

**POLICY BRIEF No. 1/2024**  
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## **Responses to Substance-Based Income Exclusion (SBIE)**

By Asia Voices Working Group convened by IPS

### **RECOMMENDATIONS**

This policy brief outlines the potential implications of the substance-based income exclusion (SBIE) element in Pillar Two Global Anti-Base Erosion (GloBE) rules.

While acknowledging the need for carve-outs to accommodate the diversity in the global economy, there are risks and unintended effects that can arise from consequential decision-making based on the way SBIE has been designed. The adverse outcomes of accommodations to adjust to the limitations of the SBIE may result in lose-lose scenarios for jurisdictions and the in-scope multinational enterprises (MNEs) that operate those jurisdictions.

The following are two main approaches that can be taken to mitigate the effects and continue to promote economic growth:

- I A long-term approach includes continuing to influence the design of global taxation policies through ensuring coherent and aligned perspectives are articulated from Asia;
- II A more targeted approach is to leverage carefully designed Qualified Refundable Tax Credits (QRTCs) to mitigate the unintended effects of SBIE as it is currently defined, and to promote growth in targeted sectors of the economy. Some suggested elements of such QRTCs are specified in this policy brief.

A holistic view must be taken in designing policies in response to the GloBE rules. This means the consideration of longer-term impacts, with the purpose of encouraging growth in the domestic and regional spheres, instead of eyeing Pillar Two as opportunities to gain revenue.

## CONTEXT & ANALYSIS

### Substance-based income exclusion (SBIE) in Pillar Two

The Pillar Two GloBE Model Rules comes with a SBIE rule (Article 5.3.2), which identifies a certain percentage of the carrying value of tangible assets and payroll as defined as being excludable from the GloBE tax base.

In other words, the SBIE amount for a jurisdiction is the sum of a pre-defined return on the payroll carve-out and the tangible asset carve-out for each constituent entity (OECD, 2021).

<p>Substance-Based Income Exclusion (SBIE) = 10% of + 8% tangible assets<sup>1</sup></p>
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<p>Net GloBE Income – SBIE = Excess Profit</p>
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Following the definitions laid out above, greater SBIE amounts equate to lower excess profit and hence lower top-up tax liability. The intuition and aim of SBIE is therefore to carve out a routine for companies on the basis that such returns do not represent excess of profits and are not the subject of base erosion and profits shifting (BEPS) activities. The SBIE formulae focus on payroll and tangible assets as these are considered less mobile factors of production and therefore are less amenable to tax avoidance and profit shifting to low-tax locations through the transfer of mobile factors.

### Design limitations of SBIE

The provision of the carve-outs like the SBIE is necessary to ensure that Pillar Two GloBE does not inadvertently impose a top-up tax up to 15% on legitimate returns on the activities of in-scope firms that are not related to profit-shifting.

Nonetheless, the assumptions underlying SBIE can also be problematic and lead to other unintended consequences.

For example, narrowly defining substance-based activities as only those that are tied to tangible assets and employee compensation might not be appropriate in today's knowledge economy, where the intangibles might be driving most of the substance and value creation.

What SBIE might encourage therefore, is investments in tangible assets that might not generate value as much as intangible ones. This would be a distortion to the flow of economic resources, resulting in less-than-optimal resource allocation in the longer run, and pose a drag on the world economy.

The simplicity in the SBIE's assumptions does not cater to the different social and economic circumstances of different jurisdictions, and its effects are especially salient in the context of small knowledge-based and high-talent centric economies. Take Singapore as an example, an open economy that is geographically small, Singapore is naturally constrained in terms of investments in tangible assets and having large numbers of workers. Consequently, in-scope companies based in Singapore would have significantly less income excluded by SBIE compared to other countries where there are significant tangible assets such as mines for extraction and large plants. The current formula also assumes a low (5%, leaving aside the transitional provisions) or routine return on these factors, which may not always be reflective of value-add (e.g., a dollar on a research and development engineer's salary will not yield an identical

<sup>1</sup> These carve-out percentages will be progressively reduced during a 10-year transition period to 5%.

return to a dollar spent on wages of someone performing a routine function).

In Briefing Note 2 of Asia Voices: Perspectives on Tax Policy (Gee & Woo, 2022), it was also explained how non-tangible qualities such as political stability and skilled workforce have been vital in drawing MNEs to Singapore and in establishing itself as an investment hub. The currently (narrowly) defined SBIE regime therefore fails to recognise these intangible qualities in a holistic economic and regional ecosystem that do generate significant value for knowledge-based economies and the MNEs that base themselves in these jurisdictions in order to leverage on these intangible qualities. This could lead to risks of diminishing economic growth and the development for small open knowledge-based economies such as Singapore, which has negative impacts for the region.

### OPTIONS

Having laid out the potential implications that could arise with SBIE, two approaches could be considered.

#### Coherent regional response and feedback

The first and longer-term approach is to continually provide feedback and articulate the impacts of these rules.

While the formative phase of deliberation and consultation on SBIE has passed, there is still the need to continually make clear the coherent and unified perspective reflecting the impacts and unique circumstances of different economies and their role in the region as the GloBE rules roll out in the coming years.

In the presentations at the Asia Voices Seminar 2023 (Gee & Yap, 2023), there

were discussions on how revenue collectable by different jurisdictions differed in scenarios with and without SBIE. The value of such research and discussion lies in having the comparison of how different jurisdictions across regions are differently impacted by the same rules. However, as discussed in the seminar, there also remains many limitations to research in these areas mainly due to lack of data in developing countries like those in Asia.

Even with sufficient analyses and understanding of the play-out and impacts of these tax policies, the bigger hurdle is to align responses with jurisdictions in the region and avoid either complications from inconsistent cross-border rules or uncoordinated policies that result in a net loss overall for everyone. To be able to coherently and articulate with suasion the perspectives of the region (especially where they differ from assumptions made by international bodies) known on global platforms would be another important effort that has to be made.

#### Leveraging tools like QRTC

The second more targeted suggestion is to adjust the policy design of the Qualified Refundable Tax Credit (QRTC) so as to offset possible unintended impacts of SBIE, and drive growth in the economy, particularly to correct negative externalities from market misallocations of resources (e.g., under investment in sustainability efforts).

## SPECIFIC RECOMMENDATIONS

### Principled use of QRTC with measurable impacts

A Qualified Refundable Tax Credit (QRTC) is a “refundable tax credit designed in a way such that it must be paid as cash or available as cash equivalents within four years from when a constituent entity satisfies the conditions for receiving the credit under the laws of the jurisdiction granting the credit” (OECD, 2021).

Other than the definition stated above, the model rules and commentary have not dictated the conditions of QRTCs. It therefore lies upon jurisdictions in the Inclusive Framework to agree and then for individual jurisdictions to design QRTCs in ways that can overcome those unintended impacts of SBIE and positively promote growth.

The recommendation is therefore to design QRTCs that offer relief to modern factors of production that truly deliver substance and value. For QRTCs to be effective in mitigating the possible distortions caused by reactionary responses towards SBIE, they must be designed with principles that drive long-term growth in knowledge-based economies such as and the Asian region.

### Fundamental principles of taxation

To begin, one should be reminded to return to the basic principles of tax policy in designing QRTC. This is especially important in the already complex and uncertain GloBE context.

The principles of certainty, simplicity and fairness, for example, ought to be central to the QRTCs. What this means is that there should be clear (and if possible,

early) identification and communication about the type of industries or activities that are encouraged and hence be offered QRTCs.

The next sub-section offers suggestions of the principles that should guide the considerations of what these industries and activities might be.

### Driving sustainable growth in Singapore

First, it should also be clear that QRTCs should not be deployed as a tool to counteract the effect of GloBE top-up taxes (for in-scope MNEs) but to encourage the sustainable pro-growth economy and deliver benefits not only to in-scope firms but also those not in scope.

One way of thinking about a sustainable pro-growth economy is looking at the industries or activities that could deliver solutions to long-term.

A clear example is that of climate change. The five-fold increase in carbon tax in 2024 is aimed at changing behaviours towards minimising emission of carbon. On a positive end, QRTCs can be the “carrots” used to encourage more research and development towards green transition and clean energy resources.

Significant innovations or activities that offer solutions to major problems posed by Singapore’s ageing population and manpower issues should also be rewarded. Therefore, instead of taking the unsustainable and possibly socially detrimental practices of hiring more workers or increasing wages for the sake of getting more out of SBIE, QRTCs can mitigate the top-up taxes for activities that uplift the whole ecosystem of targeted sectors.

Other principles that should ground the design of QRTCs are fiscal prudence and public accountability. It is worth repeating here that tax incentives should not be given out merely to retain businesses. Where activities are recognised as being of value, there should be processes of evaluation to ensure that the said value are clearly measured on an ongoing basis. This is not only to be accountable to the public where incentives are given, but for corporations, there could also be more assurances in ensuring that these QRTCs meet the agreed-upon global standards. To take this point further, QRTCs can be given for activities aimed at building capacity in targeted industries or sectors.

To drive sustainable growth on a broader basis, there can be overall investment in the ecosystem complementing the targeted QRTCs. An Ecosystem Development Fund, for example, can be set up with any revenues raised from the GloBE rules.

Such a fund can be used to implement “soft support measures” that strengthen the overall ecosystem (and thus it is clear that the additional tax revenues raised are not routed back to the in-scope companies). This might include fostering industry skills development via the establishment of skills institutes or setting up platforms and conferences for professionals and people from the same industry to interact and network.

“Indirect support measures” to improve business environment can also be considered. For example, resources might be channelled into creating common facilities or services that benefit the entire industry rather than individual companies. How this might be done is through funding research that benefit the impacted industries and also carry out promotional

activities that profile the Singapore companies and their products abroad.

To conclude, it is intentional that the suggestions in this policy brief have not been specifically targeted at answering the needs of specific corporations. Asia is a diverse region with countries in different stages of economic development. The overarching point is that responses and policies to the GloBE rules should be considered with long-term interests of each nation, bearing in mind their unique social and economic circumstances. This means seizing the opportunities to use taxation as a tool to overcome challenges and drive solutions within the contours of the new international taxation landscape under Pillar Two. Ultimately, these targeted policy measures should build up the tangible and intangible advantages of countries including Singapore so as to maintain their growth trajectory in the long run.

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*The Asia Voices: Perspectives on Tax Policy Working Group is formed by the Institute of Policy Studies to contribute meaningful, policy relevant research on important cross-border and regional tax issues as they relate to Asia and especially the developing countries in the region.*

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