



**UNIVERSITY OF BELGRADE
FACULTY OF ECONOMICS
AND BUSINESS**



MASTER THESIS

**THE FATE OF TAX INCENTIVES IN THE ENVIRONMENT
OF OECD'S PILLAR 2**

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ABSTRACT

This thesis discusses the fate of tax incentives upon the application of the BEPS project, Pillar two. It presents a review of existing tax incentives in the world and in part in Serbia upon the implementation of Pillar two and possible alternative plans for tax incentives which would help in future tax planning and structuring. The thesis is using a theoretical method and certain empirical findings which place conclusions on how tax incentives are planned by governments and possible changes in the future upon placement of Pillar two rules and also predicts alternative options for governments. With this method, we have a general idea in what way are countries likely to move in terms of tax policies for their tax incentives and Pillar two. Through this analysis, we get to understand how tax incentives are used in attracting foreign investments in order for governments to collect taxes and abide by the Pillar two rules. Results are based on defined and researched policies of countries and may depend on future politics which are not connected to tax policies, but this thesis does give an idea on what course should governments move in terms of changes of tax policies.

Key words: tax incentives, Pillar two, international taxation, Serbia;

APSTRAKT

Ova teza razmatra sudbinu poreskih podsticaja nakon primene projekta BEPS, drugog stuba. Predstavlja pregled postojećih poreskih podsticaja u svetu, a delom i u Srbiji, nakon implementacije drugog stuba, kao i moguće alternativne planove za poreske podsticaje koji bi pomogli u budućem poreskom planiranju i strukturiranju. Teza koristi teorijsku metodu i određene empirijske nalaze koji donose zaključke o tome kako vlade planiraju poreske podsticaje i moguće promene u budućnosti nakon uvođenja pravila drugog stuba, a takođe predviđa alternativne opcije za vlade. Ovom metodom imamo opštu predstavu o tome na koji način će se zemlje verovatno kretati u pogledu poreskih politika za svoje poreske podsticaje i drugi stub. Kroz ovu analizu, razumemo kako se poreski podsticaji koriste za privlačenje stranih investicija kako bi vlade naplaćivale poreze i poštovala pravila drugog stuba. Rezultati se zasnivaju na definisanim i istraženim politikama zemalja i mogu zavistiti od budućih politika koje nisu povezane sa poreskim politikama, ali ova teza daje predstavu o tome u kom pravcu bi vlade trebalo da se kreću u pogledu promena poreskih politika.

Ključne reči: poreski podsticaji, drugi stub, međunarodno oporezivanjem, Srbija.

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1. INTRODUCTION

The aims of this thesis are to look through existing tax incentives and with recent admittance of Pillar two as part of a BEPS 2.0 project, also predict possible new ways of tax planning through placement of new policies and retiring old ones. Pillar two is a project which introduces a global minimum tax of 15% on all multi-national entities (MNEs) with an annual revenue of €750 million. Intentionally, this project is meant to limit MNEs who with tax structuring want to pay less than 15% of tax and with that evade payment of tax. This evasion is often done with the appliance of tax incentives, because countries who offer them grant those incentives in return for the investments. As a consequence, existing tax incentives now need adapting to the new legislation.

This paper intends to answer how governments are supposed to change their legislation and also how affected enterprises have to modify their investments in terms of tax planning so they achieve the most benefits, but also comply with new rules.

The importance of this thesis lies in understanding of tax incentives and tax planning in the future in accordance with new policies placed by the Organisation for Economic Co-operation and Development (OECD). New policies along with other non-tax policies are changing the way companies, in this case, MNEs function. Large companies hold great influence not only within their industries, but also influence political decisions and policies. For them, tax planning is an integral part of corporate functioning. In this thesis, we acknowledge that MNEs have a great influence on the country's economics. More often than not, they influence more than economical aspects on one country. They also wield great political influence. For the purpose of this thesis, we will not dwell too much on their political influence. Predicting the amount or greatness of their influence would make this thesis less reliable and in general is of less importance to this thesis.

To add on why tax planning is crucial, a lot of industries rely on successful operation of these MNEs as much for their own stability, but also for employment of people and further economic development. Consequently, successful tax structure brings more benefits to both investors and governments because it lowers the possibility of tax fraud.

Only recently did developments including the actual adoption of policies of Pillar two into national legislation raise questions about the effect on tax incentives. These changes made it difficult to reach conclusions on the way tax incentives will evolve and affect tax revenues. One of the purposes of this thesis is to examine these uncertainties and reach a conclusion which covers both of these questions.

Before the implementation of Pillar two, countries were faced with a problem which is more known as a "race-to-the-bottom" between countries which want to offer the least amount of tax rates and favorable terms of taxation to their countries as a way of attracting investment. These countries are more known as tax havens and would otherwise be less attractive for new investors to put businesses to these places.

The second problem is with the way countries offer tax incentives. While companies still needed to fulfill certain conditions, countries, for the sake of the investment, allowed a lot to companies. To mention, in a similar manner as through low tax rates attract foreign investment, also do so through favorable tax incentives. In comparison, countries place more control onto foreign companies cause of the need to fulfill needed requirements and remain within required policies to get wanted tax incentives. Both of these issues come together with the introduction of Pillar two and raise questions as to how we can solve these issues.

Contribution of this thesis is to see what were existing tax incentives in the world and also in Serbia, what influence their policies had. Along with the majority of countries that have accepted Pillar two and have implemented it into their national laws, the end result is to reach a conclusion on the future of tax incentives and alternative options.

This paper aims to address the impact of tax incentives while looking at Pillar two rules.

Therefore, the structure of this thesis is to explain what tax incentives are. As it goes for any legislation, the definition and purpose of tax incentives is enormously important. With the understanding of what tax incentives are, we can begin to understand their appeal for investors. We will also be defining tax incentives in Serbia.

In continuation of this section, we explain what is the use of tax incentives. For this part, understanding what tax incentives attract what type of investor and industries, we get a

through insight into the impact of tax incentives. Governments through tax incentives give us a comprehension of what industries are welcome and wanted.

To dive further, we aim to explain what are different types of tax incentives. Within the category of tax incentives and centered industries to which tax incentives are catered to, there are a few ways to which governments are able to offer them. Tax incentives themselves can be divided into tax holidays, tax exemptions, tax deductions, tax credits, cash grants etc. They serve the same purpose, but the requirements to which they are given to and how they are used are vastly different. For a bit, we will be discussing what types of tax incentives Serbia has.

The second part of this thesis is meant to explain what Pillar two is. We are looking at the definition of Pillar two and requirements a company is fulfilling.

This part of the thesis seeks to examine the effect of tax incentives with the implementation of Pillar two around the world and in Serbia. In this section, we are incorporating previous analysis of what are tax incentives and what is Pillar two.

Because this concept of Pillar two is completely new, we will be exploring new types of tax incentives. In the third section, the main object of this thesis is focused on alternative options of tax incentives. With any change of legislation, new alternatives are possible and even more, preferable. We are analysing the possibility of subsidies and tax credits specifically as new forms of tax incentives. The nature of those two tax incentives is what is most likely the future of tax incentives.

2. DEFINITION OF TAX INCENTIVES

Defining tax incentives may seem an easy feat, but it is no wonder that we still don't have a conclusive definition of tax incentives. No consensus exists on how tax incentives should be defined. Typically, tax incentives are described as targeted tax provisions that yield a tax treatment that deviates from the standard tax treatment in a country with the objective of encouraging a certain behaviour. Tax incentives may take different forms, but share several common features:

- (i) they are targeted, i.e. available only to a specific group of taxpayers, for example, based on their specific activity, sector, location or any other investor - or project-specific characteristics;
- (ii) they result in reduced or postponed tax liability for the taxpayer and consequently forgone tax revenue for the government, everything being equal; and
- (iii) they aim to incentivise a certain behaviour.¹

As it is mentioned in the first paragraph, they are targeted. This implies that many tax incentives have a purpose they are trying to achieve with their implementation. Purpose is found in the type of incentives countries are trying to introduce into their legal systems.

There are many ways that authors have tried to define tax incentives and some definitions would define them as fiscal measures used by governments to attract investment domestically and internationally in certain key sectors of the economy.²

Another one defines tax incentives in statutory and effective terms. A statutory tax incentive is a special tax provision granted to qualifying investment projects and this provision would not be applied to other investment projects outside the selected qualifying categories. An

¹ Celani, A., L. Dressler and M. Wermelinger (2022), "Building an Investment Tax Incentives database: Methodology and initial findings for 36 developing countries", *OECD Working Papers on International Investment*, No. 2022/01, OECD Publishing, Paris, <https://doi.org/10.1787/62e075a9-en>, pg. 14.

² Munongo, S., Akanbi, O.A., & Robinson, Z. (2017). Do tax incentives matter for investment? A literature review. *Business and Economic Horizons*, 13, 152-168., as cited in Bolnick, B. (2004). *Effectiveness and economic impact of tax incentives in the SADC Region*. Gaborone: SADC Tax Subcommittee, SADC Trade, Industry, Finance and Investment Directorate.

effective tax incentive is a special tax provision granted to qualifying investment projects with the goal of reducing the effective tax burden.³

To provide further thoughts to the definitions of tax incentives, it is said that measures that provide for a more favorable tax treatment of certain activities or sectors compared to what is granted to the general industry.⁴ There are also international organizations that have also defined tax incentives as any special tax provisions granted to qualified investment projects or firms that provide favorable deviation from the general tax code.⁵

That is to say that targeted tax provisions that constitute a deviation from the standard tax treatment in a country resulting in reduced or postponed tax liability with the objective of promoting investment.⁶ Overall, what is a standard in one country may not be in the other country and so the lowered tax liability may vary depending on the country. As mentioned, some places are viewed as tax havens (often viewed as developing countries) and that is because they have more beneficial taxation rules compared to some other places (more often in developed countries).

To further prove the point of targeted tax incentives, one author points out that policy makers employ both tax and non-tax incentives to lure investment across their borders. He also concludes that the economy's investment climate is critical to the effectiveness of tax incentives. One author defines tax incentives as those tax reduction treatments offered to foreign investments and not to domestic investments with the view to attracting foreign direct investment (FDI).⁷

³ Munongo, S., Akanbi, O.A., & Robinson, Z. (2017). Do tax incentives matter for investment? A literature review. *Business and Economic Horizons*, 13, 152-168., as cited in Zee, H., Stosky, J., & Ley, E. (2002). Tax incentives for business investment: A primer for policy makers in developing countries. *World Development*, 30, 1497-1516.

⁴ Valderrama, I.J. (2021). Tax Incentives: From an Investment, Tax, and Sustainable Development Perspective. *Handbook of International Investment Law and Policy*. (as cited in Klemm A (2010) Causes, benefits and risks of tax incentives. *Int Tax Public Finance* 17(3):315–336)

⁵ Valderrama, I.J. (2021). Tax Incentives: From an Investment, Tax, and Sustainable Development Perspective. *Handbook of International Investment Law and Policy* (as cited in IMF, OECD, UN et al (2015) Options for low-income countries' effective and efficient use of tax incentives for investment: a report to the G-20 development working group by the IMF, OECD, UN and World Bank, p 8. Available at <https://doi.org/10.1596/22923>. Accessed 6 Nov 2019)

⁶ Celani, A., L. Dressler and M. Wermelinger (2022), "Building an Investment Tax Incentives database: Methodology and initial findings for 36 developing countries", *OECD Working Papers on International Investment*, No. 2022/01, OECD Publishing, Paris, <https://doi.org/10.1787/62e075a9-en>.

⁷ Munongo, S., Akanbi, O.A., & Robinson, Z. (2017). Do tax incentives matter for investment? A literature review. *Business and Economic Horizons*, 13, 152-168. As cited in James, S. (2010). *Incentives and*

To analyse the last two definitions, countries give special treatment in comparison to their standard tax provisions as a way of incentivising companies to invest in their countries. The problem with that is, every single country has its own tax system and with that, its own tax rates that they are implementing. To put into perspective, country A taxes all business at a 10% CIT rate, while country B taxes manufacturing activities at a 20% CIT rate, but other activities at a standard 25% rate. While country A taxes manufacturing activities at a lower level in absolute terms (the 10% standard rate in country A is lower than the 20% preferential rate in country B), only the tax treatment of manufacturing in country B is considered a tax incentive in the context of this work.⁸

This example represents the difference between these countries, because only when the country offers preferential treatment at a lower tax rate only for certain activities, then it can be said that that country offers tax incentives. Even though that is to be perceived as a tax incentive, we would like to point out that companies, in order to use the tax incentive, have to fulfil requirements. It will be mentioned further in the thesis, but companies need to invest and show seriousness in investing in that country.

To explain further in practical terms, for example, in Serbian law, in article 41 of Law on corporate income tax, tax incentives are defined as, in order to achieve the goals of economic policy in terms of stimulating economic growth, taxpayers are provided with tax incentives.⁹

That is to say, when performing a review of tax incentives used in Western Balkan countries, that is, in Slovenia, Croatia, Serbia, Montenegro, Macedonia and Albania, the survey-based study concluded that like other transitional economies, the Western Balkan countries use tax incentives in under developed regions to attract investment and to develop the regions.¹⁰

investments: Evidence and policy implications. World Bank, Washington, DC: Investment Climate Advisory Services of the World Bank Group.

⁸ Celani, A., L. Dressler and M. Wermelinger (2022), "Building an Investment Tax Incentives database: Methodology and initial findings for 36 developing countries", OECD Working Papers on International Investment, No. 2022/01, OECD Publishing, Paris, <https://doi.org/10.1787/62e075a9-en>, pg. 15.

⁹ The law on corporate income tax (2024)

¹⁰ Munongo, S., Akanbi, O.A., & Robinson, Z. (2017). Do tax incentives matter for investment? A literature review. *Business and Economic Horizons*, 13, 152-168., pg. 164, As cited in Šimović, H., & Žaja, M. (2010).

We can see that the definition of tax incentives depends on the economic development of the country. If one is considered a developing country, then it is going to offer more tax incentives to appear more economically attractive and investor friendly. This may seem as a form of tax planning and tactic from countries themselves.

Similarly, but not quite the same, are preferential regimes which aim to attract investment to certain sectors of the economy or certain geographic areas or to make the country attractive as a business hub for other countries within the region.¹¹

Consequently, there may be policies that resemble tax incentives, share similar ideas and that is the attractiveness from foreign companies and their investment. The understanding of tax incentives will be explained further in the thesis, where we cover the use and types of tax incentives.

2.1. The use of tax incentives

As we have explained, tax incentives are used as an instrument in order to promote economic growth as a way to improve investment competitiveness.

Furthermore, differences do exist depending on the purpose they are trying to fulfill. Tax competition in the corporate income tax (CIT) area comes in many forms, including low general tax rates, tax incentives, favourable tax ruling schemes, etc. Therefore, the widespread use of tax incentives in domestic corporate tax laws - directly affecting the Effective tax rate (ETR) - is only one of the tools of competition. With competition also comes concerns considering sunstaining State's sovereignty.

The connection between ETR and tax incentives is that ETR represents the actual percentage of tax levied on a company's profits. ETR can be higher or lower than the statutory (nominal) corporate income tax (CIT) rate due to various adjustments to accounting profits prescribed by the CIT Law in order to arrive at taxable profits (depreciation, impairment, non-deductible expenses etc). ETR is also an indicator of how

Tax incentives in Western Balkan countries. World Academy of Science, Engineering and Technology International, *Journal of Social, Business, Psychological, Human Science and Engineering*, 4(6),103-108.

¹¹ Valderrama, I.J. (2021). Tax Incentives: From an Investment, Tax, and Sustainable Development Perspective. Handbook of International Investment Law and Policy.

well the company manages its CIT cost.¹²

To calculate ETR, we are dividing total tax expense with pre-tax expense. Total tax expense represents the amount of taxes paid, while pre-tax expense represents the amount before applied tax rate. As we have mentioned, the result presents a percentage of taxes paid on profits.

That is to say that it is very important how companies use different instruments to lower taxable profits and avoid paying the statutory CIT rate. ETR will be an important part in calculating the minimum tax rate, but more on that later.

As it was explained, in simple terms, since every country chooses its own tax structure and makes relevant tax rules as a matter of the exercise of its sovereignty, any effort to curtail tax competition entails inter-state coordination, enshrined in an agreed legal instrument. This may be either a 'hard-law' instrument e.g. an international treaty or a 'soft-law' instrument, such as recommendations adopted by the OECD.¹³

Although in this thesis, we are focusing on effects tax incentives have between countries, it is somewhat important to mention that tax competition doesn't solely depend on tax incentives, but also on other tax concepts such as, nexus, double taxation, withholding tax etc.

Tax incentives are used in order to reduce the cost of investment from foreign investors. By reducing costs, it attracts FDI. That is why, the private sector plays an essential role in innovation processes. It does not capture all the positive externalities created by this activity; the private sector would produce substantially less innovation than economic efficiencies. As a result, government policy plays a critical role in fostering innovation, including contributing inputs to the innovation process and improving innovators' incentives.¹⁴ Depending on the economical status of a country and its development there

¹² PricewaterhouseCoopers. (n.d.). Optimizing effective tax rate. PwC. <https://www.pwc.rs/en/services/tax/optimizing-effective-tax-rate.html>

¹³ Stjepan Gadžo, Šime Jozipovic (2020), International Corporate Tax Regime Post-BEPS: A Regulatory Perspective, 48, Intertax, Issue 4, pp. 432-445, <https://kluwerlawonline.com/journalarticle/Intertax/48.4/TAXI2020038>

¹⁴ Balsalobre-lorente, D., Zeraibi, A., Shehzad, K., & Cantos-Cantos, J.M. (2021). Taxes, R&D Expenditures, and Open Innovation: Analyzing OECD Countries. Journal of Open Innovation: Technology, Market, and Complexity, <https://www.sciencedirect.com/science/article/pii/S2199853122008058>

are noticeable differences. With that, we have differences for which developed and developing countries use tax incentives.

As one paper suggests, developed countries aim to introduce tax incentives to promote export, research, and economic activities and to improve the overall position of domestic firms on the global market. Examples are compensation of losses and tax incentives for research and development (including Intellectual Property Regimes). That is why tax incentives for innovation should be even larger than they are already and also that those for larger economies are more important for global welfare.¹⁵

Developing countries aim to introduce tax incentives to improve the development of certain regions (underdeveloped regions or rural areas) or specific sectors (natural resources (oil, mineral resources), plantation (agriculture, land grabbing to guarantee food security), manufacturing, financial sector (banks and financial institutions), intellectual property (information technology and biotechnology), tourism (hotel services, air and water transportation of tourist)).¹⁶ To put it plainly, such incentives may give these countries access to technology and know-how, and the opportunity to provide employment for local residents.¹⁷

Even with the above mentioned, for location-specific rents, tax incentives might play a modest role since foreign firms have no choice but to operate in that particular location to earn them. If prospective rents are more of the firm-specific type, on the other hand, the local government may find it beneficial to provide tax incentives to attract foreign investors.¹⁸ Even though differently implemented incentives want to achieve different effects and no matter the state of the country, want to improve the state of it, we need to see what are dominant incentives in tax systems. The dominance in tax incentives can be described as the amount of influence the tax incentives have on the tax systems. As the

¹⁵ Hall, B.H. (2019). Tax Policy for Innovation. Political Economy: Fiscal Policies & Behavior of Economic Agents eJournal, <https://ssrn.com/abstract=3375834>

¹⁶ Stjepan Gadžo, Šime Jozipovic (2020), International Corporate Tax Regime Post-BEPS: A Regulatory Perspective, 48, Intertax, Issue 4, pp. 432-445, <https://kluwerlawonline.com/journalarticle/Intertax/48.4/TAXI2020038>

¹⁷ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

¹⁸ Jun, J. & UN.ESCAP (2017). Tax incentives and tax base protection in developing countries. Retrieved from: <https://hdl.handle.net/20.500.12870/1209>

latest OECD brochure from 2022 with its database presents, over one-third of all incentives are aligned with sustainable development goals. Almost half of the studied economies (48%) offer incentives that strive to enhance the environmental impact of investments.¹⁹ Furthermore, 40% of the economies use tax incentives to support employment. In addition, incentives are being employed to promote social inclusion and economic development in other areas related to sustainable development.²⁰ Considering the data and the preferences of countries in adopting specific incentives, we can see that developed countries are the ones that focus on environmental and sustainable policies. On the other hand, developing countries are more focused on solving their employment and industrial problems. Developing countries mostly fall behind on environmental policies.

As we can see, even though we can intuitively say that they are solely for the improvement of economies and social standing for countries themselves, it appears as if it is more about how countries present themselves to other countries and the improvement within the countries is a consequence of good actions from investors. A more prominent topic on the worldwide stage is sustainability and environmental policies. A new way of holding MNEs accountable for their giant influence on different economies is through environmental, social and governance (ESG) principles. This is a battle against climate change. To be more conclusive, tax incentives governments can provide tax benefits that promote a “green” and sustainable economy. This could include, for instance, incentives for transitioning to renewable energy sources, fostering more sustainable supply chains, encouraging the purchase of energy-efficient materials or offering benefits for employees who choose eco-friendly commuting options.²¹

¹⁹ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. (as cited In OECD, OECD Investment Tax Incentives Database – 2022 Update: Tax incentives for sustainable development (brochure) (OECD 2022), available at <https://www.oecd.org/investment/investment-policy/oecd-investment-tax-incentives-database-2022-update-brochure.pdf>.)

²⁰ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. (as cited In OECD, OECD Investment Tax Incentives Database – 2022 Update: Tax incentives for sustainable development (brochure) (OECD 2022), available at <https://www.oecd.org/investment/investment-policy/oecd-investment-tax-incentives-database-2022-update-brochure.pdf>.)

²¹ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD., pg. 3.

Tax incentives allow national businesses and MNEs to substantially reduce the level of their effective taxation, even in countries where statutory tax rates are high. However, due to the scale of the activity, it is reasonable to state that MNEs seem to be the greatest beneficiaries of tax incentives. By structuring business with a proper tax strategy, they can benefit from multiple tax advantages in different jurisdictions at the same time.²²

To summarize, the use of tax incentives equally depends on the offered incentives and on investors whose business ideas align with the offered tax incentives.

2.2. The types of tax incentives

As mentioned in the previous part of the thesis, tax incentives are different depending on the goal they are trying to achieve and for what purpose are investors even using those incentives. For the tax incentive to work, it needs to be tailored to the purpose it is trying to achieve. Tailoring of a tax incentive largely is made of conditions one needs to fulfil in order to be able to use the incentive. Conditions vary and can be focused on what part of the taxation is incentive applied, for how long the incentive is to be used for, the amount of investment needed (could be in money and/or machines), in some cases, how many people need to be employed, etc. Because of those differences, categorisation of tax incentives helps us greatly in further understanding of them and their use.

As we have seen in the section of the Definition of tax incentives, there is no official division of tax incentives, but it became apparent that some were focused on incentivizing tax reliefs on income and some on expenses. That is why, starting from corporate tax incentives (direct taxation), we can classify tax incentives into two broad categories: income-based and expenditure-based.²³

The first category covers full or partial exemptions and reduced tax rates (e.g. tax holidays or income derived under patent box regimes). While these incentives can be found in developed economies their use seems to be more widespread in developing countries and

²² Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD., pg. 4.

²³ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

emerging economies²⁴ due to their relatively easy administration and, while being non-refundable, they do not require any cash expenses from the government.²⁵ Income-based tax incentives reduce the tax rate paid on the income earned from an investment. They are closely associated with the profitability of a company and, as such, they are mainly targeted at prosperous businesses.²⁶ Because they invest a lot of money, the profit itself is high which can be of help to those businesses as it lowers the amount of tax payable.

On the other hand, expenditure-based incentives, includes tax credits (refundable and non-refundable) and tax deductions such as immediate expensing or accelerated depreciation/amortization or tax allowances linked to tangible or intangible assets. Its characteristic is that they are linked directly to the value of the investment made, regardless of its return.²⁷ They appear more common in developed countries which have stronger fiscal capacity and more available funds at their disposal, which play an important role in the case of refundable tax credits.²⁸ With that, accelerated depreciation and immediate expensing have been proven to be successful in boosting investment in developed countries.²⁹

2.2.1. Income-based incentives: Full tax exemption

In essence, income-based tax incentives are the ones which focus on giving relief on realised income. Through incentives, the amount of tax the company will need to pay is less than it's supposed to be.

²⁴ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. As cited in *Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules* p. 15 (OECD 2022).

²⁵ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

²⁶ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

²⁷ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. Ac cited in G. Perez-Navarro, *What Does Pillar Two's Global Minimum Tax Mean for Tax Incentives?*, 51 *Intertax* 2, p. 102 (2023).

²⁸ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. Ac cited in OECD, *Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules n. 9, at p. 15.*(OECD 2022).

²⁹ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. Ac cited in G. Maffini, J. Xing & M.P. Devereux, *The Impact of Investment Incentives: Evidence from UK Corporation Tax Returns*, 11 *American Economic Journal: Economic Policy* 3, pp. 361-389 (2019).

With full tax exemption, companies are completely exempt from paying income tax depending on a type of income for a certain amount of time.

That is because a company is fully exempted from paying any tax on income. Applying the formula we have seen used for the calculation of ETR, the numerator in this case would make the total tax expense a 0. Consequently, ETR is also 0%.

This outcome can raise different reactions which can range from how well a company is doing to how they have aggressive tax planning which can put investors in danger.

The message it sends to investors and other interested parties is that the company has used aggressive tax planning methods, which can imply non-compliance or faulty government which lets tax manipulations. A recent OECD Working Paper indicates that over the past two decades, there has been a significant increase in the use of IP related income-based incentives.³⁰ According to the OECD, R&D income based tax incentives can significantly reduce the taxes on successful R&D investments.³¹ However, their impact on the cost of capital (the return required to make an investment worthwhile) and the B-Index (a measure of the tax burden on investment) is much lower than for expenditure-based R&D tax incentives, which directly reduce the initial cost of the investment rather than reducing income taxes.³²

2.2.2. Expenditure-based incentives: Tax allowances

Tax allowances are a type of expenditure-based tax incentive which can often be found in developed and developing economies. Tax allowances essentially act as tax deductions, to the extent that they exceed the expenditure to which they relate.³³

³⁰ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. (as cited in A.C. Gonzalez Cabral et al., *Effective tax rates for R&D intangible*, OECD Taxation Working Papers No. 63, p.9 (OECD 2023), available at <https://dx.doi.org/10.1787/191dad43-en>.)

³¹ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

³² Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD (as cited in A.C. Gonzalez Cabral et al., *Effective tax rates for R&D intangible*, OECD Taxation Working Papers No. 63, p.9 (OECD 2023), available at <https://dx.doi.org/10.1787/191dad43-en>. at pp. 7 and 46.)

³³ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

For the purpose of calculation of ETR, tax allowance reduces taxable income, which by using the formula lowers ETR and with that, the tax payable.

The main difference between tax allowance and accelerated depreciation or immediate expensing is that the former allows for the deduction of more than 100% of the incurred cost of an asset acquisition/expenditure, while the latter assumes a faster write-off of the value of the asset which, by definition, does not allow the deduction of more than 100% of the acquisition cost.³⁴ By the rules of tax accounting, a company is allowed to write off only the in the amount of cost of the asset. On the contrary, governments are allowing companies a higher amount of depreciation of the asset than its worth.

A similar conclusion can be drawn for other incentives such as, for example, the Notional Interest Deduction (NID). This incentive is typically designed to encourage equity financing.³⁵ It allows companies to deduct a notional (or hypothetical) amount of interest on their equity for tax purposes, similar to the tax deductions available on interest paid on debt, thereby reducing taxable income, while the financial accounting income remains unaffected.³⁶ As a result, the companies are more willing to use their equity other than debt. The practical reason is that interest on debt is tax-deductible, while interest on equity is not. For example, this tax incentive balances the use of equity and debt.

2.2.3. Expenditure-based incentives: Immediate expensing and accelerated depreciation

In the case of accelerated depreciation, the asset is depreciated for tax law purposes faster than ordinary accounting rules, resulting in lower tax payments in the earlier years because the taxes are deferred to the future. Immediate expensing operates similarly but allows for a one-time deduction of the asset's value from the taxable income base. For financial and tax accounting, these differences reverse over the time.

³⁴ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. (as cited in A.C. Gonzalez Cabral et al., *Effective tax rates for R&D intangible*, OECD Taxation Working Papers No. 63, p.9 (OECD 2023), available at <https://dx.doi.org/10.1787/191dad43-en>.) at p. 40.

³⁵ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. (as cited in U. Romaniuk & K. Malik, *Notional Interest Deduction– Impact on the Cost of Equity in Investment Projects*, XXIV European Research Studies Journal Volume 4, pp. 333-341 (2021).

³⁶ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

Analysing from the ETR perspective, accelerated depreciation doesn't have a dramatic fall and rise when calculating ETR, whereas immediate expensing from a one-time deduction can almost bring ETR to a 0 and from then on ETR is higher than the statutory tax rate.

Similar logic is applied for immediate expensing of tangible assets.

2.2.4. Expenditure-based incentives: Tax credits

A different type of relief on the payment of tax is a tax credit. Tax credit is the amount which lowers the tax liability. It lowers the end amount of tax one has to pay. That is to say, tax credit is applied only at the end of the tax calculation. To explain further, it is different from a tax deduction which reduces taxable income.

Within the category of tax credits, we can differentiate non-refundable tax credit, refundable tax credits and partially refundable tax credits.

Non-refundable tax credits are a type of tax credit which if the amount of received tax credit is higher than the tax owed, is 0. That means the excess of received credit is only used for paying of tax owed.

With refundable tax credit, the excess amount of received credit can be used as a refund. It means the excess amount of money received is not lost, but instead, relocated.

Partially refundable tax credits are similar to refundable tax credits, but the refundability is limited.

2.3. Tax incentives in Serbia

Throughout this section, we aim to discover what tax incentives Serbia has, how they are presented and what purpose they are trying to fulfill.

Most tax incentives established in the Republic of Serbia are placed in Law on Corporate Income tax. For the purpose of this thesis, we will be analyzing only tax incentives presented in the Law on Corporate Income tax because these incentives are the ones targeted by Pillar two and will be used for further conclusions.

Starting from article 22g, expenses directly related to research and development carried out by the taxpayer in the Republic can be recognized as expenditure in the taxpayer's tax balance, in a doubled amount.³⁷

In terms of paragraph 1 of this article, research is considered to be original or planned research undertaken with the aim of acquiring new scientific or technical knowledge and understanding, and the development of the application of research results or the application of another scientific achievement or production design of new significantly improved materials, devices, products, processes, systems or services before entering commercial production or use.

The provisions of this article do not apply to research costs incurred for the purpose of finding and developing oil, gas or mineral resources in the extractive industry.

The Minister of Finance regulates in more detail what are considered to be expenses that are directly related to research and development, as well as the conditions and method of exercising the rights referred to in paragraph 1 of this article.

Analysing this article, we could come to the conclusion that this article is meant to pull in investors whose business activity is anything in innovation. This is meant for investors as a way to open businesses and research centers and to go through all the trials of the product before it goes into mass production. The article may insinuate that this is exclusively applied on technological companies, but according to the opinion of the Minister of Finance, that can be applied to anything that is inovative and new. That would be food, design, technology and anything else.

The benefit that investors can derive from applying this article is whatever expenditure the companies have, when they are filling in the tax return, they can recognise the double of that amount. The effect this has is lowering the taxable amount, which in return makes companies pay less tax. To explain further, we will use article 6 of the Law on the Corporate Income tax and say that the basis of corporate income tax is taxable profit.

³⁷ Law on Corporate Income tax ("Official Gazette of RS", no. 25/2001, 80/2002, 80/2002 - other laws, 43/2003, 84/2004, 18/2010, 101/2011, 119/2012, 47/2013, 108/2013, 68/2014 - Dr. Law, 142/2014, 91/2015 - authentic interpretation, 112/2015, 113/2017, 95/2018, 86/2019, 153/2020, 118/2021 and 94/2024)

Furthermore, taxable profit is determined in the tax balance sheet by harmonizing the taxpayer's profit shown in the income statement, which is prepared in accordance with international accounting standards (hereinafter: IAS), i.e. international financial reporting standards (hereinafter: IFRS), i.e. the international standard of financial reporting for small and medium-sized legal entities (hereinafter: IFRS for SMEs) and regulations governing accounting, in the manner established by this law.

In article 7, for the determination of taxable profit, expenses are recognized in the amounts determined by the profit and loss account, in accordance with IAS, that is, IFRS and IFRS for SMEs, as well as regulations governing accounting, except for expenses for which this law prescribes another method of determination.

When companies have calculated income and expenses, they come to the amount of taxable income which they will apply on the tax return. In general, the rule to paying less tax is to have less generated income and more generated expenses as the taxable amount would be at its lowest. That has its pros and cons, but what Serbia and many other countries offer with this incentive is not to have to intentionally mark up the expenses, but just for tax purposes double up their expenses as that way, the companies will pay less tax without affecting the actual business activities.

This tax incentive would be considered an expenditure-based tax incentive, specifically tax deduction. It is using expenses as a way of paying less tax.

Next tax incentive we will be talking about is more known as the IP box. As per article 25b of Law on Corporate income tax, Qualified income, which is achieved by the obligee, holder of copyright or related right, based on the fee for using the deposited author's work or subject of related right, except for the fee for the transfer of the copyright or related right as a whole, may, if the obligee decides to do so and in accordance with the conditions and in the manner provided by this article, exempted from the tax base in the amount of 80% of the income thus achieved.³⁸

³⁸ Law on Corporate Income tax ("Official Gazette of RS", no. 25/2001, 80/2002, 80/2002 - other laws, 43/2003, 84/2004, 18/2010, 101/2011, 119/2012, 47/2013, 108/2013, 68/2014 - Dr. Law, 142/2014, 91/2015 - authentic interpretation, 112/2015, 113/2017, 95/2018, 86/2019, 153/2020, 118/2021 and 94/2024)

Qualified income from paragraph 1 of this article is excluded from the tax base less the amount of total historical or current tax-recognized expenses in connection with research and development activities that resulted in the creation of that author's work or subject of related law in accordance with the provisions of art. 7, 7a, 8, 9, 9a, 10, 10a, 10b, 15 and 22g of this law (hereinafter: qualified expenses).

Qualified income in the sense of paragraph 1 of this article, after the deduction from paragraph 2 of this article, will be considered that part of the taxpayer's income based on fees for using the deposited author's work or subject of related rights, except fees for the transfer of copyright or related rights as a whole, which is proportional to the participation of qualified expenditures in connection with research and development activities that resulted in the creation of that deposited author's work and the subject of related rights in the total costs in in connection with that deposited author's work or subject of related right.

In the sense of this law, a deposited work of copyright or subject of related right is considered to be a work of copyright or subject of related right defined by the law regulating copyright and related rights, recorded by depositing in the register of the competent authority.

The provisions of this article shall accordingly be applied to the income generated by the obligor, the holder of rights or the applicant in connection with the invention, on the basis of the assignment of rights in connection with the invention with compensation based on the license agreement, excluding the compensation realized for the transfer of rights in connection with the invention, based on the law governing patents.

The taxpayer is obliged to show the income from paragraph 1 of this article separately in his tax balance, as well as to prepare and submit special documentation at the request of the Tax Administration in the manner and in the form prescribed by the Minister of Finance.

The Minister of Finance, relying on sources related to the good practice of tax incentive measures in the field of intellectual property rights of the Organization for Economic Cooperation and Development, regulates more closely the conditions and method of excluding qualified income from the tax base.

Understanding the purpose of this article is that instead of paying a tax rate of 15% on taxable income, startups would effectively be paying a tax rate of 3%. On surface this is presented as a great way for incentivising firstly the investments from startups to secondly put their research base in Serbia and thirdly to solely do their research and development in Serbia. We would guess that that is a great way for startups to lower their costs when they are most vulnerable, but to also present opportunities in terms of employment.

This tax incentive would be placed in the income-based tax incentive. This way, qualified income is taxed at a lower rate than it would be if tax incentive wasn't used, which makes it a partial tax exemption.

Next tax incentive would be article 30 which defines that capital gain is included in taxable profit in the amount determined in the manner referred to in Art. 27-29. (regarding Capital gains) of this law.

Exceptionally from paragraph 1 of this article, 20% of the capital gain realized by the transfer of property rights as a whole is included in the taxable profit based on:

- 1) copyright or related rights on the deposited author's work, i.e. the subject of related rights,
- 2) rights related to the invention, based on the law governing patents.³⁹

A capital loss realized during the sale of one property right can be offset against the taxable amount of the capital gain realized during the sale of another property right in the same year, with the provision that a maximum of 20% of the capital loss realized by the transfer referred to in paragraph 2 of this article can be set off against the taxable amount of the capital gain realized from the sale of another right from the property in the same year.

Law on Corporate Income tax in the part of 6 of mentioned law specifically says that next articles are tax incentives despite before mentioned articles also being tax incentives by their nature.

Article 30 would be considered an income-based tax incentive and a partial tax exemption.

³⁹ Law on Corporate Income tax ("Official Gazette of RS", no. 25/2001, 80/2002, 80/2002 - other laws, 43/2003, 84/2004, 18/2010, 101/2011, 119/2012, 47/2013, 108/2013, 68/2014 - Dr. Law, 142/2014, 91/2015 - authentic interpretation, 112/2015, 113/2017, 95/2018, 86/2019, 153/2020, 118/2021 and 94/2024)

The beginning of that section starts with the article 44, a non-profit organization is exempted from paying profit tax for the tax period in which the realized excess of income over expenses does not exceed RSD 400,000, provided that:

- 1) does not distribute the realized surplus to its founders, members, directors, employees or persons related to them;
- 2) the annual amount of personal income paid to employees, directors and persons related to them does not exceed twice the amount of the average annual salary per employee in the Republic in the year for which the right to tax exemption is determined, according to the data of the republican authority responsible for statistics;
- 3) does not distribute property in favor of its founders, members, directors, employees or persons connected with them;
- 4) that it does not have a monopoly or dominant position in the market in the sense of the law governing the protection of competition.⁴⁰

This article is interesting as a specific type of organisation is included in this incentive, as mentioned non-profit organisation. One of two presented conditions is that even though non-profit organisations don't generate much excessive profit, government doesn't want to tax them if the difference between expenses and income is up to 400.000,00 RSD. Along with that, this incentive can not work unless the second condition is fulfilled. We can say that the reason for the second condition is rooted in the initial fear when allowing for tax incentives. That would mean less tax transparency allowing corruption to take place. Smartly, if the government doesn't allow for generated profit to be distributed to others who would benefit from it the most. This also keeps afloat non-profit organisations as the realised income is to be used for the next year's activities and plans.

Tax incentives that non-profit organisations would use would be considered an income-based tax incentive and a partial tax exemption.

⁴⁰ Law on Corporate Income tax ("Official Gazette of RS", no. 25/2001, 80/2002, 80/2002 - other laws, 43/2003, 84/2004, 18/2010, 101/2011, 119/2012, 47/2013, 108/2013, 68/2014 - Dr. Law, 142/2014, 91/2015 - authentic interpretation, 112/2015, 113/2017, 95/2018, 86/2019, 153/2020, 118/2021 and 94/2024)

Article 46 says that enterprises for work training, professional rehabilitation and employment of disabled persons are exempted from paying tax on profits of legal entities, in proportion to the participation of those persons in the total number of employees.⁴¹

As it can be seen, this article is here to motivate companies to employ more marginalised groups in a society. This incentive offers full exemption if they are fulfilling other conditions based on proportionate employment.

Tax incentive used to propose more employment for disabled and other marginalised groups would be placed in an income-based tax incentive group and a partial tax exemption.

Serbian corporate income tax law presents a different opportunity for investors. As article 50a mentions, a taxpayer who invests in his fixed assets, i.e. in whose fixed assets another person invests more than one billion dinars, who uses these funds to carry out the main activity and activities listed in the founding deed of the taxpayer, i.e. listed in the other deed of the taxpayer, which determines the activities which the taxpayer performs and during the investment period additionally employs at least 100 persons for an indefinite period, is exempted from paying tax on the profit of legal entities for a period of ten years in proportion to that investment.⁴²

An investment in fixed assets by another person is considered to be both an investment in the fixed capital and an increase in the fixed capital in accordance with the law and are valued at market (fair) value.

The tax exemption is applied from the first year in which the profit was realized.

Newly employed persons are considered to be persons employed by the taxpayer during the investment period, so that at the moment of fulfilling the conditions for using the mentioned tax exemption, the taxpayer has at least 100 additional permanent employees in

⁴¹ Law on Corporate Income tax ("Official Gazette of RS", no. 25/2001, 80/2002, 80/2002 - other laws, 43/2003, 84/2004, 18/2010, 101/2011, 119/2012, 47/2013, 108/2013, 68/2014 - Dr. Law, 142/2014, 91/2015 - authentic interpretation, 112/2015, 113/2017, 95/2018, 86/2019, 153/2020, 118/2021 and 94/2024)

⁴² Law on Corporate Income tax ("Official Gazette of RS", no. 25/2001, 80/2002, 80/2002 - other laws, 43/2003, 84/2004, 18/2010, 101/2011, 119/2012, 47/2013, 108/2013, 68/2014 - Dr. Law, 142/2014, 91/2015 - authentic interpretation, 112/2015, 113/2017, 95/2018, 86/2019, 153/2020, 118/2021 and 94/2024)

relation to the number of permanent employees that had on the last day of the period preceding the period in which he started the investments.

Newly employed persons are not considered to be persons who, starting from the last day of the tax period preceding the investment period, were employed by, directly or indirectly, a related person, as well as persons who are not directly employed by the taxpayer.

As we can see from above mentioned, this presents a big organisational task for companies. Even though the reward is high, as the company essentially doesn't have to pay any tax on corporate income for the next 10 years and even longer (if they after the 10 year period fulfill the same conditions, as there is no limit to how many times a company can use this incentive) is a great incentive to companies to invest and function in Serbia.

To analyse through conditions once more, the investing company has to invest one billion dinars into the fixed assets (which are usually machines and property) and employ 100 new people. There has been an opinion of the Ministry of Finance whether the employees have to be citizens of Serbia or they can be foreign people who for the purpose of the job move to Serbia to work. That has been answered as only the citizens of Serbia are the employees who fulfill the condition of this tax incentive. That doesn't mean that no foreign person can't be considered, but other provisions are in charge of answering that question.

Having these conditions in mind, we need to ask, what if the company starts firing people, or stops investing the fixed assets? Those questions are answered in article 50v and 50g. First one says that if the taxpayer, while using the tax exemption reduces the total number of permanent employees below the total number of permanent employees he had in the tax period in which he met the conditions for the tax exemption, so that the average total number of permanent employees is, determined on the last day of the period for which the tax return is submitted, is less than the total number of permanent employees he had in the tax period in which he met the conditions for tax exemption, loses the right to tax exemption for the entire period of using the tax exemption.

Second one says that If, before the end of the tax exemption period, the taxpayer ceases to operate, stops using or disposes of the assets and does not invest in new fixed assets in the same tax period an amount equal to the market price of the alienated assets, and at

least in the value that ensures that the total investment amount does not fall below the amounts in this law, he loses the right to tax exemption.

In both cases, if the employer no longer continues to fulfill conditions arranged by article 50a of this Law, then the company will have a burden.

The consequences are explained in both article 50v and 50g, and mean the same and that is that the employer is obliged to calculate in the tax return for the tax period in which he reduced the number of employees, as well as to pay the tax that he would have paid if he had not used this incentive, valorized from the date of submission of the tax return for the tax period in which achieved the right to tax exemption, until the date of filing the tax return for the tax period in which he reduced the number of employees, by the consumer price index according to the data of the republican authority responsible for statistics.⁴³

Considering the second part of these articles, the consequences are not easy as the company would have to retroactively account for the unpaid corporate income tax, all up to the first year it was implemented.

This tax incentive is a prime example of an income-based tax incentive which is also a tax holiday.

The last tax incentive Serbia has to offer is in the form of a tax credit. According to Article 50j, A taxpayer who cannot be considered a newly founded business company performing innovative activity, and who makes an investment in the capital of a newly founded business company performing innovative activity, is granted the right to a tax credit in the amount of 30% of the investment made.

The right to a tax credit is granted to a taxpayer who, before the investment, alone or together with all related parties, did not own more than 25% of shares or shares, i.e. votes in the management bodies of a newly established business company that performs innovation activity in whose capital it invests.

⁴³ Law on Corporate Income tax ("Official Gazette of RS", no. 25/2001, 80/2002, 80/2002 - other laws, 43/2003, 84/2004, 18/2010, 101/2011, 119/2012, 47/2013, 108/2013, 68/2014 - Dr. Law, 142/2014, 91/2015 - authentic interpretation, 112/2015, 113/2017, 95/2018, 86/2019, 153/2020, 118/2021 and 94/2024)

This tax incentive presents another way for startups to get investments as the companies who invest into startups along with a share in the company, also get a 30% tax credit on the said investment. On the other hand, a startup gets the money and stable shareholders in the shares of their company.⁴⁴

Other paragraphs within the article 50j, say that investment is realized only on the basis of fully paid financial contributions, which increase the capital of a newly established business company that performs innovative activities.

The monetary investment is recognised as one when the taxpayer has not reduced his investment continuously for a period of three years from the date of investment and he may use the tax credit in the first subsequent tax period following the period in which the condition is met.

The unused part of the tax credit can be transferred to the income tax account from future accounting periods, but not longer than five years.

The invested amount is the most 100.000.000 RSD, or if invested throughout the years, 50.000.000 RSD in one fiscal year.

This tax incentive is expenditure-based incentive and as it was mentioned in the article itself, it is a tax credit.

In conclusion, Serbia's government uses both tax incentives, but we can see that mostly imposed ones are income-based. This way, Serbia is rewarding investors by making it easier for them in terms of paying less tax when deducting tax payable. Additionally, this look-through Serbian tax law aligns with previously mentioned theory that income-based tax incentives are more closely connected to developing countries than they are with developed countries.

⁴⁴ Law on Corporate Income tax ("Official Gazette of RS", no. 25/2001, 80/2002, 80/2002 - other laws, 43/2003, 84/2004, 18/2010, 101/2011, 119/2012, 47/2013, 108/2013, 68/2014 - Dr. Law, 142/2014, 91/2015 - authentic interpretation, 112/2015, 113/2017, 95/2018, 86/2019, 153/2020, 118/2021 and 94/2024)

3. DEFINITION OF PILLAR TWO

3.1. Introduction into Pillar two

As times were changing, especially after major historical events such as World War II, many organisations were established with a goal to reestablish stable relationships between countries and rules.

For tax matters, there was the establishment of the Organisation for European Economic Co-operation (OEEC). After that, the Convention transforming the OEEC into the Organisation for Economic Co-operation and Development (OECD) was signed at the Chateau de la Muette in Paris on 14 December 1960 and entered into force on 30 September 1961.⁴⁵

The purpose of the OECD has been to deliver greater well-being worldwide by advising governments on policies that support resilient, inclusive and sustainable growth. Through evidence-based policy analysis and recommendations, standards and global policy networks, including close collaboration with the G7 and the G20.⁴⁶

For that reason, OECD has proposed an Inclusive Framework on Base Erosion Profit Shifting (BEPS). To be able to do all above-mentioned actions, the 15 Actions in the BEPS package equip governments with the domestic and international instruments to ensure that profits are taxed where economic activity and value creation take place.⁴⁷ Throughout the years, the membership of the Inclusive Framework has grown to over 145 countries and jurisdictions, including 14 observer organisations. The ongoing work of the OECD/G20 Inclusive Framework is led by a 24-country Steering Group.⁴⁸

Up until this point, Pillar One and Pillar Two were established.

⁴⁵ Our history | OECD. (n.d.-a). <https://www.oecd.org/en/about/history.html>

⁴⁶ Our history | OECD. (n.d.-a). <https://www.oecd.org/en/about/history.html>

⁴⁷ Base erosion and profit shifting (BEPS) | OECD. (n.d.-a). <https://www.oecd.org/en/topics/base-erosion-and-profit-shifting-beps.html>

⁴⁸ Base erosion and profit shifting (BEPS) | OECD. (n.d.-a). <https://www.oecd.org/en/topics/base-erosion-and-profit-shifting-beps.html>

Known as BEPS 1.0, Pillar One does not exist by itself, as countries have found a way to deal with the tax avoidance in the digital economy and have established their Digital tax law.

On the other hand, on 20 December 2021, the OECD/G20 Inclusive Framework on BEPS released the Global Anti-Base Erosion (GloBE) Model Rules to ensure the 15 per cent global minimum tax agreed under Pillar Two of BEPS 2.0 is consistently adopted. The GloBE Model Rules are supplemented by a Commentary which provides tax authorities with guidance on the interpretation and implementation of the rules.⁴⁹

Unlike BEPS 1.0, which was predominantly focused on abusive tax structures leading to tax evasion and avoidance, GloBE has a much broader scope and is aimed at reducing tax competition between jurisdictions.

To be able to understand the implications that Pillar two may have on tax incentives, we have to understand what Pillar two is and what are conditions for its application. Only then can we analyze the future it hold in the world of international and domestic taxation.

Pillar two is complex, has a lot of rules and is very possible to misunderstand its purpose. Throughout this thesis, we will be able to understand what Pillar two is and what it represents.

To understand Pillar two, we want to present one broad definition which explains that The Global Anti-Base Erosion (GloBE) Rules provide for a co-ordinated system of taxation intended to ensure large multinational enterprise (MNE) groups pay a minimum level of tax on the income arising in each of the jurisdictions where they operate. It does so by imposing a top-up tax on profits arising in a jurisdiction whenever the effective tax rate, determined on a jurisdictional basis, is below the minimum rate.⁵⁰

To explain further, the questions that arise from this definition are, what is that minimum level of tax paid on income and how is it possible to impose it in every operational jurisdiction. There are also other questions, but the answers lay in the next definition.

⁴⁹ Liotti, B.F., Ndubai, J.W., Wamuyu, R., Lazarov, I., & Owens, J.P. (2022). The Treatment of Tax Incentives under Pillar Two. SSRN Electronic Journal. <https://doi.org/10.2139/ssrn.4132515>

⁵⁰ OECD (2024), Tax Challenges Arising from the Digitalisation of the Economy – Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023): Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/b849f926-en>, pg. 34;

The application of the GloBE Rules to MNE Groups whose annual consolidated revenues in at least two of the four preceding Fiscal Years equal or exceed EUR 750 million.⁵¹

As a way of easier understanding of Pillar two, OECD has presented a structure by which companies should determine a Top-up Tax liability for an MNE. That is to say, when it is time for MNEs to invest and then pay certain amount of tax on income, they have a job of determining what percent of tax they owe to that jurisdiction.

Important to note is that Pillar 2 reflects a “common approach,” meaning that it is not mandatory to implement these rules, but by agreeing countries must accept adoption and application by others and any implementation must be consistent with the agreed rules.⁵²

As a response to the implementation of Pillar two, on 14th of December 2022, an EU Minimum Corporate Income Tax (CIT) Directive has been introduced. It was introduced as a Council Directive (EU) 2022/2523. This Directive is meant to ensure a global minimum level of taxation for MNEs within the European Union. The rules of ensuring a minimum tax paid are the same as we have mentioned above, but the scale of application is what makes it different. At the moment, all 27 EU Member States have to implement this Directive into their national laws. This is a contradiction, or rather a specification of OECD GloBe rules which are giving an option for implementation of Pillar two rules.

The reason for mandatory implementation of rules with the 27 EU Member States is based on the founding idea of EU. Regulating the Single Market and ensuring an equal treatment for all goods, services, capital and people within the states of EU. This Directive stabilises the market and makes new rules.

Up until now, we have introduced a general idea of Pillar two through the framework of OECD GloBe rules, which were more specifically implemented within the EU through the EU Minimum CIT Directive. The question that arises is, what happens to other countries not included in the Directive?

⁵¹ OECD (2024), Tax Challenges Arising from the Digitalisation of the Economy – Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023): Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/b849f926-en>.

⁵² International Corporate tax reform. (2023, February 6). IMF. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>

For example, USA is one of the countries that has a great economic influence around the world considering the large number of companies founded in the USA. They often spread through Europe and with that, they have to comply with tax laws of that country.

For that matter, USA hasn't adopted OECD's Pillar two rules and instead is applying its own set of rules. The way USA has tried adopting rules with the idea of an implementing minimum tax rate is through the Tax Cuts and Jobs Act (TCJA) international tax reforms relied on several principles that were ultimately included in the Pillar 2 reform in BEPS 2. The global intangible low-taxed income (GILTI) provision is a minimum tax on foreign income, but it does not satisfy all the Pillar 2 requirements. Among other differences, the GILTI tax rate is currently 10.5 percent (and set to increase to 13.125 percent in 2026), which is less than Pillar 2's 15 percent global minimum tax rate, and GILTI liability is calculated using "global averaging" rather than on a country-by-country basis. TCJA also implemented the base erosion and anti-abuse tax (BEAT), which limits profit shifting by taxing many payments to foreign affiliates. The current BEAT rate is 10 percent, and it will increase to 12.5 percent in 2026.⁵³

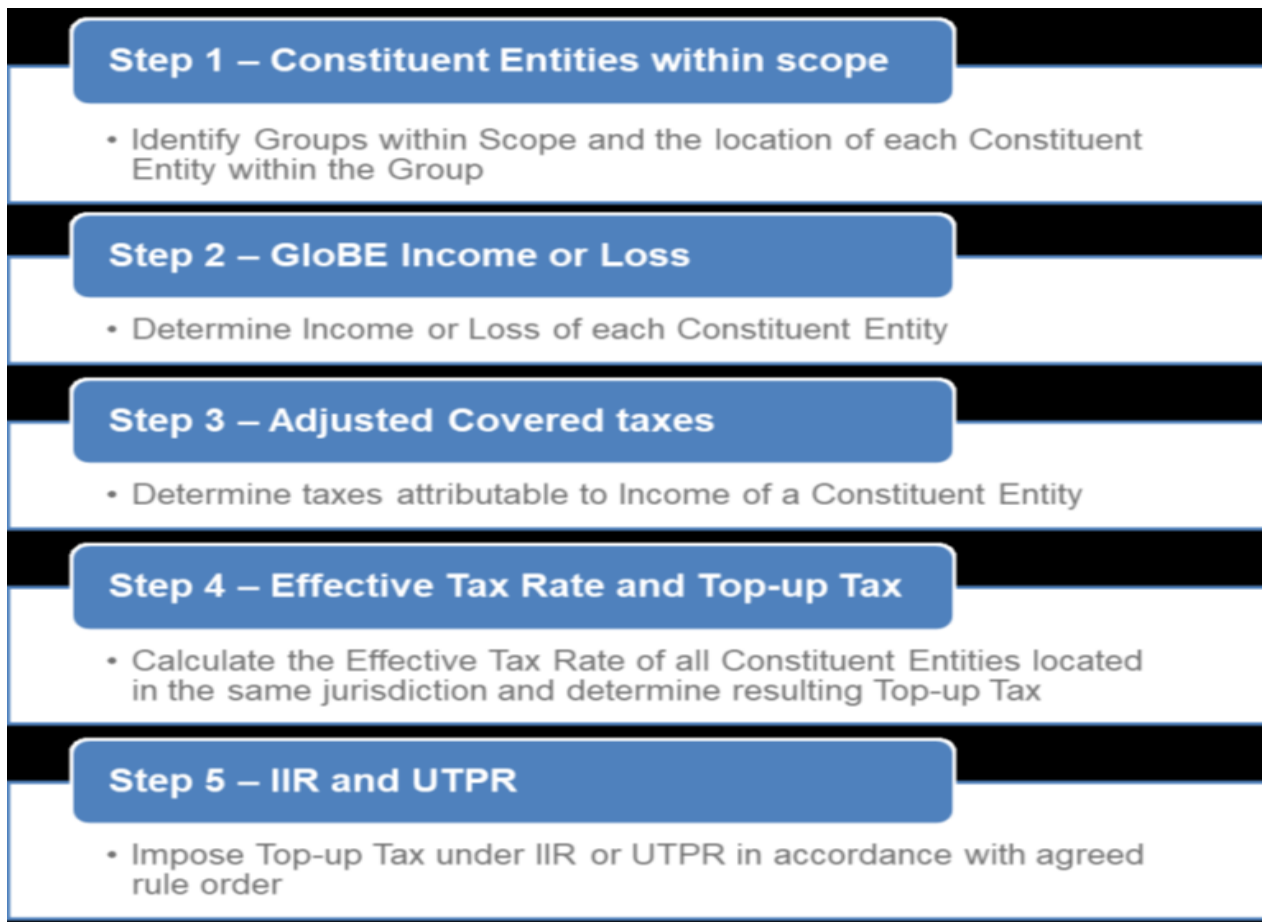
We can see that the ideas are similar and there is a will for establishing a minimum tax rate for companies, but it depends on its implementation. Because of the changes in the political current, the level of compliance with the OECD rules is highly influenced and unstable.

3.2. Requirements for Pillar two

In this part of the chapter, we will explain Pillar two rules and their requirements.

Requirements are necessary for understanding rules of Pillar two, but they will also be our guide to an understanding a definition completely and to help with further analysis. If we refer to picture 1 below, in step 1, it says that we need to identify Groups within the scope and locate each Constituent Entity within the Group. As any tax analysis goes, that would mean that we need to identify a taxable subject.

⁵³ What are the OECD pillar 1 and Pillar 2 international taxation reforms? (n.d.-e). <https://taxpolicycenter.org/briefing-book/what-are-oecd-pillar-1-and-pillar-2-international-taxation-reforms>



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For an entity to be considered an MNE, it needs to have at least one entity, which can, but doesn't have to be, its permanent establishment in one jurisdiction, while in the other jurisdiction has the Ultimate Parent Entity (UPE) which we will explain in following sections. Essentially, affected MNEs are those Groups or Entities with foreign subsidiaries or branches. Groups not included into the definition are the Constituent Entities of a Group will not be subject to the GloBE Rules unless they are members of an MNE Group.⁵⁵

A Group means a collection of Entities that are related through ownership or control such that the assets, liabilities, income, expenses and cash flows of those Entities:

- a) are included in the Consolidated Financial Statements of the UPE; or

⁵⁴ OECD (2024), Tax Challenges Arising from the Digitalisation of the Economy – Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023): Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/b849f926-en>.

⁵⁵ OECD (2024), Tax Challenges Arising from the Digitalisation of the Economy – Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023): Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/b849f926-en>.

- b) are excluded from the Consolidated Financial Statements of the UPE solely on size or materiality grounds, or on the grounds that the Entity is held for sale.⁵⁶

To be able to understand which entity is the one being taxed and on what metrics, we need to break down what types of groups are or are not included in the Pillar two scope.

Ultimate Parent Entity means either:

- a) an Entity that:
 - i. owns directly or indirectly a Controlling Interest in any other Entity; and
 - ii. is not owned, with a Controlling Interest, directly or indirectly by another Entity; or
- b) the Main Entity of a Group.

To clarify, we can think of UPE as the end of the company's chain. If we would follow the line of companies the MNE has, we would have UPE at the end which in some form owns another entity as we mentioned above.

A Constituent Entity is:

- a) any Entity that is included in a Group; and
- b) any Permanent Establishment of a Main Entity.

A Constituent Entity is any company within the MNE, which by itself is subject to taxation. Specifically, it means that its financial statements are included in consolidated financial statements.

An Excluded Entity is an Entity that is:

- a) a Governmental Entity;
- b) an International Organisation;
- c) a Non-profit Organisation;
- d) a Pension Fund;

⁵⁶ OECD (2021), *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/782bac33-en>, pg. 8.

- e) an Investment Fund that is an Ultimate Parent Entity; or
- f) a Real Estate Investment Vehicle that is an Ultimate Parent Entity.⁵⁷

For the purpose of this thesis, any analysis of tax incentives and rules of Pillar two will not apply to an Excluded entities.

Now that we know which entities are taxable subjects, the next step would be to find a taxable base. The GloBE Rules rely on financial accounting to determine the GloBE income or loss, which is used in turn to compute the ETR for each jurisdiction and the Top-up Tax, if any, of each member of the MNE Group. With that, OECD has decided that more consistent outcome among jurisdictions to determine the GloBE tax base if compared to the use of local tax rules.

Furthermore, any reductions to the local tax base by virtue of tax exemptions or non-economic deductions will not affect the GloBE Income because such reductions are not made to financial accounting income. This has important implications for the use of tax incentives. Given that these incentives will not affect financial accounting income but will affect taxes paid, many incentives may reduce the GloBE ETR.⁵⁸

It is important to note that financial accounting is used for calculation of income and expenditure. In the end, tax accounting is the one which determine the amount of taxes company need to pay and not financial accounting.

The GloBE Income or Loss is subject to certain adjustments to better align financial accounts and tax accounting. These adjustments have been kept to a minimum and are made where necessary to reflect common permanent differences, such as to remove most dividends and equity gains so that the minimum tax does not apply to such income, or corrections for prior year errors.⁵⁹

⁵⁷ OECD (2021), *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/782bac33-en>, pg. 9.

⁵⁸ OECD (2022), *Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules*, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>. pg. 25.

⁵⁹ OECD (2021), *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/782bac33-en>.

Third step is to see what taxes are we attributing to Constituent entity. Covered taxes include income taxes, which are defined in a way to provide consistent and flexible recognition across a wide range of tax systems, but does not include non-income-based taxes such as indirect taxes, payroll, and property taxes. Taxes imposed 'in lieu' of a generally applicable CIT (e.g., a tax that substitutes an income tax) are also regarded as Covered Taxes. Taxes imposed in lieu of a generally applicable CIT would also include taxes arising from the „a subject to tax rule” (STTR).

A “subject to tax rule” (STTR) is a treaty-based rule allowing source jurisdictions to impose limited source taxation (for example, withholding taxes (WHTs)) on certain related-party payments subject to tax below a minimum rate of 9 percent.⁶⁰

The GloBE Rules also allocate withholding taxes (except for those imposed on intra-group dividends) and taxes paid under a CFC regime to the entity that earned the underlying income to be considered as Covered Taxes for that entity (subject to some limitations). Along with that, the GloBE Rules provide for a mechanism to address temporary differences, which arise when income or a loss is recognised in a different year for financial accounting and tax purposes. With this objective in mind, the GloBE Rules use deferred tax accounting with certain GloBE specific adjustments to address temporary differences. The GloBE Rules, however, penalize any temporary difference that goes beyond five years to avoid long-term deferrals. This does not apply to certain categories of temporary differences such as those produced by virtue of accelerated depreciation and immediate expensing of tangible assets.⁶¹

Forth step is based on calculations of Covered taxes. Along with some other requirements, this one is surely the most memorable one, because it is groundbreaking as it imposes minimum 15% of ETR for MNEs. As it is, every country has its own tax rate for taxation of CIT and other taxes and along with that diversity, OECD has thought it needed to introduce a global minimum tax for MNEs that fulfill these conditions. To elaborate more, where in-

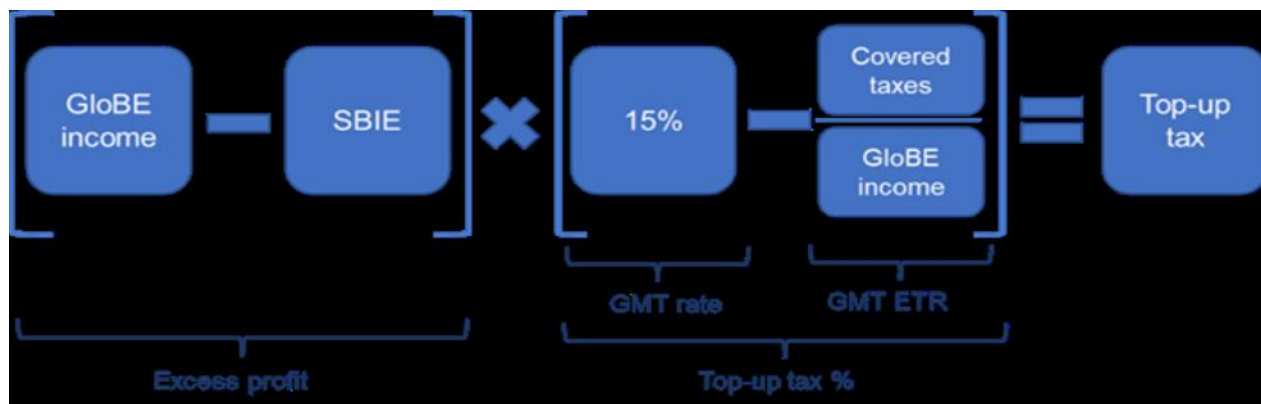
⁶⁰ International Corporate tax reform. (2023, February 6). IMF. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>, pg. 8.

⁶¹ OECD (2021), *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/782bac33-en>.

scope MNE profit in a given jurisdiction is subject to an ETR below the 15% rate, a top-up tax equal to the difference between the 15% rate and the ETR in the jurisdiction is levied.⁶²

To determine whether top-up taxes are due for a given MNE, the first step is to calculate its jurisdictional GloBE ETR. The tax base for the GMT is calculated as GloBE Income in excess of the Substance-Based Income Exclusion (SBIE), which excludes a ‘routine’ return from the GloBE tax base.

The SBIE excludes a share of GloBE Income from the tax base under the GloBE Rules, based on the amount of tangible assets and payroll reported in a jurisdiction. A transitional period of ten years is provided for in the GloBE Rules during which the size of the SBIE gradually declines. At the beginning of the transitional period, i.e., the first year of the introduction of the GMT, the SBIE equals the sum of 8% of the value of tangible assets and 10% of the value of payroll (hereafter, year-one SBIE). These shares decline over the transition period until SBIE is equal to the sum of 5% of the value of tangible assets and 5% of the value of payroll ten years after the introduction of the GMT (hereafter, year-ten SBIE).⁶³ The bottom picture represents a top-up tax calculation at jurisdictional level.



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⁶² Hugger, F., et al. (2024), "The Global Minimum Tax and the taxation of MNE profit", *OECD Taxation Working Papers*, No. 68, OECD Publishing, Paris, <https://doi.org/10.1787/9a815d6b-en>.

⁶³ Hugger, F., et al. (2024), "The Global Minimum Tax and the taxation of MNE profit", *OECD Taxation Working Papers*, No. 68, OECD Publishing, Paris, <https://doi.org/10.1787/9a815d6b-en>.

⁶⁴ Hugger, F., et al. (2024), "The Global Minimum Tax and the taxation of MNE profit", *OECD Taxation Working Papers*, No. 68, OECD Publishing, Paris, <https://doi.org/10.1787/9a815d6b-en>.

The last step would be determination of the Constituent Entity liable for the Top-up Tax.⁶⁵ Because we have calculated top-up taxes for every entity, there is a question of which jurisdiction is going to collect that tax.

The collection of top-up tax has a sort of hierarchical structure. The primary rule is the Income inclusion rule (IIR), which requires the Ultimate Parent Entity (UPE) of the MNE Group to pay the tax. If the UPE is located in a jurisdiction that has not introduced the IIR, then the next Intermediate Parent Entity (IPE) down the ownership chain can apply the IIR. If the UPE is not located in a jurisdiction with an IIR or the Top-up Tax that should have been collected by the UPE is not collected under the IIR by other Parent Entities, then the Undertaxed protifts rule (UTPR) applies.

The UTPR uses an allocation mechanism to distribute the Top-up Tax among jurisdictions where the MNE Group operates. These jurisdictions will then apply the UTPR and collect the Top-up Tax by denying a deduction or requiring a similar adjustment to the CEs located in their jurisdiction.

A Qualified Domestic Minimum Top-up Tax (QDMTT) may allow jurisdictions where a CE is operating to collect such Top-up Tax before it is collected by either the UPE jurisdiction or other jurisdictions.⁶⁶ The addition of the QDMTT effectively alters the rule order of Pillar 2. It moves “source” countries to the head of the queue to collect the top-up tax generated by Pillar 2.⁶⁷

All in all, the chain of collection of Top-up tax depends greatly on what countries accept. If they don't accept QDMTT, there are possibly missing out on Top-up tax.

As we have mentioned in the previous section, EU Minimum CIT Directive is making mandatory rules for EU Member States on the application of Pillar two rules. Such rules are

⁶⁵ OECD (2024), Tax Challenges Arising from the Digitalisation of the Economy – Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023): Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/b849f926-en>.

⁶⁶ OECD (2024), Tax Challenges Arising from the Digitalisation of the Economy – Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023): Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/b849f926-en>.

⁶⁷ Devereux, M.P., Vella, J., & Wardell-Burrows, H. (2022). Pillar 2: Rule Order, Incentives, and Tax Competition. SSRN Electronic Journal, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4009002

the implementation of IIR and UTPR, while QDMTT is up to those member states. Voluntary application of QDMTT doesn't give free reign to countries on how they will apply the top-up tax within that country, but rather it is giving regulations which would consist of meeting the OECD standard and following the rules of the Single Market.

What is allowed is the way it will be administered and the rights to collecting authority.

There is another difference between OECD GloBe rules and an EU Minimum CIT Directive and those would be affected companies. Before, we have mentioned that GloBe rules only affect MNEs. OECD GloBe rules, say that a QDMTT could also apply to purely domestic groups, i.e. groups with no foreign subsidiaries or branches.⁶⁸ That is to say that it is up to countries to decide if they want to apply QDMTT to MNEs as well as large domestic groups.

EU Minimum CIT Directive says that rules should also apply to large-scale purely domestic groups. In that way, the legal framework would be designed to avoid any risk of discrimination between cross-border and domestic situations.⁶⁹

The implementation of Pillar two seems to be answered when we are talking about companies who are in Europe and depending on the implemented rules of Pillar two, that country has a right to a top-up tax.

As we have mentioned beforehand, some countries, for example USA, have not implemented these rules. On that note, how do we ensure the application of minimum tax rate on their profits?

We believe that countries would still be able to collect top-up tax even though the MNE is from a non-applicable OECD country. For example, if a USA MNE has a subsidiary in a low-tax jurisdiction, through UTPR another country will be able to collect top-up tax or

⁶⁸ OECD (2024), Tax Challenges Arising from the Digitalisation of the Economy – Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023): Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/b849f926-en>.

⁶⁹ Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, OJ L 328, 22.12.2022, pp. 1. , <https://eur-lex.europa.eu/eli/dir/2022/2523/oj/eng>

QDMTT in its own country. That means that if USA doesn't accept OECD Pillar two or make GILTI similar to the rules of Pillar two, it is in danger of losing on serious tax revenue.

Having this in mind, OECD is one way or another having a global effect on businesses.

3.3. The effect of Pillar two on tax incentives around the world

For some time, there has been debate about what will be the effects of implementation of Pillar two into the country's legislation systems. There were theoretical speculations on whether Pillar two will have positive or negative effect on taxation and what purpose it's supposed to fulfill, which is presented as an analysis throughout this segment.

Implementation challenges arise also as the evolving details of the rules to implement the two-pillar agreement are increasingly complex and will create high administrative and compliance costs.⁷⁰ As it was previously written about, Pillar two has very complex rules and requires a lot of planning from countries who plan to implement them. Along with that, a lot of existing legislative rules need to fit in with the the new Pillar two rules. The level of compliance from countries depends from each of them and with that, administrative compliance differs. This can be done with an implementation of a new law or lower-level legislative laws.

Of course, it can be assumed that countries will carefully consider what part of the Pillar two they will be implementing. Carefullness of countries to implement these rules comes mostly from the fact that a lot of investors in these countries are MNEs and these rules directly affect them. This argument points out two things. First is the importance of investment coming from multi national enterprises, which by themselves generate a lot of revenue and profit. This makes them a target for minimum taxation as dictated by Pillar two. Second point is the importance of the investment itself that MNEs bring. If the system of taxation isn't carefully thought out, the consequences could be too great for countries.

⁷⁰ International Corporate tax reform. (2023, February 6). IMF. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>

Other than that, it takes time for developing countries to review the effect and collect data on Pillar two from ones who implemented these rules and also to find knowledgeable administration that will suggest these implementations. Many tax administrations lack the capacity to reform. While managing their day-to-day work with often limited human, technological and financial resources, they are confronted with multiple reform initiatives, including for general revenue mobilization and new international standards.⁷¹ That is why, starting from accounting rules, several adjustments must be made to define which taxes and income are covered for the minimum tax calculation—sometimes leading to gray areas that call for legal interpretation. Then, different and interrelated top-up taxes could apply. A country's application of the rules will depend on what other countries do, requiring adequate cooperation and exchange of information.⁷²

In order to collect data, we can say that countries have to interact and reach compromises in terms of the cooperation. At this point, Pillar two is already broadly accepted in the world, the compliance is mostly based on previous acceptance from other countries and then plans for those who didn't accept the rules earlier.

Also, the experience of developing countries is limited. They traditionally focus on administering and auditing inbound investments and often have limited experience in collecting revenues from outbound investment. This will hinder the administration of, for instance, the IIR and the UTPR (if adopted). Also, they usually have limited experience in coordinating and cooperating with foreign tax administrations and especially in participating in cross-border dispute resolution.⁷³

As it was explained, it is certain that Pillar two will have the effect on tax incentives. Sort of a reminder, but tax incentives are used to lower the amount of taxes that a company has to

⁷¹ International Corporate tax reform. (2023, February 6). IMF. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>,

⁷² International Corporate tax reform. (2023, February 6). IMF. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>

⁷³ International Corporate tax reform. (2023, February 6). IMF. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>

pay and contrary to that, Pillar two is stopping that initiative of companies and countries which let them by applying the minimum of payable tax.

That is to say, tax incentives will suffer with the implementation of Pillar two. They will be less effective and they will be less useful when attracting FDI. Pillar two will apply only if the incentive regime reduces the measured ETR below 15 percent and if the accounting profit of the incentivized entity is above the substance-based income exclusion. Not all incentives are treated equally for this computation.

According to OECD analysis, income-based incentives under which belongs the full tax exemption, are the most likely to have tax benefits affected by the GloBE ETR calculation.

Also, for instance, accelerated depreciation schemes or immediate expensing—which are relatively efficient approaches to reducing companies’ METRs—will have a limited impact on computed ETRs as deferred tax adjustments are used in computing covered taxes. Immediate expensing and accelerated depreciation falls into tax deductions and these are less likely to have tax benefits affected by the GloBE ETR calculation.⁷⁴ Tax incentives such as accelerated depreciation and immediate expensing will not trigger any additional tax liability under the GloBE Rules, provided that no “recapture” is required and the tax rate is moderate.⁷⁵

The recapture rule means that if the amount of a deferred tax expense that was included in the total deferred tax adjustment amount (and taken into account to adjust covered taxes) was not paid (or reversed) within five subsequent fiscal years, then it must be recaptured and treated as a reduction of covered taxes in the fiscal year in which it was originally recorded.⁷⁶ In certain cases, the government which gave the tax relief has conditioned the company that if it doesn’t use the given amount of tax relief, needs to „give back“ to the

⁷⁴ OECD (2022), *Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules*, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>.

⁷⁵ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. As cited in OECD, *Tax Incentives and the Global minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules* p. 15 (OECD 2022).

⁷⁶ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

government. As it is mentioned, recapture rule applies only if the government demands it in a tax incentive.

Also for immediate expensing of tangible assets, when expensing comes right away for tax accounting purposes, then we have differences in financial and tax accounting and for that we have to smooth out these differences for which, the GloBE Rules require adjusting covered taxes by adding the amounts of deferred tax asset/liability thereto.⁷⁷ According to the GloBE Rules, the total deferred tax adjustment amount for a constituent entity is added to the adjusted covered taxes of a constituent entity for a fiscal year. Thus, this adjustment will result in an increase in covered taxes which consequently boosts the ETR for GloBE purposes.⁷⁸

Refundable tax credits, on the other hand, will be treated as income (the denominator of the ETR computation) and hence reduce the ETR to a lesser degree than non-refundable tax credits that reduce covered taxes (the numerator of the ETR computation).⁷⁹

In response to that, the recent administrative guidance now categorizes tax credits into five distinct types:

- a) qualified refundable tax credits (QRTCs);
- b) non-qualified refundable tax credits (NQRTC);
- c) marketable transferable tax credits (MTTCs);
- d) non-marketable transferable tax credits (Non-MTTCs); and
- e) other tax credits (OTCs).⁸⁰

⁷⁷ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

⁷⁸ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. (As cited in *Model Rules Commentary to Art. 4.1.1 Model Rules* and art. 21 *EU Directive*.)

⁷⁹ International Corporate tax reform. (2023, February 6). IMF. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>

⁸⁰ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

For each category of credit, the GloBE Rules assign specific treatments, regardless of how these tax credits are recognized for financial accounting purposes.⁸¹

3.3.1. Qualified refundable tax credits

QRTCs are refundable tax credits designed in a way such that it must be paid as cash or available as cash equivalents within four years from when a CE satisfies the conditions for receiving the credit under the laws of the jurisdiction granting the credit.⁸² Refundable tax credits imply a cash payment to firms that are not able to fully utilize the tax incentive and are treated as income for financial accounting purposes.⁸³ The GloBE Rules follow financial accounting by treating cash grants and refundable tax credits as income, which means that these types of incentives are less likely to be affected by the GloBE rules.⁸⁴

3.3.2. Non-qualified refundable tax credits

NQRTCs are tax credits that are not limited to a taxpayer's tax liability and are refundable after four years.⁸⁵

3.3.3. Marketable transferable tax credits

In the case of marketable transferable tax credits, when companies are in the need of a tax credit, fulfill the conditions when granted one, but sometimes the way they operate isn't enough to be able to pay off the given tax credit. That is when transferable tax credits, akin to refundable tax credits, can be utilized by the originator to offset covered taxes. In cases where the originator's tax liability is insufficient to fully utilize the credit, the transferable tax credit is sold at a discount, thus making it less beneficial than a refundable credit.

⁸¹ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD.

⁸² OECD (2022), Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>.

⁸³ OECD (2022), Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>, pg. 51

⁸⁴ OECD (2022), Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>, pg. 17

⁸⁵ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD., pg. 17

Nonetheless, it retains value due to its tradability. From a GloBE perspective, such credits are treated in the same manner as QRTCs.

The impact of MTTC is how it's treated in terms of covered taxes. It essentially doesn't reduce covered taxes which opens a possibility of triggering top-up taxes. By the rules of what is existent in the calculation of covered taxes, it is only the income-based taxes that fall into the category of covered taxes. But because this is a tax credit, it can only be sold or transferred, from which the profit gained from it doesn't represent income-based one. The use of MTTCs is then viewed as less favorable.

3.3.4. Non-marketable transferable tax credits

Non-marketable transferable tax credits is a type of tax credit that is dependent on the holder of the tax credit. NMTTC is a type of tax credit “that, if held by the Originator, is transferable, but is not a Marketable Transferable Tax Credit, and if held by a purchaser, is not a Marketable Transferable Tax Credit”.⁸⁶

In the end, other tax credits are non-refundable and non-transferable, meaning they can only be used by the originator to reduce their covered taxes. Given they can be used only to reduce originator's covered tax liability, these credits should be considered as a tax reduction in the context of GloBE Rules.⁸⁷

The incentives which will be affected are the ones companies are using to shift profit in hopes of paying less tax. That is to say, the only existing tax incentives will be the ones where investors are effectively creating jobs – labor and using tangible assets – capital.

In a way, rules of Pillar two have found a way to apply substance-based rules on places that are viewed as tax havens. Substance-based rules are not something new, it presents an effective way for countries to locate tax subjects for effective taxation, for example, by their residency or the place of their operations.

⁸⁶ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD., As cited in *Administrative Guidance of July 2023*, p. 35, para. 40.

⁸⁷ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD., pg 20, as cited in *Administrative Guidance of July 2023*, p. 35, para. 41.

We suppose the biggest question of future tax planning will be, what is going to be included in the profit which is to be taxed at 15%? The above-mentioned substance-based income exclusion rule would be that a portion of company's income is excluded from global minimum tax. That would mean that if the company is actively investing in labor and tangible assets, then the income received from that is to be excluded from global minimum tax. In a way, companies are being rewarded, similarly to the function of tax incentives.

A real example of how tax planning of maximum usage of tax havens happened, the companies would create and place subsidiaries in countries where there were really low-income taxes. There, the companies would transfer certain rights so they are to be taxed there, but there is basically no employees, offices or any tangible assets. With Pillar two, the companies that apply that type of strategy, are now faced with the danger of being taxed in other countries which have implemented Pillar two and are able to claim and apply top-up taxes on all profit made from those transferred rights. In a way, other countries are able to steal profit from taxes from countries who haven't yet applied Pillar two rules.

Further investigation from administrations for the purpose of assessing existing and future investments. Assessment of existing investments is determination of existence of in-scope MNEs. Which ones fulfill the Pillar two requirements, are they multi-national, do they have annual revenues over 750 million euros and other requirements. Those questions make it easier to assess whether the country requires the application of Pillar two and if so, in what scope. On whichever one, there should be a calculation of ETR on profits following the GloBE model rules. This requires aggregating the covered taxes and book profits for all subsidiaries in a country that operate within the same group. The starting point for the computation of covered taxes are taxes charged on business income, most prominently the CIT and rent taxes. Taxes charged on gross income (such as royalties or DSTs), in contrast, are not included. Subsequently, adjustments to recorded tax payments are necessary, for instance, to account for the treatment of timing differences or non-refundable tax credits (which reduce covered taxes). Similarly, book profits need to be

adjusted for refundable tax credits. The ETR is the ratio of covered taxes to accounting profits. With that, administrations should be able to determine additional tax from Pillar two.⁸⁸ Existing investors may reevaluate the optimal size of their undertakings which are affected by METR.⁸⁹ Should they realize that the amount of tax they have to pay is not efficient, they may opt out for the option of bigger investments on already existing investments. That way, as it was mentioned before, investors may be able to use benefits from enlarged substance-based exclusion rules.

Assesment of future investments really comes down to the likeliness of investors coming to that country and actually investing in it. Analysis which companies use is based on AETR (Average effective tax rate). They are calculating how much is company paying on average, what is the usual amount of taxes one company pays in taxes. If analysis says that the AETR is really low and the viewed investment is in low-tax jurisdiction, then that would mean that the investor will need to pay top-up tax on all recognised profit. If the low-tax jurisdictions continue like that, they are faced with the danger of existing investors leaving and having no investors in the future. As a consequence, future investors are more likely to go to countries where there is closer to 15% minimum tax on profit.

As it was mentioned, countries are alone in deciphering and implementing them into their systems. It is advised that governments need to revisit policies that introduce legal barriers, such as stabilization clauses or excessive scopes of bilateral investment treaties (BIT), that could hinder leveraging Pillar two reforms.⁹⁰ Big investors a lot of the times use clauses in a contract with the country they are investing in to secure their position in a number of situations. Those are known as stabilization clauses. Similar to that, but not exclusive to specific investor, are BITs. They are less specific in terms of knowing the other party of the treaty, but both methods in their own way are dangerous for the successful implementation of Pillar two. This would mean that countries should be in a hurry to revise and in a way

⁸⁸ International Corporate tax reform. (2023, February 6). IMF. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>

⁸⁹ International Corporate tax reform. (2023, February 6). IMF. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>

⁹⁰ International Corporate tax reform. (2023, February 6). IMF. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>

change their policies and laws in order to implement Pillar two otherwise they're either faced with the danger of losing existing/future investors or the loss of tax revenue. In the paper is suggested that to maximize their effectiveness, such as by focusing on cost-based incentives, which are closest to income-based inclusion rules. As noted, the introduction of a QDMTT would reduce the risk of redundant tax expenditures and prevent taxes from being topped up elsewhere.

Having previous analysis in mind, we have to raise the question, is there a need for a dual tax system? A system which on one hand taxes MNEs and on the other hand taxes regular, non-required companies. In a way, the purpose of having a separate system is to bring another type of relief on the MNEs. Those would be incentives, benefits or something else. It seems contra intuitive to have another type of government help when the need for Pillar two rised from the idea of equality between the MNEs.

Overall, it needs to be adapted to the State aid rules so that it doesn't give any benefits above the implemented Pillar two. We think that the problem of a dual tax system isn't in the losses a regular company can have, but in the disloyalty towards a accepted system.

3.4. The effect of pillar two on tax incentives in Serbia

Up to date, more than 140 countries have accepted OECD rules which accomodate Pillar two rules. While a lot of countries have accepted Pillar two rules, there is still a number of countries which have not made any progress in terms of developing and implementing the Pillar two rules. Serbia is one of the countries that has accepted, but is yet to enact the official rules in its legislation.

The general tax rate in Serbia is 15%. In essence, that would mean that Serbia is already in alinement with Pillar two rules. However, as it is the case for many other developing countries, they offer tax incentives which put the general tax bellow 15%. In case of Serbia, it offers some interesting exemptions which put tax rate bellow 15%.

As it was explained in the previous section, there are many reasons and variables which influence the implementation of Pillar Two. With its implementation, Pillar two is introducing

a lot of new terms and definitions for which Serbia would need to do a lot of changes within its legislation.

One of the problems Serbia is faced with is a problem of administrative capacity in its tax administrations and with new rules there is a need for more human power and knowledgeable staff. At the moment, Tax administration is actively recruiting new people, which sheds an optimistic light on the future of tax administration in Serbia. The purpose of employment of more people is to take of the burden of an overworked institution and education for the purposes of successful implementation of Pillar two.

If Serbia doesn't implement Pillar two rules in a close future, it is risking the loss on the difference from 15% and other concluded tax rate. There is the possibility of Serbia losing out on collection of tax because the tax rate is below 15%. It is very possible that this may urge Serbia into introduction of at least QDMTT as a way of keeping the tax within the country. That is possible to happen because all other countries have already accepted other rules of Pillar two using IIR or UTPR, which allow them to collect the difference of tax rates.

Of course, there is attractiveness of the investments. In recent times, Serbia has become popular place for investors because of incentives it offers. In a way, MNEs may be discouraged from investing in Serbia because they may not be able to use tax incentives to their full extent. By that, we mean that even if Serbia continues to offer tax incentives with lower tax rate than 15%, MNEs would still be in a obligation to pay the difference in tax rates somewhere else.

To explain further, there is no conclusive number of MNEs in Serbia and it can be safe to say that it doesn't have at-home MNEs which would satisfy the requirements of Pillar two. Possibly, there is a word on foreign MNEs. What can be analysed is what types of industries there are. In Serbia, popular industries for investments are IT companies, production companies, retail companies which are a part of MNEs. As it was mentioned, tax incentives in Serbia offer incentives which cover all of mentioned industries, with just a bit more concentration on IT and production industries.

As a consequence, even though Serbia is by its benefits a nice place for investors, without the implementation of Pillar two, it is likely to suffer from the lack of urgency. Slow reaction to the administration of rules just may influence MNEs in Serbia and with that, lose on the benefits which it may have if the Pillar two was implemented.

When faced with all those uncertainties, the question would be, what Serbia has to do to with Pillar two?

As mentioned, it would be the safest option for Serbian government to implement QDMTT of UTPR and secondary IIR as the first two are necessary in order to eliminate the possibility of taken over taxation on corporate profits that could've been paid in Serbia. IIR is unnecessary, because there are no serbian MNEs which would need this type of protection.

Then, employment and strenghteing of tax administration makes them more efficient in recognising MNEs. Along with that, collection of data from other countries who have implemented the Pillar two is useful. Lastly, government has to go over Double taxation treaties (DTT) and multinational instruments (MLI).

We have to question again the idea of dual tax system and its possibilities. We think that right now, there is no need for that type of system, as it would seem a waste of government resourses in setting up a system which doesn't call for it.

4. ALTERNATIVE POLICY OPTIONS OF TAX INCENTIVES FOR COUNTRIES

4.1. Introduction

Throughout the thesis we have seen that Pillar two has demonstrated a challenge for countries. It is now up to them to organise and put in place regulations concerning tax incentives. Intuitively, we can conclude that there is going to be a need for them to dramatically change tax incentives and that they are faced with difficult choices considering the importance of investors.

Governments start to come up with mechanisms of coping with changes which affect the biggest stakeholders in an economy. They need to play by the rules, but also present a stance to other countries to still have some sort of competition between each other. With this type of change, where certain threshold of tax must be fulfilled, countries are thinking of other incentives and advantages they can offer to foreign investors to keep investments coming and collect that tax.

To keep up with the changes, there have been recommended actions to be taken so countries reap the most benefits from new rules implementation. Existing tax incentives have to be analysed and thought through before introducing any new ones as there is a chance that any hastily movements may harm countries long-term. The reason why some tax incentives may continue to exist no matter the policies in place could be because of the influential companies who present as important investors have a big influence on the governments for which the said governments aren't willing to change the policies. They deem existing investors as better option for governments revenue even though this argument can be faulty. That is why in the absence of any reform, low-taxed profits arising from the use of certain tax incentives would likely be taxed by other jurisdictions under the IIR or the UTPR.⁹¹ That is why countries are likely to be losing in terms of unused tax incentives and lost tax revenue.

⁹¹ OECD (2022), Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>.

When examining tax incentives, tax reform should be guided by economic principles that lead to well-designed tax incentives which maximise additionality, minimise windfall gains, and ensure that their benefits outweigh their costs. Simply reforming tax incentives to become less affected by the GloBE Rules may lead to ineffective incentives being retained and may have unintended consequences and lead to undesirable outcomes.⁹² By the strict manner of which the Pillar two has been implemented, countries most likely take tax incentives reform very seriously and are in need of serious change. Even if the tax incentives most affected by the GloBE Rules may be the most urgent priorities, jurisdictions, in particular those in developing and emerging economies, may wish to use the momentum to reassess the tax incentives offered more broadly. Better tax policy can help mobilise resources by removing redundant and inefficient incentives, reducing distortions and improve signalling for investors.⁹³

As it is important that we stay on topic of in-scope MNEs, it is worth mentioning that changes in legislation may also depend on out-of-scope companies and other legal entities which do not fall into the category of Pillar two. These entities do have a large presence in the economies and are of importance, but for a functioning economy within its country, it is necessary to pay attention to other actors. That is to say, tax incentives targeted to SMEs, young firms, start-ups that are standalone or not part of an in-scope group are not affected by the GloBE Rules. Similarly, tax incentives can still be used for smaller MNEs not in scope. Tax incentives targeted to income that is out-of-scope, e.g. shipping income will also be unaffected (with some limitations) by the GloBE Rules.⁹⁴

When analysing which tax incentives are more or less likely to continue existing, it can be concluded that tax incentives that are narrowly targeted to certain categories of income or expenditure or that have design features that effectively limit tax benefits are likely to be less affected, all else equal.⁹⁵

⁹² OECD (2022), Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>.

⁹³ OECD (2022), Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>, pg. 49.

⁹⁴ OECD (2022), Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>, pg. 50.

⁹⁵ OECD (2022), Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>, pg. 51.

That is because they can reduce the tax burden without triggering top-up tax of 15%, which leaves for the country who gave the tax incentive the ability to collect the tax. Compared to them, but very popular, are tax holidays. The ones who offer 0% on almost all tax (depending on the jurisdiction) for certain amount of years (from 5 to 10 years). With the application of Pillar two, the problem arises for country who gave the tax holiday. If the investor is allowed to pay no tax, then the top-up tax is at its maximum, 15%. There is a danger of the country on missing the significant tax revenue. Rethinking the tax holidays doesn't seem as a bad of an option considering administratively and practically. On the side of the administration, there is a possibility for developing countries to fall victim to uncontrolled given tax holidays and receiving very little in return. Usually tax holidays focus on giving employment by investment in certain areas, contrid are seen as exploited by those companies. On the other hand, tax incentives who focus on specific areas are more controlable and to others seem more focused on specific areas of growth.

Before the BEPS 2.0. project, it didn't necessarily matter whether the incentive was expenditure or income type, but rather what type of investor and business it brought. Now we are experiencing a change, where to maximize the potential of incentives, governments are focusing on expenditure type of incentives.

When analysing why expenditure-based tax incentives are now popular, we come to the realisation that expenditure-based tax incentives that allow the immediate expensing or that accelerate the cost recovery of tangible assets and certain short-lived intangibles will be less affected than other types of incentives under the GloBE Rules. Also, expenditure-based tax incentives targeted to provide relief on payroll costs such as R&D tax incentives or training expenses or to incentivise investment in tangible assets such as investment in infrastructure or machinery will induce investment in substantive activities that will increase the value of the SBIE.⁹⁶

Further in the thesis, we explain why subsidies and tax credits are most likely to be used as types of tax incentives.

⁹⁶ OECD (2022), Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en.>, pg. 51.

4.2. Subsidies as a way of incentivising

In previous sections we have mentioned that changes would have to be made within the legal system regarding tax incentives. Throughout the analysis, constant ideas of subsidies have risen and this idea has placed its roots in the new system of tax incentives. Subsidies are a well-known concept, there are widely used as a sort of help from the government to the investors.

The term “subsidy” encompasses a broad spectrum of financial and economic support provided by the government to individuals and businesses. This support may take different forms ranging from direct fiscal expenditures such as cash grants, to a variety of tax incentives such as tax holidays, tax credits, tax deductions. States can also subsidize by offering equity infusions or preferential loans (forgivable or below market interest), or through the provision of goods and services by the government on preferential terms of procurement. States can also give land or emission certificates.⁹⁷

There are different forms of subsidies, placed on different levels. Whether it is by EU, locally or some other ways, they all have in common the approach and benefits that is they are generally shown as income items in an MNE’s country-by-country report.

Consequently, taking this into account, one of the possible effects of Pillar Two may be a stronger motivation for countries to attract investments by offering subsidies instead of adopting equivalent tax incentives at the same economic cost.⁹⁸

As it was mentioned earlier in the text, subsidies are also tax holidays, tax credits and tax deductions.

The difference between subsidies and tax incentives is that both are used to stimulate certain behaviors from investors. Behaviors are manifested in the form of investments in

⁹⁷ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. <https://www.ibfd.org/shop/journal/impact-pillar-two-corporate-tax-incentives-and-incentives-post-pillar-two-potential>, pg 37. As cited in IMF et al., Subsidies, Trade, and International Cooperation (OECD 2022), available at <https://doi.org/10.1787/a4f01ddben> (accessed 11 Dec. 2023).

⁹⁸ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. <https://www.ibfd.org/shop/journal/impact-pillar-two-corporate-tax-incentives-and-incentives-post-pillar-two-potential>, pg.45.

return for the beneficial financial aid. In the former case, subsidies are given as cash grants and supports. They can be viewed as dollar-by-dollar reduction in the amount of money invested. They are not tied in the tax amount payable and with that, it has a different effect on ETR. When calculating the tax payable, it doesn't influence top-up tax because it has never been connected to the tax, but to the financial structuring.

We need to direct the attention to the subcategories of tax incentives. Within tax incentives, we have encountered terms like tax exemption, tax holiday or tax deduction.

We can say that tax exemption is a term when a subject is exempted from paying some sort of tax. Difference between tax exemptions is depended on period of exemption on which a subject doesn't have to pay some sort of tax.

We can divide tax exemptions on for how long is the exemption allowed for, whether that is for one year or a permanent exemption.

In essence, Serbia doesn't offer an tax exemption which is more oriented towards the time the exemption will be used for.

On the other hand, article 22g and 25b are more focused on how much tax is allowed to be exempted. As it was mentioned in the section of Tax incentives in Serbia, article 22g is related to R&D of a company and is doubling the amount of expenses that can be recognised as expenditure in the tax balance. In article 25b, known as IP Box regime, offers a exemption of 80% from the tax base of the income achieved. Other countries also offer similar exemptions for which next conclusion is most likely to also apply to. Because lowered expenditure makes bigger space within income and expenses, it forces companies to apply higher income. With that GloBe ETR is lower, which makes it more likely for a top-up tax to apply.

Within that group, we have tax holidays which allow companies to lower the tax rate to 0% for a certain period of time, so that companies initially don't have to pay any tax if companies fulfill certain conditions.

That is the case with Serbia's tax holiday article 50a Law on Corporate income tax. In return for the invested money and machinery and newly employed people, it offers a 10 year tax exemption on made profit. This is exactly why, with the implementation of Pilar

two, MNEs (who mostly are capable of using this type of tax incentive) are less likely to use this type of tax incentive because it will trigger a top-up tax. This is the case for both Serbia and any other country who offers tax holidays.

We can say that subsidies will have a great importance with the implementation of Pillar two and will present as a alternative in the new era of incentivising. Governments are more directly involved with the process of giving benefits to companies and in a way, have better control over investing companies.

As we mentioned, with the higher possibility of triggered top-up tax, we are most likely to see a seize on usage of tax holidays and tax exemptions for MNEs. With that being said, there is a possibility of governments in keeping tax holidays and tax exemptions, which will only be used by other companies which don't fullfill requirements of application for Pillar two, but are successful enough to use these tax benefits.

4.3. Tax credits as a way of incentivising

As an intro to the third section of this thesis, we began explaining alternative options of tax incentives and have found a second option of possible tax incentives. Throughout the thesis, it is evident that tax credits aren't a new option of incentivising. The raised question is, are tax credits a new alternative for tax incentives to the onces we know?

Tax credits are deductions from the amount of taxes due that relate to capital or current expenditures with a specific target. Qualifying current expenditure typically relate to current expenditures for certain activities (e.g. spending on training, R&D activities, exporting), while qualifying capital expenditures are generally asset-specific (e.g. machinery, buildings, equipment).⁹⁹

The GloBE Rules follow financial accounting by treating cash grants and refundable tax credits as income, which means that these types of incentives are less likely to be

⁹⁹ Celani, A., L. Dressler and M. Wermelinger (2022), "Building an Investment Tax Incentives database: Methodology and initial findings for 36 developing countries", OECD Working Papers on International Investment, No. 2022/01, OECD Publishing, Paris, <https://doi.org/10.1787/62e075a9-en>.

affected.¹⁰⁰ As we have mentioned cash grants in the previous section, where similar logic applies, but we would like to explain the effect of cash grants and refundable tax credits.

When a government allows a certain company a cash grant or a refundable tax credit, it finances it from the government revenue. On the other hand, in the case of tax holidays, tax exemptions and non-refundable tax credits (NQRTs), governments are essentially renouncing that tax revenue.

The benefits from former mentioned incentives is that they are considered GloBe income, but they don't reduce covered taxes, which means that they don't affect the ETR. It stays the same, enough not to trigger top-up tax.

In continuation of previously mentioned, within the category of tax incentives, most possibly the favorable alternative options for tax incentives are most likely to be QRTCs. Because of the effect they have when combined with Pillar two rules they are deemed as a more favorable. They influence ETR less than other types of tax credits.

In order to further understand tax credits, with the illustration of a real life tax incentive, according to the Serbian Income tax law, in Article 50j, an already existing company which invests in a newly founded company which performs innovative activity, is granted a tax credit in the amount of 30% of the investment made. We have mentioned this article in the section of Tax incentives in Serbia and in the analysis of this article, we have explained that this tax incentive is considered a NQRTC, because the unused amount of tax credit can be carried forward for a period no longer than 5 years. Serbia doesn't offer any other tax incentive which is effective for MNEs.

There is a question as to what extent do we offer QRTCs. There could be a possibility to offer them from small businesses to large enterprises. As a result, countries will need to carefully design their tax credit policy. The authors' suggestion would be to link such credits to expenditure (or income in certain cases) and not profits. At the same time, countries which offer such QRTCs (or MTTCs) will need to coordinate extensively with all other ministries (for example, the Ministry of Finance will need to coordinate with the Ministry of

¹⁰⁰ OECD (2022), Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules, OECD Publishing, Paris, <https://doi.org/10.1787/25d30b96-en>, pg. 7.

Industry, the Ministry of Economy and so on). Thus, the administrative burden on countries may increase. Furthermore, they will need to ensure that the risk of tax fraud associated with such credits is low.¹⁰¹

¹⁰¹ Chand, V. & Romanovska, K. (2024). The impact of pillar two on corporate tax incentives and incentives post pillar two – the potential rise of tax credits and subsidies. IBFD. <https://www.ibfd.org/shop/journal/impact-pillar-two-corporate-tax-incentives-and-incentives-post-pillar-two-potential> as cited in HMRC annual report and accounts document for 2021/22 estimating error and fraud in the R&D tax relief scheme at the level of 4.9% of the total value, (18 July 2022), available at <https://www.gov.uk/government/publications/hmrc-annualreport-and-accounts-2021-to-2022/hmrc-annual-reportand-accounts-2021-to-2022--2> (accessed 11 Dec. 2023).

5. CONCLUSION

Companies heavily rely on good business structure and maximized benefits. In one of the areas of structuring, tax planning is one of most important ones as it allows companies to avoid payment of taxes. Because of tax planning, as a consequence, tax revenue was one of the most affected areas. Consequenses on the governments revenue which would've been recieved from the paid tax weren't there and the benefits countries got in return were not propornate.

Up until the implementation of Pillar two, what made jurisdictions attractive, was the opportunity for an MNE to recieve tax benefits in return for the investment in that country. Tax benefits are in the form of tax incentives. The first question for this thesis was to define tax incentives. We can conclude that the definition of tax incentive isn't universal for everyone and highly depends on the authority/government offering it.

Developing countries are more likely to offer a tax incentive offered to a broader group of investors in order to attract and stimulate economical development. On the other hand, developed countries are more likely to target a specific group of investors and for specific sectors.

Different types of tax incentives were created. From the analysis, we have concluded that developing countries are more likely to offer income-based tax incentives, because invested countries are not directly involved in giving the tax benefits and incetive is used on the derived income from the investment. Those incentives would be tax exemptions and tax holidays.

In contrast, expenditure-based tax incentives are more connected to developed countries. Because of a strong fiscal existence, they are directly involved with the amount of tax incentive given. Those incentives are tax credits, tax deductions and tax allowances.

As a consequence, developing countries became popular for their benefits applied in a form a tax incentive and more famously became known as tax havens. Benefits from those tax incentives lowered a stipulated tax rate (different depending on the country) to a much lowered tax rate. Along with that, investors were able to pay taxes at a much lower tax rate

and at times even nothing. In a way, abuse of tax incentives wasn't only because investors were able to pay taxes at a much lower rate, but the return for the benefits, results weren't there. In many cases, companies found a way to only exist on paper or with a minimum investment, but to maximize their profits due to a low tax rate.

As a counter to a rising problem, OECD has implemented a Pillar two as part of a BEPS 2.0 project, which introduces a global minimum tax of 15% on the income of multinational companies (MNEs) with an annual revenue of €750 million.

In the case when tax incentives are allowing payment of tax less than 15%, as a consequence, tax incentives are triggering top-up tax which will need to be paid by the country which accepted rules of Pillar two.

Throughout this thesis, we have come to a conclusion that in order for countries to protect their tax revenue, need to revisit existing legislation regarding tax incentives. Suggestion for governments who are yet to implement rules of Pillar two, in which Serbia falls into, is that governments need to analyse existing tax incentives and those who aren't of use anymore, they should be removed and new ones need to be implemented. Analysis shows that tax credits and subsidies are new alternatives for tax incentives. These incentives still make countries competitive with each other, but now is the question of best tailored tax credits and subsidies.

Successful implementation of rules would be best done if developing countries form a working group which would focus on establishing new Pillar two rules in a form of a separate Law or within an existing Law.

Also, reallocation of resources into educating people working in the tax administration so they would know to recognise which MNE is fulfilling Pillar two requirements.

The given suggestions are strongly connected to the tax incentives which affect MNEs and that governments have to be careful regarding those tax incentives. Any other tax incentives which do not fulfill the requirements for Pillar two, are most likely to continue existing and these suggestions are not affecting those.

One of the most important points is that Pillar two is there to connect the investment into substance in an invested country. If the company meets the requirements for a tax incentive,

then investment needs to be real and a set of operations from a company really needs to exist in a place. That is what we mean as substance-based incentivising. In a way, only tax credits and subsidies prove the existence of the investment which is relayed as R&D, tangible assets and payroll (employees). This way, countries benefit as they keep the tax revenue from spilling and have real investments, which proves why rules of Pillar two are important.

We are mentioning that Pillar two isn't an end for tax incentives, but that it is necessary to redefine them and adjust to changes. In the end, Pillar two still leaves space for countries to be competitive with each other as it just makes transactions more transparent and investments real.

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