintain its attractiveness to foreign companies and investment in the new economic and tax environment.

2. International Taxation and Its Constraints Today

Raising money to finance government expenditure is the principal and most accepted goal of the tax system. State tax revenues are central to countries' ability to fund public services and invest in human capital and infrastructure.[9] In recent decades, economic globalization

8 See https://www.whitehouse.gov/presidential-actions/2025/01/the-organization-for-economic-co-operation-and-development-oecd-global-tax-deal-global-tax-deal/

9 Leviner and Nir (2015) explain the complexity of promoting public systems that are unassociated with promoting tax collection by means of the tax system.

and digitalization processes have put the international taxation system through acute changes in a way that threatens the ability of the modern tax system to fund government outlays.

Given the growing digitalization of the global economy, the world today is increasingly reliant on borderless transactions and transactions in intangible assets. These developments are challenging the importance of key principles of taxation and international trade that are associated with physical location. While value creation once focused on the time and place of the production of a good or service, the time and place of consumption is much more dominant now, and the physical location of production has become less significant. MNEs that base themselves on digitalization can offer services anywhere and at any time. Concurrently, intellectual property (IP), which is particularly complex to price in terms of "market" value, is becoming the dominant share of these companies' assets. Therefore, these entities are well positioned to apply aggressive tax planning by improving their profit-shifting abilities in a major way, primarily between companies within the MNE, taking advantage of the international variance of corporate tax rates in order to minimize their total tax burden.[10]

Profit shifting occurs in various ways. For example, a large multinational tech company may transfer its intellectual property to a subsidiary in a country that does not impose a corporate tax and then oblige its other subsidiaries to pay royalties to that subsidiary for their ongoing use of the very same IP—while the IP remains in the parent entity's possession for all intents and purposes. Thus the expenses of subsidiaries in the MNE that are recorded in countries typified by tax burdens greater than zero increase, while their profits are shifted to the subsidiary that pays no tax on them at all.[11]

In this manner, the global environment serves as a springboard for heightened tax competition and, in turn, for international profit shifting and tax-base erosion. Evidence of these processes includes, for example, a global downturn in statutory and effective corporate-tax rates for several decades now. Thus, the average global statutory corporate income tax (CIT) rate dropped from 31 percent in 2000 to 22 percent in 2023 (and in developed markets, from 31 percent in 2000 around 21 percent in 2023). The trends in Israel

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[10] See, for example, Grubert (2003) and Heckemeyer & Overesch (2017).

[11] An example of a country that has not imposed a corporate tax for years is Bermuda. In 2025, however, Bermuda will introduce a 15 percent effective rate of corporate tax after having adopted the rules of Pillar Two. For the legislative minutiae, visit https://www.gov.bm/CIT.

are consistent with the global developments; Israel's 23 percent statutory CIT in 2023, for example, resembles the average among other developed markets (Figure 3).

This combination of profit shifting and base erosion is injurious to tax revenues. Various current estimates of the tax revenue lost to BEPS processes fall into the range of 4–10 percent of annual global corporate-tax revenues (Table 1).

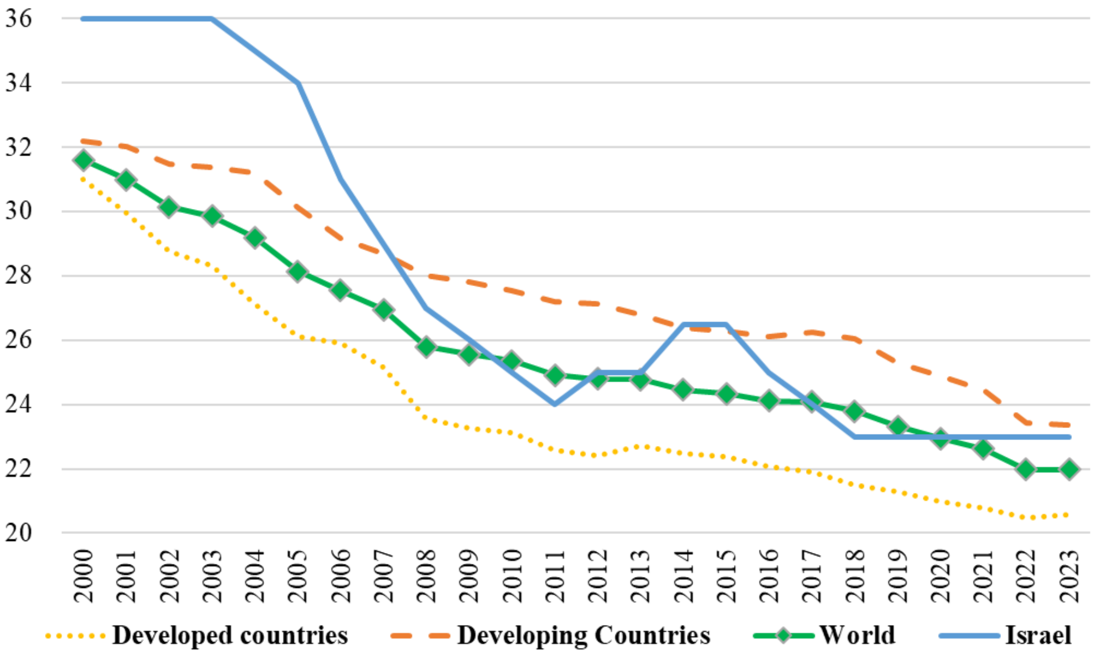
Table 1

Estimates of corporate-tax revenue loss due to BEPS processes

Annual loss	As pct. of corporate-tax revenue	Sample	Source in the economic literature
USD 100–240 bn	4%–10%	Global (incl. developed markets)	OECD (2015b)
USD 187 bn		Global (incl. developed markets)	Torslov et al. (2018)
USD 200 bn		Global (incl. developed markets)	Bolwijn et al. (2018)
USD 245 bn		Global (incl. developed markets)	Bratta et al. (2021)
USD 450 bn		Developed markets	Crivelli et al. (2016)
USD 100 bn		Developed markets	Bolwijn et al. (2018)
USD 300 bn		Developed markets	Cobham et al. (2018)
EUR 160 bn	EU 7.7% USA and Japan 10.7%	USA, EU, Japan	Álvarez-Martínez et al. (2021)
USD 200 bn		USA	Zucman (2014)
USD 200 bn		Developing markets	Crivelli et al. (2016)
USD 200 bn		Developing markets	Cobham et al. (2018)

Figure 3: Statutory corporate tax rate

(2000-2023, excluding countries with 0% corporate tax)



Source: OECD Statutory Corporate Income Tax Rates Database

These developments make it imperative to align the international tax system with the challenges of the digital era to the global economy. Over the past decade, this necessity fathered an initiative by the OECD and the G20 for to combat BEPS. The next part of this paper describes the initiative, its sections and their implications, and the Two Pillar Reform that it sired.

3. The Anti-BEPS Initiative and the Two-Pillar Reform

The BEPS initiative was, as stated, launched in 2013 by the OECD member states and the G20.[12] The war on base erosion and profit shifting represents a major accomplishment in the international coordination of economic policy. International coordination in tax policy has been rare historically, making the BEPS initiative an important outlier. From 2013 to the present writing, 147 different jurisdictions (most of them states) have joined the

[12] See the OECD site in regard to anti-BEPS measures, available at https://www.oecd.org/tax/beps/beps-actions.

initiative by adopting an Inclusive Framework that the OECD spearheaded.[13] In 2015, the BEPS initiative led to the formulation of a comprehensive fifteen-step action plan designed to contend with tax avoidance, simplify international tax rules, and ensure greater transparency in the tax environment.[14]

Since 2015 and the formulation of the comprehensive action plan, taxation of the digital economy has, as stated, been the focus of the BEPS project, setting in motion a fundamental and thoroughgoing examination of how this challenge may be confronted globally. The onset of the Covid crisis in 2020 and the large public expenditure that accompanied it emphasized the need to stabilize the tax base in order to fund government spending. After the first Trump Administration opposed the international taxation reform, the Biden Administration took over in early 2021 and announced its willingness to support the reform.[15] This led to intensive discussions of the topic within the OECD and in other international economic bodies including the G7 and the G20. These debates came to fruition in July 2021, when the 136 countries that were participating in the Inclusive Framework at that time reached another historical milestone by agreeing to move forward on the so-called Two Pillar Solution (P1 and P2).[16] The Two Pillar Solution is intended to contend with the tax challenges that originate in the digitalization of the global economy, restabilize the international tax system, and thwart domestic tax initiatives that intensify competition among states.

The Two Pillar Reform was originally meant to go into effect in 2023. In July 2022, the Secretary General of the OECD advised the G20, meeting in Malaysia, that the start of the reform would be postponed, likely to 2024. By then many countries had begun the process of adopting the GloBE rules from Pillar Two and enshrining them in legislation.[17] In mid-2023 the OECD disseminated the Multinational Convention to Implement Amount A of Pillar One (the Amount A MLC).[18] Thus far, the convention has not yet been opened for international signature and will go into effect only when ratified by a critical mass of states

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13 For an up-to-date list of the members of the Inclusive Framework, visit the OECD site: https://www.oecd.org/content/dam/oecd/en/topics/policy-issues/beps/inclusive-framework-on-beps-composition.pdf.

15 "Yellen Picks Notable Experts to Join the US Treasury's Digital Tax Talks", https://www.internationaltaxreview.com/article/b1qfh1hw0xy7z2/yellen-picks-notable-experts-to-join-the-us-treasurys-digital-tax-talks, February 5, 2021.

16 OECD (2021b).

17 OECD (2022a).

18 OECD (2023e).

participating in the Inclusive Framework. Also in mid-2023, the OECD distributed the Multilateral Convention to Facilitate the Implementation of the Pillar Two Subject to Tax Rule (the STTR MLI). This accord was opened for signature in September 2024 and developing countries began to sign it. A revised version of the Commentary on the GloBE rules (part of Pillar Two was distributed in April 2024.[19]

The most important country that has not yet adopted the Two Pillar Reform—given, *inter alia*, the great number and importance of multinational entities registered in it—is the United States. American opposition in 2017–2020 prevented significant progress of the reform at that time. The administration then in power opposed Pillar One and demanded various adjustments and leniencies for companies registered in the United States; similarly, it opposed application of the Pillar Two rules to American firms. Accordingly, with the onset of President Trump's second term, it is worth bearing in mind that the administration may again oppose or demand further adjustments in order to move the reform forward. This document analyzes the reform and its implications on the assumption that it will progress and/or be based on its current format.

3.1 Pillar One

Pillar One (P1) is meant to strengthen the relationship between the place where economic value is created and the place where the profits flowing from said value creation are taxed. The underlying principles that determine where international profits are taxed were formulated at the beginning of the previous century. They are based on several key concepts. One of them is nexus, which, for example, entitles a state to tax a foreign firm's business profits provided said firm has established a permanent establishment on its soil.[20] Another is the market-price (arm's length) principle, which requires a company, among other things, to treat its transactions with other companies, including those in its MNE, as though they are distinct and different entities. As stated, however, these traditional rules of international taxation are struggling to align themselves with the characteristics of the digital era, in which profits can be created with little or no physical activity and many of the goods and services supplied, as well as much of the capital to produce them, are based

[19] OECD (2024b).

[20] A permanent establishment is a fixed place of business through which some of the company's business affairs, including branches, offices, plants, service delivery, and so on, are managed continually. By and large, the international requirement for a permanent establishment is that the establishment be physically managed within the confines of the state for half a year or longer.

on knowledge, IP, or some other intangible asset. Thus the traditional principles of international taxation, including the attribution of profits from international business activity, are acutely challenged in the digital era. (For a sample calculation that shows how P1 works in this context, see Appendix 1.)

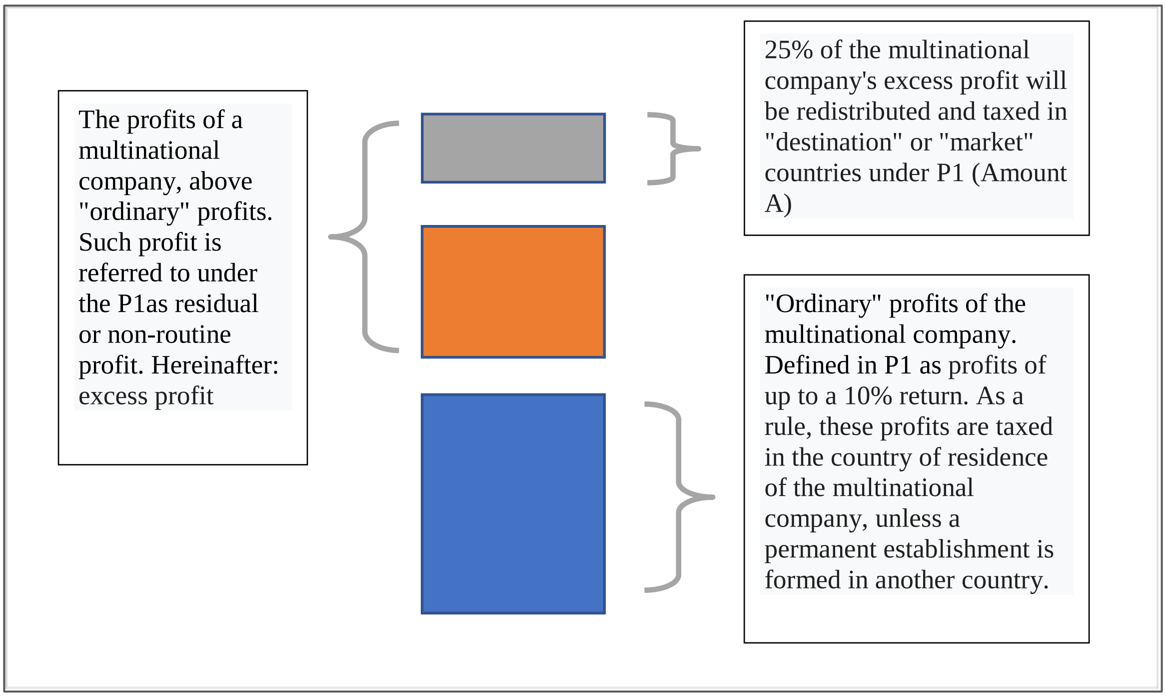
Pillar One was designed to solve this problem. For the first time in a hundred years, it establishes a new taxation right that reallocates some business profits of especially large and profitable MNEs (those with turnover of EUR 20 billion or more) to the country or market where the economic activity that created these profits is consumed. In cases where the tax rates and tax laws relevant to international business activity are similar between the countries, this reallocation will likely have little or no effect on the amount of tax paid; only the identity of the country applying the taxation will change. However, if the tax rates and relevant laws are different n the various countries, the reallocation of a share of the profits will also affect in the total amount of tax that the MNE will have to pay. This will happen, for example, if the original taxation of profits took place in countries and jurisdictions that had low or zero tax rates and those profits were very large relative to the MNE's local expenditure on labor and assets. In such a case, the reallocation of the rate of business profits will increase the multinational entity's total tax liability.

Under P1, the reallocation of some of an MNE's business profits takes place in several key steps. The first and most important of creates a new taxing right on the largest and most profitable MNE, and allocates it to "destination" countries or "markets" where said MNEs operate. The taxable profit (Amount A, as specified in Figure 4) will be divided between those countries or markets based on several criteria, including the extent of the income produced in each countries, the location of the final consumers, the level of profits, and prevention of double taxation.[21] Practically speaking, 25 percent of an MNE's excess profits (those surpassing 10 percent of turnover, as defined in the P1 rules) will be transferred to the target countries or market for taxation (Amount A). In practice, this obviates the need for the traditional requirement of a physical presence for tax purposes under the aforementioned circumstances and converts it into taxation on the basis of where the "value" is created. The remaining profits, however, continue to be taxed under the traditional tax rules. Thus, even though P1 somewhat broadens the tax take of the target

[21] It must be noted that for a state to be allocated taxation rights under Amount A, the MNE must have an annual turnover of at least EUR 1 million in said state. This turnover threshold is EUR 250,000 for states whose GDP is lower than EUR 40 billion.

countries or markets (mostly developing countries) at the expense of the profit-making firms' states of residence (mostly developed countries), the latter will still have the vast majority of the international taxation rights on business profits and, accordingly, of the tax receipts derived from them, even under the rules of P1.

Figure 4: Schematic diagram of multinational company profits and their distribution according to the first pillar (Amount A)



The second component of P1 (Amount B) is meant to enhance certainty and simplicity in international taxation by recognizing certain marketing and distribution expenses for transfer pricing purposes. This recognition takes place by establishing an agreed-upon basis for the pricing of these expenses and specifying the documents that the process entails. Unlike Amount A, which is geared to especially large and profitable MNEs, Amount B is available to all companies, but it is particularly intended to reduce collection and compliance costs in countries which find tax collection difficult due to scant administrative resources. In February 2024, the OECD promulgated the final details of Amount B and inserted it into its guidelines on transfer pricing.[22]

[22] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022.

The third and last component of P1 includes a binding conflict-resolution mechanism in order to enhance certainty in international taxation and prevent double taxation of profits. As a broader part of this process of enhancing certainty and preventing double taxation, countries that join P1 must abolish current digital services taxes (DST) and similar measures, and refrain from imposing new taxes of this type, other than arrangements that are part of the reform.

Pillar One is expected to apply initially to some 100 especially large MNEs which that have annual turnover of at least EUR 20 billion. Its current version includes a sweeping exception for several business sectors, such as natural-resource extraction and financial-services firms. Notwithstanding the importance of the Two Pillar Reform, its economic impact, including that of Pillar One and its components, is too complex to estimate at this stage. Accordingly, the existing estimates must be treated cautiously, including in the context of tax collection, investment, and profit-shifting.

In October 2023, the OECD published updated estimates of Amount A of P1. These estimates refer to the most recent iteration of the P1 rules as published in the draft MLC, and use more recent and accurate data than those previously available.[23] Under these estimates, on the basis of 2021 data, Amount A will redistribute USD 204.6 billion in global profits of 106 MNEs and increase global tax collection by USD 17.4–USD 31.7 billion.[24] These revenues will come at the expense of potential DST and similar tax revenues, though those revenues are small at the present time. In Israel, according to initial OECD simulations from 2022, P1 is likely to increase corporate-tax receipts by only USD 6–USD 60 million per year (0.05–0.5 percent of corporate-tax revenues).

3.2 Pillar Two

In contrast to P1, which is meant to strengthen the connection between taxation of the business profits of especially large and profitable MNEs' and the location of the value creation of those profits, Pillar Two proposes to set a 15 percent global minimum effective corporate tax rate in order to ensure that MNEs' earnings will be taxed at a rate no lower than this wherever they operate. For this purpose, whenever an MNE pays an effective tax rate lower than 15 percent in a given country, the right to top up the required tax to a 15

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23 Delpeuch et al. (2023), pp. 9–15 (relating to the model of analysis in the paper) and pp. 16–20 (relating to the data on which the paper is based).

24 Ibid., pp. 8, 32–38 (in which the outcomes are discussed at length).

percent effective rate will be allocated to another country in which the MNE operates. The purpose is to limit international tax competition, mitigate BEPS, and, consequently, stabilize the international tax system and enhance global collection of corporate tax.

Pillar Two applies to multinational entities that have at least EUR 750 million in adjusted global annual turnover, far below the threshold set in P1 (EUR 20 billion). It operates by means of two complementary mechanisms:

(1) The global anti-base erosion (GloBE) mechanism, which sets rules for calculating the effective tax rate that applies to an MNE in each country where it operates and the rate of top-up tax needed in cases where the rate is below 15 percent. The mechanism includes two primary rules and a secondary rule (QDMTT, IIR, and UTPR) that together determine the way top-up tax rights are distributed among the relevant countries. This is the heart of P2 and is meant to bring about a 15 percent global minimum effective corporate tax rate. According to current estimates, GloBE is the part of the Two Pillar Reform which is most relevant and significant for Israel.

(2) The subject-to-tax rule (STTR), which is applied before the GloBE mechanism, and entitles countries where income is generated to impose top-up taxes on certain international payments between related companies when said payments will be taxed at a rate lower than 9 percent. This mechanism is geared mainly to developing countries and applies taxation on the basis of turnover rather than that of profits. Accordingly, a nominal tax rate is applied, rather than an effective tax rate as in the GloBE mechanism. The Israel Tax Authority estimates that this mechanism will be relevant primarily for payments that qualify for benefits under the Encouragement of Capital Investment Law.

3.2.1 Mechanism 1 ("GloBE")

The GloBE rules deal with calculating the effective tax rate that a MNE must pay in each country where it operates. Wherever this rate is below 15 percent, the rules calculate the top-up tax liability that will apply to the MNE in order to bring its effective tax burden up to 15 percent and apportion top-up taxation right between countries.[25] This

[25] The calculation is carried out at the country level by summing the profits and tax payments of units of the MNE in the country in order to calculate the relevant effective tax within its confines (= "jurisdictional blending"). This was chosen over other approaches, such as calculating an effective tax rate for each and

apportionment is carried out by applying the Qualified Domestic Minimum Top-Up Tax (QDMTT) rule, the Income Inclusion Rule (IIR), and the Undertaxed Profits Rule (UTPR). The mechanism forces tax havens and other jurisdictions that tax MNEs at less than a 15 percent effective rate (either sweepingly or geared to specific companies or income items) to raise the effective rate to at least 15 percent in order to prevent a situation where the top-up tax imposed under the arrangements of the Pillar will be collected in another country in the MNE's ownership chain or in which it operates.

It is estimated that countries that adopt the P2 arrangement will choose to apply the QDMTT as a first step. In this manner, in cases where a multinational entity is found liable for a top-up tax, that tax will go to the country where those domestic undertaxed profits were produced, rather than other countries.

A simplified illustrative example of the use of the GloBE mechanism:

MNE X, registered in Country B and operating in Countries A and B, generates USD 10 billion in profits in Country A and USD 5 billion in Country B. The effective corporate-tax rate that MNE X pays is 10 percent in Country A and 20 percent in Country B. Accordingly, MNE X pays USD 1 billion in corporate tax in Country A and another USD billion in Country B.

Assuming the P2 arrangements go into effect, MNE X will be identified as paying less than the 15 percent minimum effective rate in Country A. There will then be two main options, in each of which MNE X's aggregate tax burden will increase by USD 0.5 billion:

1. Country A raises the domestic effective tax rate that it applies to MNE X to 15 percent or imposes a Qualified Domestic Minimum Top-up Tax (QDMTT) to a cumulative rate of 15 percent. In this case, MNE X will pay USD 1.5 billion in corporate tax in Country A and USD 1 billion in Country B.

2. Country A does not raise the domestic rate of corporate tax that it imposes on MNE X. In this case, MNE X will pay USD 1 billion in tax in Country A but the requisite top-up tax liability in the sum of USD 0.5 billion, which is needed in order to arrive at the 15 percent minimum effective tax rate in Country A, will be collected in Country B by means of the IRR or UTPR rule. Thus, MNE X's tax payment will remain USD 1 billion in Country A but will rise to USD 1.5 billion in Country B. The order of application of P2 rules starts with the STTR, as stated above, followed by the QDMTT, IRR, and UTPR in declining hierarchical order.

every unit of the MNE (entity blending) or summing the multinational entity's profits and taxes worldwide (global blending).

The Two Pillar Reform applies to MNEs worldwide, and is therefore based on the International Financial Reporting Standards (IFRS) and not on each country's domestic tax rules. Accordingly, the process of determining the top-up tax liability is as follows (for relevant concepts and a detailed example of the calculation process, see Appendix 2):

1) Identify a multinational enterprise, including its worldwide corporate structure, i.e., identify the parent entity, its subsidiaries, permanent establishments, etc.

2) Calculate the enterprise's profit (loss) in accordance with the GloBE rules in each country where the MNE operates

3) Calculate adjusted covered taxes under the GloBE rules in each country where the MNE operates

4) Calculate the MNE's effective tax rate (ETR) in each country where it operates by dividing its total adjusted covered tax in the country (3) by the total relevant adjusted profit (2). If the ETR in a country is lower than 15 percent, a top-up tax liability may be incurred.

5) In calculating the top-up tax liability, a certain percent of the MNE's payroll expenditures and tangible assets are recognized (deducted); the MNE is not liable for top-up tax on this sum. This is the Substance-Based Income Exclusion (SBIE).

6) The exclusion (5) is deducted from the MNE's adjusted profits (2) to arrive at the profits on which top-up taxation will be assessed. In cases where the result is negative or zero, no top-up tax liability is created.

7) When the profit obtained in Step (6) is positive, it is multiplied by the difference between the 15 percent global minimum tax rate and the effective tax rate imposed on the MNE in the relevant country (4). This yields the top-up tax liability that the MNE owes in said country.

8) In cases where a Qualified Minimum Top-Up Tax exists, the domestic top-up tax amount is subtracted from the top-up tax liability according to the GloBE mechanism (7).

9) In cases where a minimum domestic tax does not exist or is not invoked, or if a positive top-up tax liability remains after it is invoked, the remaining top-up tax liability of the MNE is apportioned among the qualifying countries by invoking the IIR and UTPR rules.

10) The countries that are entitled to top-up taxes under the GloBE mechanism collect them.

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The Income Inclusion Rule (IIR)

In cases where an MNE incurs a top-up tax liability for any of its sub-entities, the IIR rule transfers this liability to the highest possible rung on the MNE's ownership chain (as close as possible to the ultimate the parent entity). From that point on, the rule is applied using the top-down approach. That is to say, when an MNE's Ultimate Parent Entity is situated in a country that joined the P2 rules, the top-up tax liability under the IIR rule is assigned to that country and it will collect the top-up tax. In cases where the Ultimate Parent Entity is situated in a country that has not joined the P2 rules or has joined but is not implementing them in practice, the right to collect the top-up tax is transferred to the residence state of the next entity down the MNE's ownership chain. If this country, too, has not joined and/or is not applying P2 arrangements, the right to collect the top-up tax continues to descend on the ownership chain. However, to ensure the application of the global minimum effective tax even in cases where all entities up the MNE's ownership chain are in countries that have not joined , or are not applying , the P2 rules, the OECD created an additional backstop rule within the framework of the GloBE mechanism—the Undertaxed Profits Rule.

The Undertaxed Profits Rule (UTPR)

The Undertaxed Profits Rule **(**UTPR) complements the IIR by dealing with cases in which the IIR is only partly applied or not at all. This happens, for example, when no entities up the ownership chain of the MNE are situated in countries that have joined the P2 rules, but rather only subsidiaries exist in other countries. It also occurs in cases where the residence country of the MNE's Ultimate Parent Entity has joined the P2 arrangements but the MNE is still paying an effective corporate tax rate lower than 15 percent. When the UTPR is invoked, it allocates the top-up tax liability to other entities within the MNE that are located in countries that have joined the reform, doing so on the basis of their share in the MNE's in-scope headcount and tangible assets. This apportionment is meant to ensure collection of the top-up tax via those entities and countries for which the likelihood of collection is the best. In addition, the headcount and tangible-assets criterion is relatively easy to measure internationally, as the data is reported in the CbCrs, and it is relatively simple to apply to both countries and MNEs.

For these reasons, the UTPR can potentially be applied in every jurisdiction in which the MNE operates—on account of foreign profits, rather than just domestic profits (as in the QDMTT rule), and by means of each associated entity within the MNE's corporate structure (and not only the ultimate parent entity or company at the top of the corporate hierarchy, as in the IIR). In addition, the outcomes of invoking the UTPR rule determined in accordance with the characteristics of the relevant MNEs toward which the rule is applied. Consequently, despite the advantages of the UTPR as an integral part of the GloBE mechanism, its characteristics introduce practical and political complexity into the mechanism and entail much more coordination between different jurisdictions than is the case with the IIR and QDMTT. In practice, however, the use of the UTPR under the GloBE mechanism is likely to be relatively narrow, assuming that the QDMTT and IIR, which take precedence over it, are in fact applied before it.

The Qualified Domestic Top-Up Tax (QDMTT) rule[26]

The Two Pillar Reform toolkit contains not only the IIR and the UTPR, both of which are embedded in the GloBE mechanism, but also the Qualified Domestic Top-Up Tax (QDMTT) rule, which is an integral part of the global minimum-taxation mechanism. The rule refers to top-up domestic taxation of MNEs in respect of domestic profits that these entities generate, in order to attain an outcome that will comply with the minimal global taxation principle of Pillar Two. This form of domestic taxation, insofar as it is applied under the QDMTT rule, does not eliminate the top-up tax liability that is calculated by means of the IIR and UTPR rules; rather, it allows the possibility, under certain circumstances, of offsetting the tax collected under the QDMTT from the compulsory tax liability under the two other rules. In this manner, for example, when a MNE's top-up tax liability for domestic profits created in Country X is USD 100 million and Country X imposes a domestic top-up tax at the same level in keeping with the requirements of the GloBE mechanism, the final top-up tax liability after offsetting the domestic top-up tax would be USD zero and would not be collected under the IIR and UTPR rules.[27]

3.2.2 Mechanism 2—The Subject to Tax Rule (STTR)

Most bilateral tax treaties include a standard clause establishing that the business profits of entities that are registered in Country A and have no permanent establishment in Country

[26] Sometimes also called the Safe Harbour Domestic Minimum Top-Up Tax rule.

[27] All of this, as stated, assumes that the domestic top-up tax liability is calculated and applied in accordance with the GloBE rules. In cases where the top-up tax liability is calculated under the domestic tax rules and not under those of the IFRS, for example, excess top-up tax liability may remain even after the domestic top-up tax liability is offset.

B shall be taxed only in Country A even if the profits originate in Country B, irrespective of the rate of corporate tax applied in Country A. In view of the international-taxation reform, however, in cases where an MNE is taxed at an effective rate lower than 15 percent, the GloBE mechanism of P2 holds the MNE liable to a top-up tax that raises its rate to the requisite 15 percent. Unlike the GloBE mechanism, which is attributed to business profits, the STTR mechanism is meant to favor, under certain conditions, countries where the income is created, when they are developing countries and specific types of payments are involved.

More specifically, the STTR allows developing countries to tax at source certain kinds of international payments in transactions between related entities in the same MNE. The rule is applied at the level of the payment and not that of the MNE, and applies to particular types of payments and transfers that are especially susceptible to BEPS activities, such as payments of interest, royalties, dividends, and payments for business services. The STTR mandates that in cases in which the nominal tax rate on that payment is lower than 9 percent, the country of origin is entitled to collect a payment at source that will top up the relevant tax rate to 9%. The level set by the STTR for the tax rate is lower than the 15 percent rate established in GloBE. This is because the tax under the STTR is an adjusted statutory tax on the revenue from a specific transaction and not an effective tax on the MNE's profits everywhere, as in GloBE. Tax payments under the STTR are recognized as effective taxes for the calculation of tax under GloBE and, as stated, the STTR is invoked in precedence thereof.[28]

One outcome of the difference between the mechanisms is that a MNE that pays corporate tax at an effective rate of 15 percent or more in the state where it receives the payment might still be liable to top-up tax under the STTR in the country of origin of the payment. This occurs when the MNE receives tax benefits on types of payments included in the STTR in the country of payment received, such that its adjusted statutory tax rate on these payments is less than 9 percent. The state where payment is received need not award a tax credit for the STTR top-up tax payment in the country of origin.

The Two Pillar Reform arrangement, certified in 2021 by the OECD member states that joined the Inclusive Framework, includes an explicit clause establishing that signatories of

[28] The adjusted statutory tax rate is the rate that applies after tax benefits on the type of payment in question and/or in accordance with the source of the payment.

bilateral tax treaties with developing countries that participate in the Inclusive Framework will add the STTR to these treaties if said developing countries ask them to do so. Thus, there would be no need for each developing country to negotiate to revise the wording of the tax treaties that it had signed. This change, however, still must be instigated by the developing country and will not be made automatically.[29]

The STTR is addressed, as stated, to developing countries, especially those that have low administrative capacity, so that they may be included in the Two Pillar Reform under the most convenient conditions possible. The rule promotes, complementarily with the GloBE mechanism, across-the-board standard-rate taxation of income (minimizing the incidence of low or no taxation) and is meant to help protect countries' tax base and encourage the broadest possible international agreement to the new international taxation reform. As in the context of the GloBE rules, here, too, government bodies, international organizations, investment funds, pension funds, and nonprofits are exempted. In mid-2023 the OECD distributed the Multilateral Convention to Facilitate Implementation of the Subject to Tax Rule (the STTR MLC). The convention was opened for signature in September 2024 and developing countries begin to sign it at that stage.[30]

3.2.3 Discussion of the Reform

Pillar Two is expected to impact the global economy considerably. A key goal of the global minimum tax is to deter large multinational entities from shifting profits to countries that typically charge low tax rates, thus giving states less incentive to compete with each other for capital and business activity by lowering tax rates and awarding other benefits. The professional literature calls this kind of rivalry a "race to the bottom." Accordingly, beyond contending with the BEPS phenomenon, the international taxation reform is likely to affect a broad range of domestic incentives. In particular, it may reduce or cancel the utility of incentives that lead to effective tax rates below 15 percent.

A major advantage of the global minimum tax mechanism is that countries may adopt it voluntarily, rather than having it imposed on them by external legislation. This means that, in contrast to P1, which requires extensive legislative changes and is therefore applied by

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[29] For a statement of intentions on the topic in the Israeli context, see the Israel Tax Authority's letter to taxpayers, August 14, 2024.

[30] See OECD site, https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/sttr/sttr-mli-signatories-and-parties.pdf

means of a multinational tax covenant, P2 may be applied unilaterally via domestic legislation. Accordingly, it has already been adopted and applied by quite a number of countries, mainly European and OECD member states.[31] Practically speaking, the main condition for the global minimum taxation mechanism of P2 to function is cooperation on the part of the G20 states, which are the states of residence of more than 90 percent of large MNEs. These countries are particularly eager to protect their tax bases, which have eroded steadily as firms shift their profits to other countries and jurisdictions which offer low tax rates.[32]

Importantly, the final amount of the top-up tax to be applied under P2 at the MNE level is likely to remain the same irrespective of the rule by which it is collected: QDMTT, IRR, or UTPR. If extensive top-up tax collection takes place in low-taxation countries, an outcome that the P2 rules seem to encourage, the top-up tax will flow mainly to these countries. In other cases, the effect of P2 is harder to predict. In this context, even if some countries that have signed the Two Pillar Reform do not cooperate in applying the rules, they will have to accept their application by other countries and act accordingly. Initial findings already attest, as stated, to far-reaching international application. According to the 2022 World Investment Report, the reform was already being taken into account in multiple bilateral double-taxation treaties.[33] This means that the impact of P2 is likely to grow in the next few years.

According to current estimates, global minimum taxation of corporations is expected to boost global corporate-tax revenue by USD 155 billion to USD 192 billion per year, equal to 6.5–8.1 percent of current global corporate-tax collection.[34] The increase in collection will occur on a worldwide basis and will be steeper in strong and weak economies than among those in the middle range, while collection is expected to decline in countries where reported rates of profit exceed the global average relative to expenditures on payroll and tangible assets. The top-up tax under the GloBE rules will account for some two-thirds of

31 IMF (2023), p. 7.

32 Most MNEs, particularly most of the very largest, are residents of G20 states. In this context, critics have claimed that the current international-taxation reform acts largely in the service of G20 states' interests at the expense of the world's other countries. Another meaningful critique concerns the exceptions offered today to application of the rules of the pillar, as well as the relatively low effective minimum corporate tax rate (15 percent). For a discussion, see, for example, Avi-Yonah & Kim (2022), pp. 510–511.

33 UNCTAD (2022a).

34 Hugger et al. (2024). Pillar Two, with all its features, is expected to yield an annual sum of USD 220 billion. See OECD (2023d).

the total increase in global corporate-tax revenue, while the rest is likely to originate (directly and indirectly) in an expected decrease in profit shifting.

Pillar Two is likely to have a greater effect on Israel than is Pillar One. Due to lack of data on MNEs and their overall corporate structure, however, the entities operating in Israel that will be affected by the reform are hard to identify accurately, making it difficult to arrive at a clear estimate of how the reform will affect them in relation to other countries in which they operate. The assessment is that several dozen multinational entities that will be affected by Pillar Two are active in Israel, such that, as stated, the added tax revenue tracing to Pillar Two is likely to be larger than that in Pillar One, but still not very significant.

In a broader context, it is important to note that Pillar Two is supposed to be applied concurrent with American legislation that relates, among other things, to taxation of income from intangible assets (Global Intangible Low Tax Income—GILTI) and minimum American corporate taxation (Base Erosion and Anti-Abuse Tax—BEAT), adopted as part of the 2017 tax reform.[35] The GILTI legislation relates to foreign income of firms under American control and focuses on easily shifted intangible assets such as intellectual property. The tax, ranging from 10.5 percent to 13.125 percent, is meant to thwart the shifting of assets and associated profits to countries typified by tax rates lower than the 21 percent American rate. The BEAT legislation, in contrast, establishes a 10 percent minimum American corporate tax rate in order to protect the USA tax base and keep firms that operate in the USA from shifting profits abroad.[36] Legislation in this field has been gaining strength in the United States in recent years, despite and concurrent with the international tax reform taking shape spearheaded by the OECD. Accordingly, companies that fail to meet the threshold requirements of P2 may still be liable to extra tax under the American legislation in cases where they, or associated entities, operate in the United States. In practice, since most large firms that operate in Israel are registered in the United States, the American legislation may have a stronger effect on Israel than will Pillar Two.[37] For a concise overview of the 2022 minimum corporate-tax legislation in the United States (the Corporate Alternative Minimum Tax—CAMT), see Appendix 3.

35 For an overview of the TCJA, visit the Internal Revenue Service site: https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-a-comparison-for-businesses. For an overview of the GILTI legislation, visit https://www.irs.gov/pub/irs-utl/global_intangible_low_taxed_income.pdf

36 For an overview, visit the IRS website: https://www.irs.gov/pub/irs-utl/irc59a-beat-overview.pdf

37 Bank of Israel (2022), p. 202.

4. Progress in the Reform in Israel and Abroad

In July 2024, the Israel Ministry of Finance announced that Israel would impose a domestic minimum top-up tax (QDMTT) at the rate of 15 percent from the 2026 tax year onward, in accordance with the rules of Pillar Two.[38] The tax would be applied to the profits of MNEs with group turnover of EUR 750 million or more and would bring these entities' effective tax rate paid in Israel to 15 percent. This would head off the collection by other countries of a top-up tax via the IIR and the UTPR in respect to the entities' activity in Israel. According to the ministry's explanation, it was decided at this stage not to adopt the IIR and the UTPR in Israel but to consider the possibility of doing so farther on. Similarly, the United States has not yet adopted the Two Pillar Reform thus far. In practice, the 2022 Inflation Reduction Act, passed by Congress that year, sets the American minimum corporate-tax rate at 15 percent.[39] The statute does set a minimum tax rate much as the Two Pillar Reform does but its tax base and particulars do not square with the rules of the reform. (For a breakdown, see Appendix 3.)

Many countries have responded to the Two Pillar Reform in different ways and intensities. Some came out with initial or general statements of intentions to deal with the reform, others promulgated detailed programs, and yet others incorporated some or all of the reform into their domestic statutes (this according to data from the PwC accounting firm, which has been tracking progress in the reform among 118 of the 147 participants in the OECD's Inclusive Framework, as of January 21, 2025; see Table 2).[40] The main group of countries that incorporated the reform into their domestic legislation includes those in Europe. In December 2022, the EU countries decided to ratify the global minimum taxation mechanism within the framework of the Pillar Two directives such as to put it in into effect by the end of 2023.[41] Among the countries that have legislated or proposed legislation on the topic, forty-five or so have progressed toward introducing a domestic minimum top-up tax (QDMTT) by 2025 and two others (Israel and New Zealand) are likely to take this step

38 Chief Economist (2024).

39 Inflation Reduction Act of 2022 (P.L. 117–169), https://www.congress.gov/117/bills/hr5376/BILLS-117hr5376enr.pdf

40 Visit the PwC website in regard to Pillar Two: https://www.pwc.com/gx/en/services/tax/pillar-two-readiness/country-tracker.html#pdf-download. For a summary of the data, see ibid. https://www.pwc.com/gx/en/tax/international-tax-planning/pillar-two/pwc-pillar-two-country-tracker-summary-v2.pdf. The data in this document are up to date on the site as of November 26, 2024 (site last visited on Decmber 3, 2024).

41 The Council Directive (EU) 2022/2523 of December 14, 2022, on ensuring a global minimum level of taxation for multinational-enterprise groups and large-scale domestic groups in the Union.

in 2026. The IIR rule, in contrast, will go into effect among forty-two participants in the Inclusive Framework in 2025 and 2026 and the UTPR rule will be applied by thirty countries in that time frame.[42]

Table 2

Responses to Pillar Two arrangements§

	All countries*	OECD countries (38)	G7 countries	G-20 countries†
Incorporated the P2 arrangements into domestic legislation	54	28	6	12
Promulgated bills	4	1	0	0
Announced plans and/or solicited comments from the public‡	12	4	0	0
Did not issue plans to respond to P2	48	5	1 (USA)	6
Total	118	38	7	18

* The PwC data relate to 118 of the 147 states participating in the Inclusive Framework.
† There are no data for Russia and the African Union.
‡ Including countries that received a six-year extension.
§ Israel is defined as a state that has announced plans. It is included in "All countries" and "OECD countries."

Source: PwC's Pillar Two Country Tracker (correct as of January 25, 2025).

Furthermore, as of this writing most diplomatic statements on applying the Pillar Two reform by states that are participating in the Inclusive Framework relate mainly to setting a domestic reform-compliant minimum corporate-tax rate. For example, reviewing the advancement of P2 arrangements in Germany and the Netherlands, we found that neither country took measures to enhance its domestic attractiveness for business or to replace tax benefits that would lose their potency due to the reform with other benefits or grants. This is so even though the Netherlands has historically been perceived as promoting such strategies.[43] Other countries, however, have introduced various mechanisms that are

42 In 2024, the IIR rule was applied by thirty-one participant states in the Inclusive Framework as against thirty-three that applied the QDMTT rule and none that applied the UTPR rule. At this stage the expected major increase in UTPR adoption will be from no countries in 2024 to 30 countries in 2025.

43 For discussion of taxation in the Netherlands, see, for example, a report published in June 2024 by the Centre for Research on Multinational Corporations, stating that the Netherlands still comports itself as a tax haven: https://www.somo.nl/the-netherlands-still-a-tax-haven.

designed to create investment incentives as alternatives to tax benefits in order to retain international investments. Major examples of this phenomenon include Switzerland and Ireland; both have long opposed the Pillar Two arrangements and have been categorized as tax havens for years. These countries are apparently concerned about the impact of the increase in the effective tax rate on corporations that operate on their soil and those corporations' investment in them.

More specifically, the Swiss Constitution was amended by plebiscite in 2023 to impose a Qualified Domestic Minimum Top-Up Tax (QDMTT) on MNEs. At that time, the Swiss government ruled that 75 percent of revenues from the new tax would be apportioned among Swiss cantons that had corporate-tax rates below 15 percent, 8 percent among the other cantons, and the remaining 16 percent used by the federal government to enhance the attractiveness of Swiss business and keep jobs and tax revenues in the country. The measures listed include, among others, increased funding for universities, support for manufacturing and R&D, and bolstering the innovativeness and competitiveness of Swiss firms.[44] The minimum domestic corporate tax went into effect in Switzerland on January 1, 2024.

Several cantons have already responded to the reform. Geneva, for example, raised its total corporate-tax rate from 14 percent to 14.7 percent. Zurich, in contrast, actually lowered its rate from 7 percent to 6 percent. Schaffhausen added a progressive corporate tax such that profits up to CHF 5 million are liable to the previous tax rate (13.8 percent) and firms with profits of CHF 15 million and above pay a total of 15 percent in corporate tax. In Grisons, in contrast, a bill has been introduced that would give direct grants to companies that generate added value within the canton and/or engage in R&D, innovation, or environmental sustainability. Similarly, in Zug there is an intention of subsidizing firms by means of grants (given that the corporate tax rate in this Canton is a relatively low 11.8 percent).[45]

In contrast to Switzerland, the government of Ireland imposed a 15 percent QDMTT on firms that generate turnover of EUR 750 million or more and concurrently raised its corporate-tax rate in the category of patents (the Knowledge Development Box) from 6.25 percent to 10 percent. Ireland, however, also emphasized that companies that fall below the

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[44] Swiss Federal Council Statement recommending that voters accept proposal to implement minimum taxation, April 24, 2023.

[45] https://kpmg.com/ch/en/media/press-releases/2024/05/clarity-swiss-taxes.html

Pillar Two tax threshold would continue to pay corporate tax at Ireland's "regular" 12.5 percent rate. The Irish government did not content itself with these measures; it also created additional ways of supporting and preserving Ireland's attractiveness to business. In 2023, the Irish government raised the level of the tax credit for R&D from 25 percent to 30 percent, compensating firms engaging in R&D for the minimum tax rate under GloBE,[46] and expanded the credit to include expenditures on cloud computing. In 2024, it also introduced a dedicated tax benefit for digital-game companies in the form of a refundable tax credit. It is set at 32 percent of expenditure on designing and developing digital games, up to EUR 25 million per game. While these legislative changes may reduce or prevent investment and business activity from leaving Ireland, they increase the cost of incentives to the Irish government.

Vietnam also acted to incentivize firms in a response to the P2 arrangements. In June 2023, its government resolved to impose a 15 percent QDMTT and offer corporate subsidies or grants to compensate firms for their top-up tax payments.[47] In response, the OECD came out with an unusual statement, explaining that such a measure transgresses the tax-reform arrangements of both pillars, the No Benefit Requirement clause in particular. Accordingly, if Vietnam takes this step, it will render its top-up tax non-qualified.[48] A non-qualified top-up tax does not absolve companies that pay it from having to pay top-up tax in other countries in accordance with the IIR or UTPR rules. In this manner, MNEs that remit the top-up tax to the government of Vietnam and obtain a refund in the form of a government subsidy or grant would have to pay the top-up tax again in other countries where they are active and that apply the GloBE arrangements.[49]

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[46] In greater detail, the tax credit becomes a grant after three years and is available to all firms countrywide, and therefore qualifies as income (and not as a tax benefit) for the purposes of Pillar Two. Thus, a company taking this credit would have to pay the 15 percent minimum tax rate on the credit as well. The increase of the credit from 25 percent to 30 percent raises the rate of the credit after the minimum tax to 25.5 percent (30%*[1-0.15]=25.5%) and thus roughly preserves its previous value. This measure was taken for the express purpose of preserving the value of the credit in view of the international tax reform.

[47] For an overview from the media, see, for example, Guarascio (2023).

[48] Den Ridder et al. (2023); see also OECD (2021c): Article 10.1. Pillar Two Model Rules—Defined Terms, "Qualified Domestic Minimum Top-up Tax," "Qualified IIR," "Qualified UTPR": "provided that such jurisdiction does not provide any benefits that are related to such rules."

[49] At the present stage, it is not clear who has the authority to determine that a given tax is non-qualified. This is because there is no central authority in charge of enforcing the rules of the reform or empowered to declare a certain country's tax benefit null and void. Accordingly, a question arises whether countries can demand that other countries revise their tax systems before they levy additional taxes.

5. Tax and Investment Incentives

5.1 Key Aspects of Investment Incentivization

International surveys indicate that investors base their investment decisions on a broad range of fundamentals including political stability, economic potential, natural resources, human capital, level and quality of infrastructure, regulatory transparency, and broader efficiency of the domestic regulatory regime.[50] Nevertheless, many countries rely on investment incentives, particularly those in the form of tax benefits—cutting tax rates, deferring tax payments, broadening and deepening deductions, and the like—in order to attract investments that would widen the domestic tax base and contribute to economic growth.[51] Even though tax incentives are not the leading consideration in investment decisions, they are a key policy tool for governments, among other things for their ability to influence these incentives directly and immediately, unlike most other determinants of investment decisions.

According to the 2022 World Investment Report, tax incentives are used widely around the world to attract and retain investment.[52] They fall into two main categories: profit-based and expenditure-based. Profit-based incentives, such as lowering the corporate-tax rate, are the more common. In contrast, expenditure-based incentives include, *inter alia,* accelerated depreciation and tax credits that lower the post-tax cost of the investment. These incentives have been found more effective in generating new economic activity and encouraging reinvestment than profit-based incentives, but the government expenditure on their account is certain even if they ultimately fail to generate added value. Other types of incentives include reduced rates of indirect taxation, labor and land taxes, social-insurance contributions, and so on. Another type of government support of investment is direct support (subsidization) by means of grants for both fixed investment and for R&D.[53]

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[50] International surveys of investors indicate that companies do not rank tax incentives among the leading considerations in their investment needs. Other considerations, such as the broad investment environment, usually come first. See, for example, Kusek & Silva (2017) and James (2009). See also World Bank (2017)—a survey of 750 executives of multinational enterprises, which finds that business-friendly judicial and political stability, security, and macroeconomic conditions are key factors in multinational entities' investment decisions, whereas tax considerations are usually a secondary consideration.

[51] For the impact of foreign investment on projects, workplaces, and capital investment, see, for example, Fleishman-Alaluf (2023), p. 12.

[52] UNCTAD (2022a), p. 78.

[53] OECD (2023b), pp. 50–51.

Despite the advantages of some of these incentives, government incentives generally and tax incentives for investment particularly are very costly. Studies show a strong negative correlation between tax incentives and tax revenues: a 10 percentage-point increase in corporate incentives triggering a total decline of 0.35 percent of GDP in corporate-tax revenues.[54] This cost is particularly burdensome to low-income countries, which find it hard to raise revenues and in which tax incentives tend to be less effective in attracting investments.

In this context, the Two Pillar Reform is likely to have a differential effect on the incentive system. Pillar One, focusing on broadening the allocation of some international taxation rights, is likely to have only a limited effect on real economic behavior and investment decisions.[55] For the time being, it targets the largest and most profitable multinational entities, including many digital firms, most of which tend not to rely on investments in assets—at least not tangible assets—in their international activity. Pillar Two, in contrast, which imposes a global minimum corporate tax, is likely to strongly impact the choice of where to invest and the effectiveness of existing tax incentives and, in turn, impact countries that currently enjoy significant foreign direct investment due to providing tax benefits for investment.[56] In the Israeli context, the effect of the reform on tax incentives may be considerable. Foreign investment figures importantly in the Israeli economy. In the 2012–2021 decade, for example, Israel's USD 243 billion in foreign investment accounted for 6.9 percent of GDP at the time. The peak year, 2021, saw deals in the sum of USD 46.9 billion, 9.5 percent of GDP.[57]

5.2 The Israeli Case of Investment Incentivization

The Law for Encouragement of Capital Investment, 5719-1959 (hereinafter: LECI), is the flagship of the Israeli system of investment incentives. In 2021, it cost NIS 5.5 billion, mostly in the form of tax benefits distributed to beneficiary corporations.[58] A large share of corporate profits and, in turn, tax payments in Israel are concentrated in the hands of several large enterprises (Table 3). According to existing data, the average effective corporate-tax rate on the upper-thousandth firms in Israel was 19.2 percent in 2018, 1.1 percent below

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54 Kronfol & Steenbergen (2020), p. 2.
55 UNCTAD (2022a), p. 101.
56 Ibid.
57 Fleishman-Alaluf et al. (2022), p. 9.
58 State Revenues Administration (2022), p. 22.

the tax rate paid by other firms that year. According to the State Revenues Administration's report for 2019–2020, the reason for this was that the large majority of Israeli firms that benefited from the LECI are in the uppermost deciles. Furthermore, the uppermost percentile of these beneficiary companies (only thirteen companies in 2018) received 56 percent of total funding under the LECI that year.

Table 3

Share of leading companies in profits and corporate tax,* 2018

	Share of all corporate profits, pct.	Share of corporate-tax payment, pct.
Uppermost decile	92	91
Uppermost percentile	67	64
Uppermost thousandth	42	39

*212,000 firms operated in Israel in 2018 and total corporate tax payments were NIS 38.2 billion.

Narrowing the analysis to enterprises that benefited from the LECI, we find that the uppermost percentile and decile of beneficiary companies paid corporate tax at average effective rates of 8.1 percent and 9.3 percent, respectively, in 2018, far below the 15 percent bound established by the Two Pillar Reform—while the rest of the beneficiary corporate population paid effective tax rates of 14.4–18.0 percent. Even if one stipulates that the calculation of effective tax rates under the LECI and the Two Pillar Reform are not the same, the practical meaning of this is that if Israel wishes to continue incentivizing corporations under the LECI after the international taxation reform goes into effect, it will have to adjust the benefits that apply to multinational entities in order to align the effective rate of corporate tax with the new minimum requirements. It may accomplish this by replacing certain tax incentives, such as reduced rates of statutory corporate tax, with other benefits, mainly grants and/or refundable tax credits. Concurrently, other tax benefits, such as accelerated depreciation and rollover of losses, which do not affect the statutory corporate tax rate, may remain in effect even after the reform is applied, but it will be necessary to examine their effects on the total calculation of effective taxation under the Pillar Two arrangements.

Similarly, it will be necessary to reassess the overall array of corporate-tax benefits in Israel, particularly in respect of exports and high tech. Companies that qualify for corporate-tax benefits in Israel enjoy especially lowered tax rates that may go as low as 6 percent, as against the regular statutory corporate-tax rate of 23 percent.[59] And even though the tax benefits do help to attract foreign investment, the revenue forgone on this account comes at a considerable economic cost: 0.3 percent of GDP per year.

A thorough review of Israel's system of corporate-tax benefits, including a comprehensive and objective assessment of all the costs and benefits attending to them, is a well-known necessity amply documented in the professional literature. This examination should include, in addition to the direct impact of the benefits on state tax revenues given the international taxation reform, a focus on enterprises which yield exceptional utility to the local economy and are especially able to leave Israel. Such exceptional utilities include investments that generate broader value than that reflected in the company's profits ("positive externalities"), including by enhancing other firms' productivity due to knowledge and technology sharing. On the other hand, it should also examine the administrative costs, compliance costs, and resource-allocation distortions that are bound up with these benefits.

6. Implications of the Reform for Israel

As demonstrated in the previous sections of this paper, the Two Pillar Reform is likely to affect the Israeli economy along several avenues including state tax revenues, location of investment, international competitiveness, and structural reforms among others. Here we discuss these effects in greater depth. The first part centers on assessing the direct effects of the reform on state tax revenues and Israeli companies' activity; the second part discusses the implications of the reform for Israel's economic policy more broadly.

6.1 Estimating the Direct Effects of the Reform on Israel Tax Revenues

At the present writing, tools for direct estimation of the effect of the Two Pillar Reform are lacking. In this subsection, we focus on simulations conducted by the OECD in 2022 and 2024 and perform an analysis based on the trade data of Israeli firms in the United States.

[59] OECD (2023b), p. 28.

6.1.1 OECD Simulations[60]

A simulation carried out by the OECD in 2022 quantifies the added tax collection that Israel expects to gain by applying Pillar One. According to the simulation, Israel's corporate-tax base will grow by USD 60–USD 190 million and tax revenues by only USD 6 million–USD 60 million (0.05–0.5 percent of corporate-tax revenues). It is important to be mindful of the limitations of the OECD's simulation. Among other things, the simulation preceded the recent changes in the Amount A mechanism that reduce the original incidence of the pillar. In addition, due to data limitation, the simulation was conducted on companies with turnover of EUR 5 billion or more even though Pillar One applies to companies with turnover of EUR 20 billion or more. In addition, the simulation relates only to Automated Digital Services (ADS) and Consumer Facing Businesses (CFB) even though the reform applies to companies in all industries apart from those exempted such as financial services and natural-resource extraction. Likewise, it is based mainly on old data (from 2017–2018) and is static; therefore, it takes no account of behavioral effects and actually tests a very simplistic and out-of-date iteration of the reform.

Similarly, an OECD simulation from early 2024 measures the additional tax revenue that the application of the Pillar Two provisions is likely to generate. According to this simulation, if Israel introduces a minimal domestic corporate tax (QDMTT), its corporate-tax revenues will increase by USD 680 million–USD 870 million (5.8–7.4 percent of corporate-tax revenues)—75 percent from the Israeli QDMTT and the rest due to less profit shifting from Israel. This means that most of the foreseen upturn in revenues will originate in the effective cancellation of corporate-tax benefits, chiefly those under the LECI.

6.1.2 Israeli Firms Traded in the United States

Given that direct and complete data on Israeli MNEs' income, profits, and detailed effective tax rates are unavailable outside the Israel Tax Authority databases, we will use foreign securities data to produce a general estimate. The securities of ninety-three Israeli firms are traded on American exchanges today, some issued in the USA only and others dual-traded via ADR (American depositary receipts).[61] The advantage of using these data is that the companies in question are multinational by definition. We carried out several

[60] Simulations obtained from the OECD in the course of direct discussions with it.

[61] ADRs facilitate dual listing of tradable securities that represent non-American public companies by placing registered equities with a large American bank for custodianship.

searches of their financial statements to determine which of them regard BEPS activities and/or the international taxation reform as possible risks to their profits. We found that twenty-two firms (24 percent) mentioned BEPS, BEPS 2.0, or the Inclusive Framework in their financial statements. Arranged by market cap in the United States, these companies include eight of the ten largest Israeli enterprises and fourteen of the twenty largest. Among them, eight reported turnover in excess of the compulsory tax threshold in Pillar Two (EUR 750 million) and one verges on this boundary.

Table 4 shows the turnover and profit rates of these nine enterprises. All mentioned the OECD's BEPS program as a risk in 2019–2021. The yellow cells in the table indicate years in which an enterprise reported the Two Pillar Reform as a risk to profitability, in addition to or instead of mentioning BEPS as a risk. The fact that some of these enterprises added the current reform to their list of risks in 2021 signals that some believe they will have to pay more in taxes if and when the reform is implemented.

Table 4

Turnover and effective tax rates of large Israeli firms listed in USA exchanges that mentioned BEPS and/or BEPS 2.0 in their financial statements

	Turnover (USD million)			Effective tax rate paid**		
	2019	2020	2021	2019	2020	2021
Checkpoint Software Technologies, Ltd. (CHKP)	1,995	2,065	2,167	14.0%	13.0%	14.0%
Elbit Systems, Ltd. (ESLT)	4,508	4,663	5,279	7.9%	13.9%	34.6%
Formula Systems (1985), Ltd. (FORTY)	1,701	1,934	2,404	23.0%	21.7%	23.0%
Israel Chemicals, Ltd. (ICL) (ICL Group Ltd. (ICL))	5,271	5,043	6,955	NA	51.0%	24.0%
Nice. Ltd. (NICE)	1,574	1,648	1,921	20.6%	17.2%	17.2%
SolarEdge Technologies, Inc. (SEDG)	1,426	1,459	1963 [3]	18.8%	14.2%	9.6%
Taro Pharmaceutical Industries, Ltd. (TARO)	670	645	549	17.9%	-2.5%	25.2%
Teva Pharmaceutical Industries, Ltd. (TEVA)	16,887	16,659	15,878	22.0%	4.0%	32.0%
Wix.com, Ltd. (WIX)	758	984	1,270	NA	NA	NA

Source: Bank of Israel and U.S. Securities and Exchange Commission.

1. As reported in the 10-K/20-F statements that were submitted to the SEC.
2. In yellow: firms that mentioned BEPS or the OECD's Inclusive Framework
3. The firm did not mention BEPS in its financial statements.

The data in Table 4 show that most large Israeli MNEs that are traded in the United States report effective tax rates exceeding 15 percent, but some fall short of this, for example, Elbit Systems in 2019 and 2020, Teva in 2020, and SolarEdge in 2021. The effective tax rates shown in Table 4 and reported in the USA, however, do not necessarily match the adjusted effective rates set forth in the Two Pillar Reform due to legislative differences that are sometimes considerable. In addition, many of these firms pay reduced rates of corporate tax in Israel as "Preferred Technology Enterprises" under the LECI.[62]

6.2 Estimated Policy Implications of the Reform for Israel

Beyond its expected effects on Israeli state tax revenue, the Two Pillar Reform may have a significant impact on the future location of MNEs' business activity; therefore, it may cause countries to continue competing over MNEs in various ways. In this section, we describe the likely initial development of the reform and discuss several possible scenarios of its effect after this period.

6.2.1 Short-Term (3–5 year) Outcomes of Reform Implementation

As we saw above, many (forty-five) countries have already begun or will begin to implement Qualified Domestic Minimum Top-up Tax (QDMTT) arrangements at a 15 percent effective rate in the course of 2025. A large majority are also progressing toward application of the IIR (forty-three countries) and UTPR (thirty) under the GloBE mechanism of Pillar Two.[63] At the current stage, the reform includes a multi-year adjustment period, during which MNEs may report and calculate their global minimum taxation with relative simplicity. The tax revenues of most countries that apply the QDMTT rule are expected to continue to grow; the exceptions are those countries or jurisdictions that had especially low effective tax rates before the reform (investment hubs). Thus, countries that do not apply a QDMTT at this stage and have MNEs that pay corporate tax at effective rates below 15 percent will trigger, in the next few years, an increase in tax

[62] See Section 51x of the LECI, which spells out the terms by which a "Preferred Technology Enterprise" and a "Special Preferred Technology Enterprise" are defined; see also "Encouragement of Capital Investment Directives (Conditions Attesting to an Enterprise Being Promotive of Innovation for the Purpose of Designation as a Preferred Technology Enterprise), 5779-2019.

[63] In fact, the greatest leap thus far in assimilating global taxation occurred in applying the UTPR rule, from no countries in 2024 to thirty in 2025. This happened despite transitional rules of the reform that will remain in effect in this context until 2026. From that year on, the UTPR rule will also apply to MNEs whose parent company is incorporated in a country that applies a statutory corporate-tax rate in excess of 20 percent (e.g., the United States and Israel).

collection in countries that apply the IIR or the UTPR. This increase in collection, in turn, is likely to incentivize other countries to make progress in applying a QDMTT, given the understanding that MNEs operating in them may be liable to a top-up tax in another country that brings their effective rate up to 15 percent by means of the IIR and the UTPR. This cascading process of global growth in tax collection will bring the minimum effective tax rates that MNEs pay up to the 15 percent level irrespective of where their profits are recorded.

Concurrently, profit shifting has indirect costs, such as a possible blow to the MNE's reputation, in addition to direct costs including paying the lawyers', investment banks', and CPAs who set up and implement the profit-shifting arrangement, maintaining offices and paying labor costs for the purpose of shifting profits to a certain country, and/or maintaining the optics of business activity in the country to which the profits are shifted. In cases where the profit (tax saving) originating in shifting profits to a tax haven are much smaller due to the application of the Two Pillar Reform, the cost–benefit ratio of profit shifting will decline and less profit will be sent to tax havens. Consequently, firms will have to decide whether to continue shifting their profits and, if they decide to continue, where to. They will also have to be mindful of the tax-sheltering Substance-based Income Exclusion (SBIE), which reduces the top-up tax that an MNE will have to pay under Pillar Two if it has physical assets and staff in the country in question. As specified above, the Two Pillar Reform establishes that insofar as an MNE records its profits in places where it has business activity that created the added value attributed to said profits, it will enjoy greater consideration of these expenses in calculating its taxes. This will be especially true at the beginning of the reform because the SBIE rate will start at 10 percent and only gradually step down to 5 percent over the course of a decade.

Given that profit shifting is an activity that comes at a cost, when an MNE's effective tax rate in countries where it has physical activity and/or in other associated countries where it maintains residence will be at or near the new minimum rate (15 percent), the MNE will likely prefer to leave its profits there. It is also reasonable to assume a home bias that will affect the MNE's choice of where to record its profits. In contrast, in cases where the effective rate paid by the MNE is above 15 percent, it may well continue to shift profits to countries where effective rate is only 15 percent or close to it.[64] This phenomenon may

[64] The incentive to shift profits is likely to be higher the more the effective tax rate applying to the MNE exceeds the compulsory 15 percent rate that the Two Pillar Reform prescribes.

incentivize countries that have tax rates exceeding 15 percent to lower their effective rate on MNEs toward 15 percent in order to prevent profit shifting away from them.

The process of implementing the Two Pillar Reform is likely to end with all MNE-hosting countries applying the IIR and the UTPR and countries where these MNEs operate applying the QDMTT rule. Ideally, this will cause all MNEs to pay an effective rate of at least 15 percent wherever they operate (the QDMTT rule), such that actual revenues from the IIR and UTPR rules will be minimal. At that point in time, most MNE profits will probably be recorded in countries where MNEs pay effective tax rates not far above 15 percent. Thus, global collection of corporate tax will probably rise by about 4–10 percent at the end of the process (see Section 2 above). This is unlikely to trigger a major transfer of physical economic activity from one country to another but will likely continue the trend of the reduction in global profit shifting and its attendant expenses.

6.2.2 Medium-Long–Term Implication Scenarios

To analyze the economic implications of the Two Pillar Reform, below we examine three main scenarios of global development of corporate tax and corporate-investment government policy after the reform is applied. The scenarios envision three kinds of impact on Israel: (1) less competition over the location of MNE activity; (2) intensified competition over the location of MNE activity by means of industrial policies and incentives; and (3) continued competition to attract and retain MNEs' activity, with an emphasis on improving economic fundamentals as underlying conditions for the encouragement of domestic business activity. Below we elaborate on each of these three scenarios.

Scenario 1: *Less Competition over the location of MNE Activity*

The scenario: After the Two Pillar Reform is applied, no serious competition erupts among countries over incentives to firms and international competition in the field of corporate tax wanes.

As described above, the Two Pillar Reform incentivizes MNEs to record their profits in countries where they conduct the business activity that generates these profits and, contrastingly, limits the most common, easiest, and least costly path to competition over the venue of their activity or the shifting of their profits by lowering tax rates. The literature on the marginal effect of tax differentials on profit shifting shows that most profit shifting takes place where large tax differentials exist, namely, when there are tax havens and the global distribution of corporate-tax rates is wide. In contrast, the effect of small deviations from the average global tax rate on profit shifting is small (see Box 1). The Two Pillar Reform is intended to limit large negative deviations from the global average effective tax rate; thus, it will reduce the ability of tax policy to encourage profit shifting, reducing the motivation to compete over corporate-tax rates and incentives. on the other hand, a country that has corporate-tax rates above the global average will not be able to raise its corporate tax rate much without risking profit shifting by MNEs to countries typified by effective corporate-tax rates that comply with the 15 percent compulsory minimum.

In our estimation, this is the most reasonable baseline scenario at the present time. The main risk to its materialization lies in the exploitation of loopholes in the mechanism used to calculate the effective tax rate under the Two Pillar Reform. The concern is that countries will offer MNEs sizable tax benefits that will not lower their effective tax rate, inducing these companies to shift profits to them again. The reform includes various details and mechanisms that are meant to keep this from happening. An example is the OECD's response to Vietnam's statements (see Section 4 above). Another is the mechanism used to adjust and update the taxation rules in the Inclusive Framework, making it difficult—over time—to leave such loopholes open once they are detected.

If this scenario comes to pass, Israel will have to set a 15 percent minimum effective corporate-tax rate and abolish or replace some of the tax benefits that it awards today under the LECI. After an adjustment period, however, there will be no acute need for alternative corporate benefits or incentives because, according to the scenario, the alternatives in terms of an effective corporate-tax burden of under 15 percent will vanish quickly and so will the incentives to shift profits.[65] Consequently, Israel's main need will be to preserve and even reinforce the other local factors that encourage MNEs to set up shop and invest in the country—including high-quality human resources, a high level of public services including infrastructures, openness to the world, and innovation.

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[65] This assumes that the current tax benefits in Israel are meant mainly to compete with other countries' benefits and not to compensate for the country's structural drawbacks.

Israel's risk premium rose considerably after war began on October 7, 2023, but in late 2024, in view of a cease-fire in the north and estimations of an impending decline in security hazards, the country's risk premium fell steeply—even though it remained higher than its pre-war level.[66] If the increase in Israel's risk premium becomes entrenched and persists over time, the country's attractiveness as a destination for investment may be impaired over the long-term. This scenario emphasizes the importance of re-examining the country's array of corporate incentives in order to identify more accessible possible ways of heading off or mitigating the blow to investment.

[66] For elaboration, see Bank of Israel (2025), Chapter 1.

Box 1: Examination of the Marginal Effect of Tax-Rate differentials on Profit Shifting

Until recent years, according to the professional literature, the linear semi-elasticity of corporate-tax-rate differentials on profit shifting was estimated at around -1 (namely, a 1 percent increase in the tax-rate differential reduces the share of MNEs' profits recorded in the country by 1 percent).[67] In the past three years, several studies have also looked into non-linear semi-elasticities. Namely, is the effect of a tax change on profit shifting contingent on the initial level of taxation? Some of these studies used detailed data on global MNE sales, profits, and actual tax payments due mainly to access to CbCr (country-by-country reporting) data.

Under Action 13 of BEPS, a MNE that has an annual turnover of EUR 750 million or more must present its Ultimate Parent Entity's residence state with a detailed report on its income, expenses, profits, and tax payments worldwide, parsed by countries (CbCr).[68] Ninety-two countries have signed the MCAA Agreement, which requires them to forward CbCr reports on companies registered in them to all other countries where these companies operate.[69] These reports play a key role in implementing the international taxation reform because they provide countries with detailed information on the global profits and tax payments of all MNEs registered or operating on their soil, enabling them to identify their relevant top-up taxation rights under the reform arrangements. These reports are bilateral—between countries—and are not shared with other players such as the OECD, which receives only aggregate annual data from the various countries.

Dowd et al. (2017) also looked into the non-linear effects of corporate-tax rates using MNE data from the United States. They found that the semi-elasticity of raising the tax rate on profit shifting is much greater in countries that raise their tax rate from 0 percent to 1 percent (-5.4 percent) than in those that raise it from 29 percent to 30 percent (-0.7 percent).

Bratta et al. (2021) investigated the relation between tax differentials and profit shifting on the basis of CbCr data from Italy in 2017. (The data included all MNEs registered and/or operating in Italy.) They found that the best-suited relation between tax change and profit shifting is a cubic polynomial. In this case, the semi-elasticity of raising the tax rate from 0 percent to 1 percent is -4.4 percent as against only -0.1 percent when the rate is raised from 29 percent to 30 percent. They also examined the effect of the difference between the tax that an MNE pays in a given country and the average tax rate that it pays to the rest of the world. They found that when the difference is zero, a 1 percent increase in the tax rate reduces the MNE's profits in the country in question by only 0.4 percent, whereas the semi-elasticity is 1.3 percent when the tax difference is 10 percentage points and 3.1 percent when a 20-percentage-point tax difference is present.

Fuest (2022b), in a study on detailed CbCr data from Germany, also found non-linear effects of the tax rate on profit shifting. Using the restricted cubic spline estimation method to calculate these effects, he found that when the tax rate is below 5 percent, raising it by 1 percentage point reduces profit shifting to that country by 13 percent. In contrast, when the tax rate is 15–20 percent, a 1 percentage point increase has no statistically significant

67 -1.5 semi-elasticity in Huizinga & Laeven (2008), -0.8 in Heckemeyer & Overesch (2017), and -0.1 in Beer et al. (2020).

68 OECD (2015a).

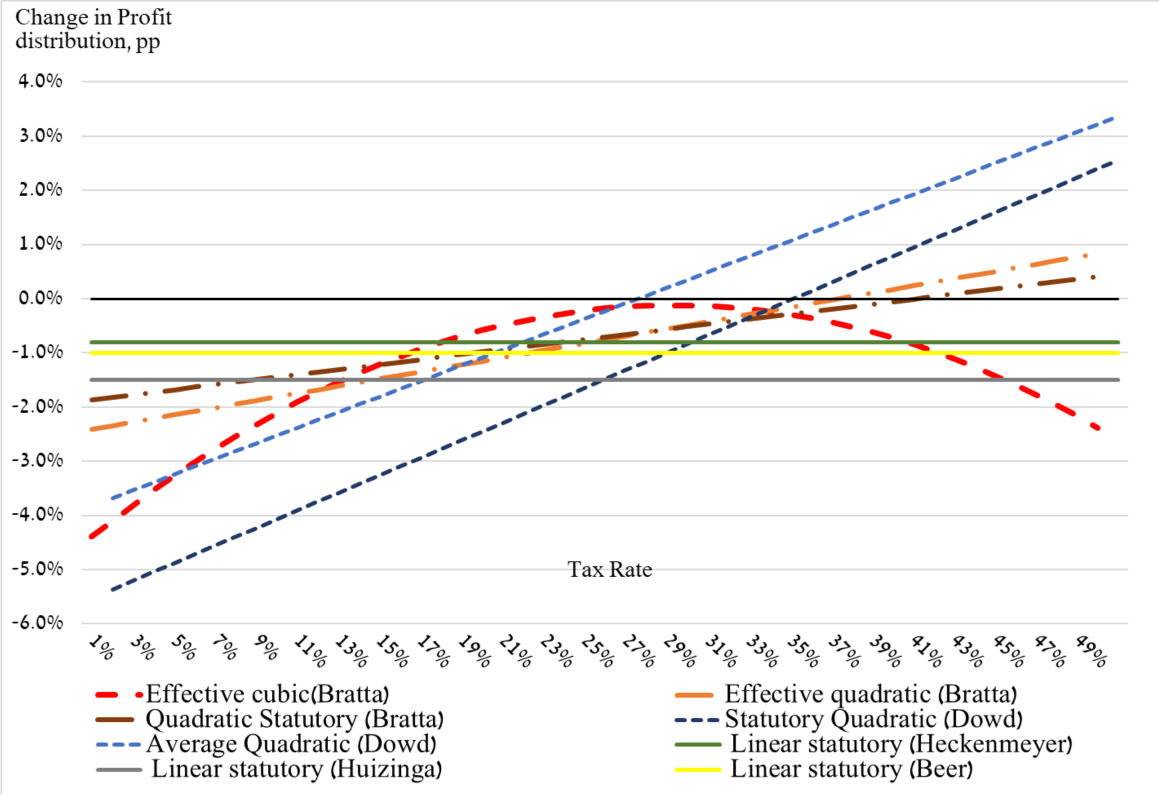
69 Signatories of the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (CbC MCAA), January 31, 2022, https://www.oecd.org/ctp/exchange-of-tax-information/CbC-MCAA-Signatories.pdf

effect on profit shifting. The greater the distance from the global average, the stronger the effect is.

Finally, Garcia-Bernardo & Jansky (2024), investigating CbCr data from the OECD, found a non-linear relation between the effective tax rate and profit shifting and reported that a logarithmic function describes this relationship efficiently. They also found that 80 percent of the profits are shifted to countries that have effective tax rates of 10 percent or lower and that 40 percent of profits are shifted to countries that have effective tax rates of 1 percent or below.

A comparison of the various methods shows that raising (lowering) the tax rate when the tax rate is low reduces (increases) profit shifting much more than does an identical change in tax when the tax environment approximates the global average. Figure B1 presents the semi-elasticity of change in the tax rate on profit shifting according to these studies and the calculation methods they adopted.

Figure B1
Estimates of semi-elasticity of statutory and effective tax rates on MNE profit allocation, by type of estimation (linear, square, cubic)*



*Profit allocation as a percent of MNE profit
Source: : Bratta et al (2021), Dowd et al (2017), Heckenmeyer & Overesch (2017), Huizinga & Laeven (2007), Beer et al (2020)

Scenario 2: *Intensified competition over the venue of MNE activity by means of industrial policies and incentives*

The scenario: Despite the Two Pillar Reform, competition among countries in pursuit of business activity and investment steadily rises. Consequently, countries expand their support and incentives for MNEs so that these entities choose them as the location of their activity.

Recent years have seen growing concern about the fragility of the global trade matrix. The Covid-19 crisis dealt global trade a serious but transitory blow. Lockdowns of factories, cities, and sometimes even countries, preventing exports and/or imports; difficulties in loading and unloading vessels; steep increases in shipping and commodity prices; and a surge in risks related to global value chains all damaged confidence in global markets. Furthermore, various countries' comportment at the beginning of the Covid-19 crisis surrounding restrictions on exports of needed medical equipment and local preference in the manufacture and distribution of Covid vaccines may have encouraged countries to attract activities that they considered important and/or sensitive. Additional shocks to the global-trade system in recent years have also reduced market confidence. Prime among them is the surging trade war between China and the United States, in which the latter is trying, among other things, to prevent the former from importing certain technologies (from the USA as well as from some other developed countries). Another shock is the regime of sanctions against Russia pursuant to the latter's invasion of Ukraine, triggering a shortage of equipment imported from Russia, particularly electronic equipment.

One of the causes, as well as one of the main results, of these phenomena is the growing global use of industrial policy. Industrial policy encourages governments to play an active role in guiding and planning their national economies, to support specific industries, and even sometimes to choose "winning" industries for encouragement and promotion for use as engines of the economy.[70] Conspicuous examples of this approach in the previous

[70] The formal definition of an industrial policy, according to Juhász et al. (2022):

A) Stated goal—Industrial policy is goal oriented state action. The purpose is to shape the composition of economic activity. Specifically: industrial policy seeks to change the relative prices across sectors or direct resources towards certain selectively targeted activities (e.g., exporting, R&D), with (ii) the purpose of shifting the long-run composition of economic activity.

B) National state implementation—Industrial policy is aimed at the stated goals at the level of the national economy. Specifically: industrial policy action is taken by a national, or extranational, state. These actions are sanctioned and financed by national governments, supranational bodies, or amalgamations of these units.

century include Taiwan and South Korea (two of the four “Asian Tigers”). These countries propelled domestic growth forward by developing strong local industries that oriented themselves to exports as vehicles of growth (export-led growth). Taiwan steered and supported its chip and electronics export industries. South Korea chose several large firms in industries geared to exports of goods and supported them in many ways in order to promote local knowledge development, learn from customers/partners abroad, and develop domestic industries that can compete in the global market.

The industrial-policy approach lost altitude at the end of the previous century and in the “aughts” but has rebounded in recent years.[71] The number of industrial-policy measures globally jumped up in 2023 and continued to climb in 2024. They included export barriers, import barriers, subsidies of local manufacture, foreign direct investment measures, localization requirements, and a range of other steps. Most of them were promoted by developed markets, particularly the United States and the European Union, and by China, with import barriers and subsidies on local manufacture as the most common of them.[72]

Although the Two Pillar Reform will limit the possibility of using some of these common measures of industrial policy, a range of other incentives exists that may be employed under the reform. These include direct grants to firms; qualified refundable tax credits (because they are considered grants from the standpoint of the reform and therefore remain effective under certain conditions); tax benefits other than corporate tax (such as discounts on municipal or property tax, reduced income-tax rates for industrial or specific company employees, income-tax or social-insurance discounts or benefits; and accelerated depreciation of physical capital or software); a government undertaking to purchase goods or services from the company, and so on. Unlike most of the tax benefits that the reform restricts, most of the foregoing incentives may be relevant only if the company’s productive activity is situated within the country. A country may also award other tax benefits as long as the companies’ effective corporate-tax rate stays at 15 percent or above. Acquisition of physical assets or hiring of local employees would, as stated above, allow additional limited tax relief even below 15 percent under the Substance-based Income Exclusion (SBIE). Importantly, however, subsidies associated with or compensating for taxes that a company pays or should pay under the international taxation reform may not be offered. Such

[71] Juhász et al. (2023).
[72] Evenett et al. (2024).

measures may, at the very least, cause the QDMTT that the state has applied to become a non-qualified tax, as is happening with Vietnam (Section 4).

The likelihood of this scenario materializing in a way that would affect the Israeli economy is medium and contingent largely on political developments among the USA, China, the EU, and Russia. The reason for this estimate of medium likelihood despite the upward trend in industrial policies around the world is that many countries had been taking multiple measures to stimulate domestic activity for years well before the renewed growth in the use of industrial policies. The reform will limit the ability to give tax benefits that would push a country's effective tax liability below the 15 percent bound, thus narrowing the breadth of the incentives that states can offer. This will improve the relative situation of countries that do not serve as tax havens and/or have not been lowering their effective corporate-tax burdens in some other meaningful way. Countries that decide to replace their current tax-benefit system with other incentives of similar value will find themselves spending large sums in support of firms, a practice that is also likely to reduce the incentives offered. In addition, most support of this kind is given up front; hardly any is contingent on the recipient company's profits or its immediate tax remittances. This increases the total cost of the support and thus lowers the potential gain from attracting business activity and/or investments to the country.

If this scenario materializes anyway, Israel will have to decide whether or not to compete to attract or retain firms' activity and, if it decides in the affirmative, how much, how, and what should be competed over. A state can support businesses in many ways, as described above. It may still award corporate-tax benefits up to a 15 percent effective rate. Using the Substance-based Income Exclusion (SBIE), Israel may offer certain tax benefits even under the 15 percent bound to companies that keep physical assets or labor forces in the country.[73] Companies may be offered direct grants or refundable tax credits as long as they are not meant to compensate for taxes imposed under the tax reform. Other strategies may be chosen, such as encouraging innovation, targeting small companies and startups for support as an alternative to support of MNEs, or even across-the-board support of firms in a given industry. However, the rise of Israel's risk premium and deficit since October 7, 2023, has seriously crimped its latitude in this field. The increase in the risk premium, insofar as it

[73] For example, since the Substance-based Income Exclusion (SBIE) will begin at 10 percent and fall to 5 percent within a few years, the extent of Intel's employment and assets in Israel would allow it to reduce its excess profits in Israel during this period of time and thus enjoy an effective corporate-tax rate of less than 15 percent and possibly as low as 7.5 percent.

becomes permanent, is liable to make Israel less attractive as an investment destination and raise the level of the incentives that would be needed to attract activity, even as the growing deficit limits the size of the incentives that can be offered. Therefore, if Israel decides that such incentives are needed, it should review its entire constellation of existing incentives and cull them in order to maximize the efficiency of the funds spent on this account.

Scenario 3: *Continued efforts to attract and retain MNE activity, with emphasis on improving economic fundamentals as a way to stimulate domestic business activity*

The scenario: Competition to attract and retain activity and investment continues. The focus of the competition, however, shifts from increasing benefits to firms in order to incentivize them to set up shop and remain in the country, to increasing general productivity and enhancing the business environment in order to increase the country's overall attractiveness to business. Such an approach may include programs meant to improve labor productivity, market development, infrastructure, and the education system at all levels to produce a higher quality labor force, promote innovation, etc.

This scenario is strongly contingent on the country's ability to change its growth trend, namely, to converge of international productivity (aka the catch-up effect). Israel's per-capita GDP has converged only partly in recent decades. In 2023, it remained roughly 9.6 percent below the average among OECD member states; in 2022, output per hour worked was 11 percent lower than the OECD average. In its productivity report, the Bank of Israel notes: "In particular, Israel's negative gap in labor productivity began to widen in the early 1990s, narrowed slightly in 2005–2011, and leveled off afterwards."[74] In 2018–2021, the gap began to close,[75] that is, to converge, but it was only slightly smaller in 2021 than in 2000. Pursuant to this durable gap, the productivity report maps the main needs of the Israeli economy in order to increase productivity and growth over time. It includes analyses and recommendations in many fields including education, early childhood, transport infrastructure, energy, business environment, and openness to imports. The recommended program is a long-term one that entails years of steady investment. Action to enhance productivity in Israel is already needed irrespective of the current reform of international taxation.

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[74] For elaboration on desired paths of strategy for the government to follow on the basis of its original 2019 productivity report, see Bank of Israel (2019, 2021, 2023a).

[75] Bank of Israel (2023b), Chapter 5.

It is hard to estimate the likelihood of this scenario, because almost every country already sees increasing productivity in various ways as an explicit policy goal. It is not clear that the international taxation reform will induce any country to invest larger sums in improving its economic fundamentals or change the ways it prefers to boost productivity over time. Just the same, Switzerland's aforementioned planned uses of proceeds of the minimum tax show that at least some countries will try to improve their domestic business environment in order to remain attractive to businesses. Whether this scenario materializes or not, every country, Israel in particular, needs to improve its productivity and its economic fundamentals. If this scenario comes to pass, Israel will find, as the literature on convergence shows, that relative improvement in productivity is a lengthy process that takes years until it has a direct effect on firms' decisions on where to operate. A country that wishes to compete in this field, however, will have to launch such programs promptly in order to make a statement of intentions and send firms a signal about expected improvements in the business environment in the medium and long terms. At the present time, with security uncertain and the deficit high, Israel will find it difficult to promote meaningful new schemes to improve its overall productivity.

7. Policy Recommendations

The Two Pillar Reform presents Israel with challenges as well as opportunities, especially in respect of tax incentives and investments. Policy should support economic growth via effective use of incentives and maximization of tax receipts under the global-tax-reform arrangements. The dynamic between the tax system and investment needs to be examined in order to ensure effective integration of these goals in a way that will move the domestic economy ahead optimally and ensure that it remains competitive relative to the global economy.

1. Adjust Tax Policy

Minimum corporate tax rate: in July 2024, Israel announced the application of a 15 percent minimal corporate tax rate on MNEs starting in the 2026 tax year by means of the QDMTT rule. Examination of whether and when to implement the rest of the GloBE rules (IIR and UTPR) should continue.

Taxation of payments included in the STTR: the potential effects of the STTR need to be examined. In particular, insofar as the statutory adjusted tax rate on the types of payments included in the STTR is below 9 percent (including tax benefits and, in particular, benefits under the LECI), thought should be given to raising this tax rate to 9 percent.

Revising the array of corporate tax benefits: tax benefits currently given to corporations should be reviewed in order to decide which should be retained for their contribution to Israel's investment attractiveness and which may be abolished due to the reform or converted into other benefits in order to maintain competitiveness and retain investment (see Section 2 above). Israel's high deficit underscores the importance of abolishing tax benefits that will no longer be relevant for the encouragement of investment in Israel.

2. Staying Competitive and Retaining Investments

Adjust incentives to the reform: by developing incentives such as refundable tax credits, regulatory dispensations, and tax benefits not applied directly to corporations, Israel may equip itself with tools to attract new investments and retain existing ones, particularly in fields such as high-tech and innovation, if it is decided that this is needed. It is important to focus these incentives on firms that give the economy special utility (such as those with positive externalities) or are of high value to the economy and have the ability to leave the country.

Improve fundamentals: investment in high-quality human resources, advanced infrastructures, and technological innovation will help to preserve Israel's attractiveness as an international business center and promote long-term economic resilience and growth. The Bank of Israel has elaborated on this in recent works, including its strategy report and productivity report.[76]

[76] Bank of Israel (2019, 2021, 2023a).

3. International Cooperation

Information exchange: By maintaining continued close working relations with the OECD and preserving and expanding cooperative arrangements with other countries' tax authorities, Israel will ensure transparency and attain deeper understanding of the effects of the international taxation reform on the global tax system, contributing to policy decisions on the topic. This cooperation is particularly important with the United States.

Bilateral agreements: signing bilateral agreements for information exchange with additional countries will help to improve transparency and enforcement.

4. Monitoring and Adjustment

Monitor the effects of the reform: By setting up a mechanism to track the effects of the international taxation reform, Israel will be able to adjust its policy rapidly commensurate with changes in the global market and avoid harm to tax revenues and competitiveness.

Examine loopholes: possible loopholes in the interface between the Israeli corporate-tax system and the arrangements of the international taxation reform should be reviewed and closed in order to prevent exploitation of the taxation system and ensure its efficiency.

5. Future Scenarios

Low competition: if competition for business activity and/or investment wanes, the focus should be placed on improving economic fundamentals such as education and infrastructure in order to maintain Israel's attractiveness.

High competition: if competition for activity continues or accelerates, Israel should examine the types of investments or MNEs that it needs to attract and review the costs and benefits of incentives for relevant fields, maintaining a balance between incentives and state tax revenues in order to ensure Israel's continued attractiveness.

The proposed policy will help Israel adjust to global changes in international taxation and preserve its economic status. By applying these measures, Israel may ensure its continued economic growth and its status as an international business center.

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Appendix 1: Pillar One—Detailed Example

Example of Taxable Activity under Pillar 1

A large entity multinational called Agas is registered in the United States and has no permanent establishment in Israel. People in Israel visit the company's site, pay on the site to view a film, and download the film to their personal computer in Israel. They pay by using international credit cards issued by banks in Israel. At the present writing (preceding the reform), Agas has no significant taxation nexus with Israel; therefore, it will not necessarily have to report to Israel, or pay corporate tax in Israel, on the profits gained from this activity. Under the international tax reform, it is established that wherever a firm has more than EUR 1 million in annual sales in Israel, said sales shall be partly taxable in Israel under Amount A of Pillar One. This is because taxation will be based on market-destination principles instead of a traditional physical nexus, assuming that the other terms of Pillar One are satisfied.

Numerical example for illustration purposes

a. In Year X, multinational enterprise Agas has a global turnover of USD 25 billion and USD 4 billion in profits. The turnover is divided among three countries—A (USD 5 billion), B (USD 15 billion) and C (USD 5 billion). Agas has no permanent establishment in Countries B and C and has not paid corporate tax there thus far. The corporate-tax rates in the respective countries are 15 percent, 22 percent, and 18 percent. Agas paid USD 600 million (4 * 15%) in Country A.

b. Agas' rate of profit is 4/25 = 16% (by simple calculation of profits as a share of income).

c. The excess profit rate is 6% (16%–10%).

d. The excess profit is USD 1.5 billion (USD 25 billion*6%).

e. 25% of these excess profits shall be apportioned among Countries A, B, and C and taxed in each country under the arrangements of Amount A.

f. The taxable profits (Amount A) are USD 375 million (USD 1.5 billion*25%).

g. The Amount A to be allocated to each country shall be calculated under different criteria including its share in turnover. Under the given data, Country A will tax 20 percent of the amount, Country B 60 percent, and Country C 20 percent. This sum may be offset in each country commensurate with the MNE’s level of sales and marketing expenses in said country. In countries where the MNE incurs relatively high expenses, the offset rate will be 35 percent; in those where it sustains relatively low expenses it will be 90 percent.[77]

1. Commensurate with its share in turnover, Country A should be entitled to tax USD 75 million. Assuming that 35 percent of the MNE’s excess profits in the country is offset (1.5*35% = USD 525 million), it receives an allocation of zero because the income exclusion is larger than the Amount A allotted to Country A.
2. Country B receives an allocation of USD 225 million.
3. Country C receives an allocation of USD 75 million.

h. The transfer of Amount A among countries (based, *inter alia*, on the exclusion method of the credit method, in accordance with the rules to be established under the country’s internal laws):

1. Country B will tax USD 225 million at the rate of 22%—USD 49.5 million.
2. Country C will tax USD 75 million at the rate of 18%—USD 13.5 million.
3. Country A will waive the right to tax USD 300 million at the rate of 15%—USD 45 million.

i. The MNE will pay total additional tax in the sum of 49.5+13.5-45=USD 18 million.

[77] “Relatively low expenses” obtain when the ratio of the MNE’s depreciation and payroll in the country to its profits in the country is less than 75 percent of the corresponding ratio in the MNE at large. “Relatively high expenses” denotes a situation where its ratio in the country exceeds 75 percent of its ratio at large. See OECD (2023e), Article 5—Allocation of Profit Associated with Revenues in Market.

Appendix 2: Pillar Two—Definitions, Further Details, and Detailed Example Mechanism 1—GloBE

The GloBE mechanism is intended to operate vis-à-vis large MNEs worldwide. Consequently, it was decided to use the International Financial Reporting Standards (IFRS) as the basis for calculations and adjustments instead of the domestic definitions that each individual country uses to calculate corporate-tax liability. To carry out these calculations, the Two Pillar Reform defines several key concepts in detail:

- *Adjusted Covered Taxes* – taxes paid on income or profits, including on distributed profits, carried profit, equity, and other adjustments. Also includes taxes that replace income tax such as taxes on interest payments or insurance premiums. It includes, for example, taxes paid under Pillar One. This clause should include only taxes that the MNE has actually paid, excluding most tax benefits. Therefore, ordinary tax credits, *inter alia*, are not included in these covered taxes. Indirect taxes and property taxes are not covered taxes.

- *GloBE Income*—net profit/loss under the IFRS rules plus tax expenditures and certain other expenditures, less certain incomes. In practice, GloBE income attempts to track pre-tax profits consistently and uniformly among countries by using accepted accounting rules.

- *Effective Tax Rate* (ETR)—adjusted covered taxes divided by GloBE income.

- *Substance-based Income Exclusion (SBIE)*—after calculating the MNE's effective tax rate, subtract from adjusted profits 5% of employer's payroll cost in the country and 5% of book value (cost price less depreciation) of the MNE's tangible assets in the country. This tax exclusion is given in order to allow a low and constant return on domestic physical activity even when this pushes the MNE's effective tax rate below the minimum rate established by the reform. This is because physical capital and labor are less portable than intangible assets, meaning that the risk of BEPS (recording profits in any venue other than that where the activity that created them took place) in these expenses is small. Conceptually, the goal is to focus the tax reform on excess profits from high-BEPS-risk intangible assets. The rate of the SBIE will decline gradually from 8 percent of assets and 10 percent of payroll at the start of Pillar Two implementation to 5 percent of assets and payroll within ten years of first implementation.[78]

- *Excess profits*—adjusted profits less the SBIE.

- *Ultimate Parent Entity (UPE)*—a corporate entity that is part of an MNE, has control or ownership of another entity in the MNE, and is not controlled by any other company in the MNE.

[78] OECD (2022b).

- *Qualified Domestic Minimum Top-Up Tax (QDMTT)*—a domestic top-up tax such that the taxed MNE will pay at least the top-up tax that the GloBE calculation mandates. This tax should be consistent with the GloBE rules, lead to results consistent with the GloBE requirements, and comply with the GloBE definitions, including calculation of the relevant excess profit and top-up tax. The tax may bring in larger proceeds than those established under the GloBE rules but must not collect less than what is required. Similarly, the domestic tax may provide a tax shelter for domestic activity that is smaller than the SBIE rate but must not provide a larger shelter. Tax credits for, or refunds of, this tax must not be given.[79]
- *Top-up tax*—the additional tax that an MNE will have to pay in order to bring the effective tax rate on its profits to 15 percent.

The following process is used to determine top-up tax liability:

1. Identify an MNE that has EUR 750 million in global income in at least two of the past four years and has corporate entities (including subsidiaries, owned companies, and permanent establishments) in the country.
2. Calculate the adjusted profit (loss) under the GloBE rules for each corporate entity in the country.
3. Calculate the adjusted covered tax according to the GloBE rules for each corporate entity in the country.
4. Calculate the MNE's effective tax rate (ETR) in the country by dividing the sum of the adjusted covered tax of the company's entities in the country by the sum of the adjusted income of the company's entities in the country. If the effective tax rate in the country is smaller than 15 percent, a top-up tax liability may exist.
5. Calculate excess profits in the country by subtracting SBIE from adjusted profits. If excess profits are zero or negative, no top-up tax liability exists.
6. Calculate the top-up tax that the MNE owes in the country by multiplying excess profits in the country by the difference between 15 percent and the company's effective tax rate in the country.
7. If the country applies a Qualified Domestic Minimum Top-Up Tax (QDMTT), it collects the top-up tax from the MNE and subtracts it from the top-up tax under GloBE.
8. If the country has no QDMTT or a top-up tax liability remains after the QDMTT is invoked, the MNE's remaining top-up tax liability is divided among the countries by applying the IRR and UTPR rules.
9. The country collects the top-up tax.

[79] OECD (2023a), pp. 98–108.

Apart from setting a low statutory corporate-tax rate, one of the common ways countries provide firms with tax benefits is by tax credits. A tax credit is a benefit that a country awards in a specific sum that the company can offset from its corporate-tax liability in the country. Countries provide tax credits for different kinds of expenses in order to incentivize companies to incur these expenses, such as tax credits for R&D. These credits, however, may also encourage companies to record profits in the country while paying little tax and without changing the statutory corporate-tax rate. "Ordinary" tax credits allow companies to offset only their tax liability. In contrast, refundable tax credits—tax credits that become grants—allow the company to receive the rest of the credit as a payment from the state in cases where the credit exceeds the company's tax liability.

Since one of the major problems that the international tax reform is meant to solve is tax competition by means of corporate-tax benefits that lower companies' effective taxation, ordinary tax credits are not included in those covered by the reform. However, the reform does allow, under certain restrictions, the recording of refundable tax credits as income.

Qualified refundable tax credit—the reform does not prevent countries from giving firms grants. One of the most common ways of doing this is by giving tax credits that become grants insofar as the credit exceeds the company's tax liability. The reform defines a tax credit that is refundable within four years or less as "qualified" and establishes that qualified tax credits shall be recorded as adjusted profits.[80] If the company uses some of the qualified tax credit to reduce its tax payments, it must restore that portion to the sum of its covered taxes (and, in turn, its adjusted profits).[81] The resulting increase in covered tax raises the company's effective tax rate and, therefore, reduces the likelihood of its having to pay a top-up tax. It also increases the company's adjusted profits, meaning that it will have to pay a top-up tax on these tax credits. It is explained in the reform that cases in which a refundable tax credit is designed such that in practice it always remains a credit clash with the essence of the reform. Accordingly, when the possibility of making a credit refundable is irrelevant and/or impractical, the GloBE rules will treat the credit as nonrefundable. The object of relevance is the general structure of the tax credit and not its implementation in a given case. For example, a tax credit that is given solely to highly profitable firms and will never exceed such a firm's tax liability, thus never becoming a grant, will be considered a non-qualified tax credit. In contrast, a tax credit that is available to all firms but, practically

80 Ibid., p. 64, Article 3.2.4.
81 Ibid., p. 88, Article 4.1.2.

speaking, is used only profitable ones will remain qualified. If the structure of the credit is such that a grant may be received on only part of the credit sum within four years, only that part will be recorded as a qualified tax credit.[82]

Non-qualified refundable tax credit—a tax credit that becomes a grant only after more than four years or is considered non-qualified for other reasons specified in the definition of the qualified tax credit in the reform. The ordinary accounting rules allow a non-qualified tax credit to be recorded as income but, for the purposes of GloBE, such tax credits must be considered not as income but solely as a method that the state uses to reduce the company's tax payment. Therefore, if a company records such a tax credit as income, for GloBE purposes it should subtract the credit from its covered tax (and also, in turn, from its adjusted profits).[83] Pursuant to this correction, the company's ETR falls and its risk of top-up taxation rises.

Numerical example that demonstrates the GloBE mechanism

a. Eshkolit, Ltd., is a MNE whose Ultimate Parent Entity is registered in Country A. Eshkolit has USD 2 billion in global turnover. It has a subsidiary named Clementine in Country B. Clementine has a headcount of 500 and a payroll of USD 50 million, USD 500 million in tangible assets (book value), and USD 40 million in pre-tax profits. The corporate-tax rate in Country B is 20 percent and Clementine has received a USD 4 million tax credit. A simplistic calculation of the outcome follows.
b. Clementine's gross tax liability is 40*20% =USD 8 million.
c. Its net tax payment is 4-20%*40 -4 =USD 4 million.
d. Its post-tax profits are 40-4=USD 36 million.
e. Its covered taxes are 20%*40-4=USD 4 million.
f. Its adjusted profits are net profits + covered taxes = 4+36=40.
g. Its effective tax rate (ETR) is 4/40=10%. This is less than 15%; therefore, the company may be liable to top-up tax under the arrangements of the reform.
h. Its Substance-based Income Exclusion (SBIE) is 500*5% +50*5%=USD 27.5 million.
i. Its excess profits are adjusted profits less SBIE=40–27.5= USD 12.5 million.
j. Its top-up tax liability is 15%–10=5%*12.5=USD 0.625 million.

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82 Ibid., p. 215, "Qualified Refundable Tax Credit."
83 Ibid., p. 89, Article 4.1.3(b).

k. If Country B has a 15 percent QDMTT, it will collect USD 0.625 million. Otherwise, the right to collect this top-up tax will be determined in accordance with the IIR arrangements.

l. If Country A is a signatory to the reform, its will charge Eshkolit the top-up tax of USD 0.625 million.

m. If Country A is not a signatory to the reform, the right to charge Eshkolit the top-up tax will be transferred under the IIR arrangements to the signatory country in which the company is resident that is closest to the top of Eshkolit's ownership chain.

n. If there is no entity at the top of Eshkolit's ownership chain in a country that signed the agreement, or if there is such an entity but the effective tax rate in these countries is below 15% (and there is no QDMTT), such that the top-up tax cannot be collected under the IIR arrangements, the right to the top-up taxation shall be reassigned to another country under the arrangements of the UTPR.

o. The following is an example of activation of the UTPR:

   1. Eshkolit has two additional subsidiaries in countries that are signatories to the reform—Tamar and Anav. Tamar has a headcount of 1,500 and USD 2 billion in tangible assets. Anav has a headcount of 2,500 and USD 2.5 billion in tangible assets.
   2. The total headcount of the multinational group in countries signed to the agreement is 1,500+2,500+500=4,500.
   3. The total book value of the group's tangible assets in the signatory countries is 0.5+2+2.5=USD 5 billion.
   4. The top-up tax liability, USD 0.625 million, is apportioned among the entities in the group as follows:
   5. Tamar is charged 1500/4500*50% + 2/5*50% = 37% * 0.625 = USD 0.23 million.
   6. Anav is charged 2500/4500*50% + 2.5/5*50% = 53% * 0.625 = USD 0.33 million.
   7. Clementine is charged 500/4500*50% + 0.5/5*50% = 10% * 0.625 = USD 0.11 million.

Appendix 3: USA Minimum Corporate Tax – The Inflation Reduction Act of 2022

The Inflation Reduction Act of 2022 became law at the beginning of August 2022. In one of its chapters, a minimum corporate-tax rate is set.

The purpose of the Act is to impose a Corporate Alternative Minimum Tax that will top up a company's corporate-tax liability to 15% of its adjusted financial statement income (AFSI). The tax will apply to firms that have an average AFSI of USD 1 billion or more in the past three years and that do not have a foreign parent entity.

The incidence of the minimum tax on entities that are part of a foreign MNE is contingent upon two cumulative conditions. The first is that the MNE's total AFSI exceeded USD 1 billion on average in the past three years; the second is that the domestic company's AFSI exceeded USD 100 million on average in the past three years.

The AFSI is the profit reported in the company's annual financial statements plus the following adjustments that reflect and promote the American statutory arrangements and tax rules:

1. Addition of dividends from non-consolidated companies.
2. If the entity has Controlled Foreign Corporations (CFCs), these corporations' undistributed profits are added commensurate with the American company's share of ownership in the foreign corporation. If this adjustment is negative, the AFSI is not reduced that year; instead, the negative adjustment on this line is recorded against positive adjustments on this line in coming years.
3. Addition of total net operating loss carryforward. This adjustment may reduce the AFSI by (total net operating loss carryforward) or (80% of AFSI before subtraction of past losses), whichever is smaller.
4. Adjustment of recording of profits to the USA taxable year (for foreign corporations).

The law awards a tax credit for this top-up tax on account of payment of corporate tax abroad (i.e., a corporate AMT foreign tax credit for the taxable year). The credit for an American firm controlled by a foreign one is (15 percent of Line 2 above) and (the share of USA company ownership of the foreign company multiplied by the tax that the foreign company paid abroad), whichever is lower. The credit awarded to a USA company that paid corporate tax abroad is the sum of the tax that it paid abroad. (This credit is more beneficial for the USA company's direct payments than for a CFC's payments.)

The minimum tax payment qualifies companies for a tax credit where said companies may use it only to offset future corporate-tax payments that exceed the minimum tax rate. This means that a company that pays corporate tax at a rate that varies over time may use CMAT tax payments to reduce its tax liability in subsequent year, but only by that portion of the future tax liability that exceeds 15 percent in effective terms.

“Ordinary” tax credits may be used to offset up to 75 percent of this top-up tax. This offsetting option reflects one of the main differences between the American legislation and the global minimum taxation set up by the Pillar Two arrangements, because “ordinary” tax credits cannot be included in calculating the adjusted effective tax rate under Pillar Two. The American statute, in contrast, does not allow a substance-based income exclusion (see above) as Pillar Two does; therefore, it affords no consideration of low but constant return on employers’ payroll cost and the book value of tangible assets. Due to these differences, one may be liable to top-up tax under Pillar Two but not under the American legislation, and vice versa. This mismatch may create major difficulties in weighting the effective tax rate that a company pays under the USA statute as against the level of top-up tax that it must pay under the OECD-led reform.

Another major difference is that the minimum tax under the USA arrangement applies only to entities that have more than USD 1 billion in profits, as against Pillar Two, which applies to MNEs that exceed EUR 750 million in turnover. This difference greatly reduces the number of MNEs that are affected by the American legislation and makes it clear that the legislation is aimed mainly at highly profitable firms in the USA, whether or not they are multinational or BEPS-oriented.