TAXPEDIA
Journal of Tax Policy, Economics, and Accounting
https//muctaxpedia.com
Volume 1 Nomor 2 November 2023
e-ISSN 2987-5366

ADAPTING INDONESIA'S TAX INCENTIVE STRATEGY IN THE POST PILLAR TWO ERA

[1)] Johanes Glorinus Saragih

Author:
[1)] Johanes Glorinus Saragih
johanes.glorinus@gmail.com
Direktorat Perpajakan Internasional, Kantor Pusat Direktorat Jenderal Pajak, Indonesia

Abstract
Indonesia, as a developing country striving for economic growth and technological advancement, faces the imperative challenge of re-evaluating its tax incentive regime in light of the global tax landscape's recent transformation through BEPS Action 1 Pillar Two. Using qualitative research methodology, this study delves into the framework of Pillar Two and its implications for Indonesia's tax incentives policy. This paper highlights the pressing need for Indonesia to recalibrate its tax incentive strategy and proposes that Research and Development (R&D) tax incentives as a promising solution, specifically focusing on input R&D activities that are compliant with The Global Anti-Base Erosion (GloBE) rules. This study examines the potential of R&D tax incentives to stimulate innovation, attract foreign investments, and ultimately contribute to long-term economic growth. As Indonesia charts its path toward economic prosperity, rethinking its tax incentive policy is paramount.
Keywords: **Tax incentive, Pillar Two, R&D activities**

Abstrak
Indonesia, sebagai salah satu negara berkembang yang sedang berusaha untuk meningkatkan angka pertumbuhan ekonomi dan mendorong perkembangan teknologi, menghadapi tugas penting untuk mengevaluasi kembali kebijakan insentif pajak, mengingat transformasi pada dunia pajak global belakangan ini melalui Pilar Dua. Dengan menggunakan metode penelitian kualitatif, studi ini meneliti kerangka Pilar Dua dan implikasinya terhadap kebijakan insentif pajak di Indonesia. Studi ini menyoroti kebutuhan mendesak bagi pemerintah Indonesia untuk mengkaji ulang strategi insentif pajaknya dan mengusulkan agar insentif pajak di bidang Penelitian dan Pengembangan (Litbang) sebagai solusi, khususnya berfokus pada kegiatan input Litbang yang sesuai dengan aturan GloBE. Studi ini juga mengkaji potensi insentif pajak Litbang untuk merangsang inovasi, menarik investasi luar negeri, dan pada akhirnya berkontribusi pada pertumbuhan ekonomi jangka panjang. Dalam rangka menuju Indonesia yang makmur, memikirkan kembali kebijakan insentif pajak adalah salah satu yang terpenting.
Kata kunci**: **Insentif pajak, Pilar Dua, Penelitian dan Pengembangan (Litbang)

Citation
Saragih, Johanes Glorinus. (2023). Adapting Indonesia's Tax Incentive Strategy In The Post Pillar Two Era. *TAXPEDIA: Journal of Tax Policy, Economic and Accounting*. Volume 1 Nomor 2

INTRODUCTION

On early October 2021, the members of the Organization for Economic Cooperation and Development (OECD) Group of Twenty (G20) Inclusive Framework on Base Erosion and Profit Shifting (BEPS) agreed on the Statement concerning the Two-Pillar Solution designed to tackle tax

challenges stemming from the digitalization of the global economy (OECD, 2021). Under Pillar One, the largest and most profitable multinational enterprises (MNEs) will be subject to a redistribution of profits across various countries worldwide. On the other hand, Pillar Two aims to ensure that a minimum tax rate is imposed on MNEs globally.

Pillar Two primary objective is to formulate rules that will enable jurisdictions to impose an additional tax on MNEs if these entities are not subject to the adequate tax rate in other jurisdictions (Obuoforibo et al., 2020). Essentially, the proposed rules seek to curb the practice of MNEs shifting their profits to jurisdictions with lower tax rates. Furthermore, the proposed rules are designed to address the concerns regarding several jurisdictions reducing their corporate tax rates, commonly known as the "race to the bottom" (Lillo, 2020). The underlying premise is that the proposed rules will help promote tax fairness and enhance the integrity of the international tax system. These proposed rules are called The Global Anti-Base Erosion (GloBE) Rules (OECD, 2020).

The GloBE rules have introduced The Global Minimum Tax (GMT), which stipulates a minimum tax rate of 15% (OECD, 2020). There are some principal rules in the GloBE framework, which are Income Inclusion Rule (IIR), Undertaxed Payment Rule (UTPR), Qualified Domestic Minimum Top-Up Tax (QDMTT), and Subject to Tax Rule (STTR). The GloBE rules enable a country to impose a top-up tax on the subsidiary of MNE that has been taxed below the GMT. Failure to apply the GMT rate in one jurisdiction would trigger its application by another jurisdiction, such as the source country or other countries where the MNE conducts its business activity, thereby ensuring that the MNE is subject to a minimum level of taxation globally.

Pillar Two has established a floor on the tax rates that countries can impose. However, it is important to note that Pillar Two does not entirely eliminate tax competition among jurisdictions. Countries may still engage in competition by offering tax incentives that comply with the prescribed guardrails while remaining within the bounds of the GloBE rules. Under Pillar Two, if a tax incentive results in one entity's effective tax rate (ETR) falling below 15%, the MNE group must pay a top-up tax at a rate equal to the difference between the ETR and the GMT in the parent company jurisdiction or other MNE group jurisdictions (OECD, 2020).

Implementing Pillar Two is expected to have implications for various tax incentives, including tax holiday. The tax holiday is a type of tax incentive that exempts taxpayers from the obligation to pay annual income tax or provides a zero percent ETR. The GloBE rules are likely to have significant repercussions for tax holiday, as they would be subject to the application of the GMT rate. Other tax incentives that are most likely to be affected by Pillar Two are super deductions, tax allowance for particular investments, non-qualifying R&D tax credits, and so forth (World Bank, 2021).

Tax holiday in Indonesia is subject to the regulatory provisions stipulated in Minister of Finance Regulation Number 130 of the year 2020. Then, Minister of Finance Regulation Number 153 of the year 2020 regulates the provision of a super deduction for R&D activities. Also, Minister of Finance Regulation Number 11 of the year 2020 jo Number 96 of the year 2020 governs the bestowal of tax allowances for investments in specific fields or designated regions. All of these tax incentives are likely to be impacted by Pillar Two.

Indonesia, which is a developing country, still needs much foreign investment to build infrastructure and improve national welfare. Through tax incentives, the government hopes it could attract investment that will contribute to economic growth, job creation, and improve national competitiveness. Therefore, the government needs to consider the design of tax incentives which could be less likely to be affected by Pillar Two if it wishes to attract foreign investment.

This study is intended to examine optional tax incentive schemes/mechanisms aligned with Pillar Two that the Indonesian government can consider. In Chapter Two, the author will discuss GloBe rules and their technical implementation. In Chapter Three, the author will discuss the advantages and disadvantages of tax incentives policy in general, as well as their implementation in Indonesia. In Chapter four, the author will discuss the result. Analyzing the GloBE rules, their technical implementation, and tax incentives policy in Indonesia can lead to the identification of alternative tax incentives policies that align with Pillar Two.

LITERATURE REVIEW

Income Inclusion Rule

Income Inclusion Rule (IIR) is a fundamental component of the GloBE rules. This rule enables the jurisdictions where the Ultimate Parent Entity (UPE) of MNE is located to levy a top-up tax on the UPE equivalent to the inadequately taxed profits of its overseas subsidiaries (OECD, 2020). IIR seeks to counteract the practice of MNEs shifting their profits to low-tax jurisdictions to avoid paying taxes in higher-tax countries (World Bank, 2021). By doing so, IIR aims to ensure that MNEs pay a fair share of tax in the countries where they conduct business activities and generate profits.

The IIR operates in a way that is similar to a Controlled Foreign Company (CFC) rule in that it subjects a domestic taxpayer to tax on its share of the foreign income of any controlled subsidiary (World Bank, 2021). The IIR is designed to be coordinated with the GloBE rules that apply in other jurisdictions where the MNE Group operates to ensure that, in the aggregate, these rules do not result in incremental taxation on low-taxed profit that is above the global minimum tax rate (ISLP, 2022).

The overall concept of IIR and top-up tax are illustrated as follows.

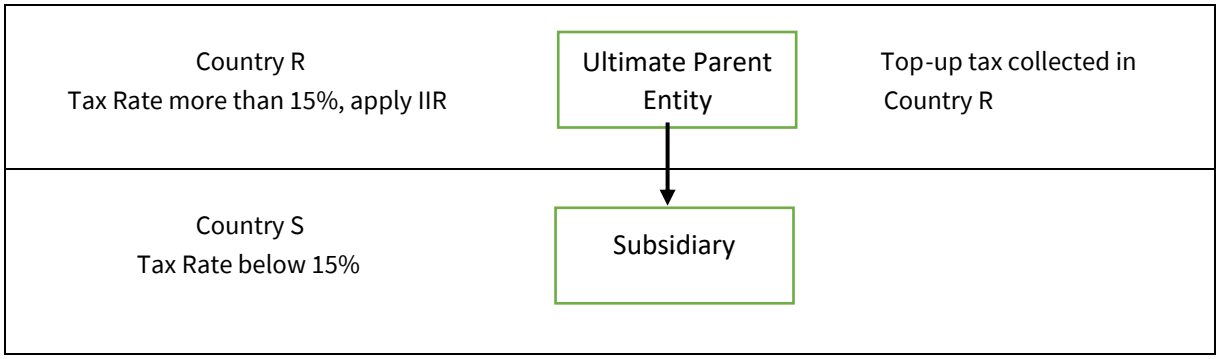


Illustration 1 The Income Inclusion Rule (IIR)

Undertaxed Payments Rule

Undertaxed Payments Rule (UTPR) represents the secondary measure within the GloBE rules, designed to further supplement the IIR and the Qualified Domestic Minimum Top-up Tax (QDMTT) (OECD, 2020). UTPR comes into play in cases where the resident jurisdiction of UPE maintains a tax rate that is below 15%, and no top-up tax is paid under an IIR or QDMTT in the source country (OECD, 2020). UTPR serves as a backstop against tax avoidance, applying only after an IIR and QDMTT (OECD, 2020). UTPR enables countries to levy a top-up tax on MNEs that have not fulfilled their tax obligations under IIR. It is essential to note that the existence of an IIR renders any potential UTPR

to be void, as the IIR operates as the primary mechanism for ensuring minimum taxation, thus emphasizing the hierarchical nature of the GloBE rules.

Any additional tax would then be collected under the UTPR by countries where other group companies are headquartered (OECD, 2020). When more than one country hosting an MNE group company adopts the UTPR, each country is allocated a portion of the top-up tax amount based on the number of employees and the net book value of tangible assets in each country (OECD, 2020). The rule is anticipated to take effect one year after the IIR (OECD, 2020). The UTPR is also known as the Undertaxed Profits Rule because it prohibits undertaxed payments from qualifying for deductions or equivalent adjustments (OECD, 2020).

The overall concept of UTPR and top-up tax are illustrated as follows.

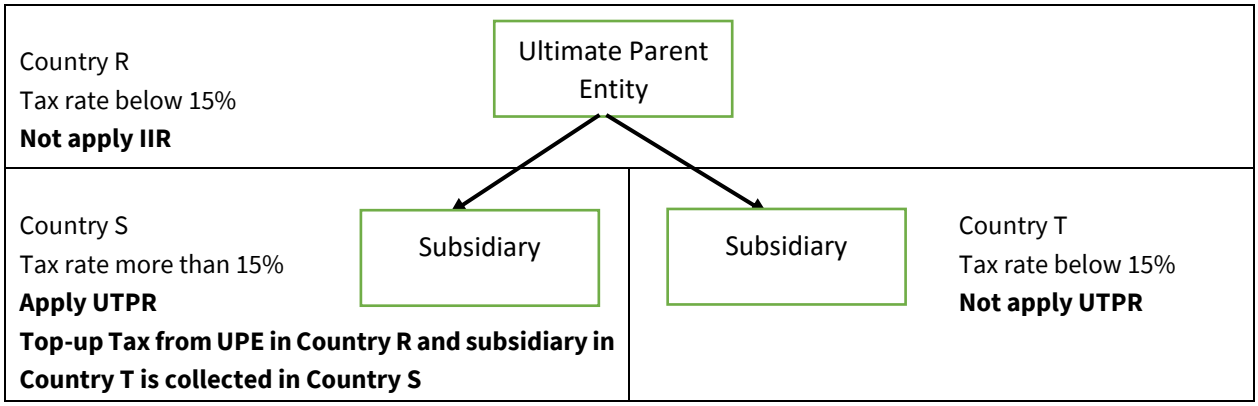


Illustration 2 The Undertaxed Payments Rule (IIR)

Qualified Domestic Minimum Top-up Tax

The GloBE rules also facilitate the implementation of minimum domestic tax rates. The QDMTT refers to a potential domestic tax mechanism that a jurisdiction may implement to guarantee that an MNE is subject to a minimum level of taxation within the country (World Bank, 2021). The introduction of this rule serves to prevent the application of both the IIR and the UTPR. By adopting the QDMTT, the source country is able to maintain its first right of taxation, while the responsibility of collecting the top-up tax is shifted to the country in which the income is generated (ISLP, 2022).

The QDMTT wholly offsets any liabilities under the GMT (ISLP, 2022). As a fundamental tenet and in alignment with the commitment to respect implementation by jurisdictions that adopt the GloBE framework, the QDMTT should be regarded as eligible for credit against taxes imposed at the shareholder level by the parent country, in the same manner as other domestic taxes originating from the source country.

The overall concept of QDMTT and top-up tax are illustrated as follows.

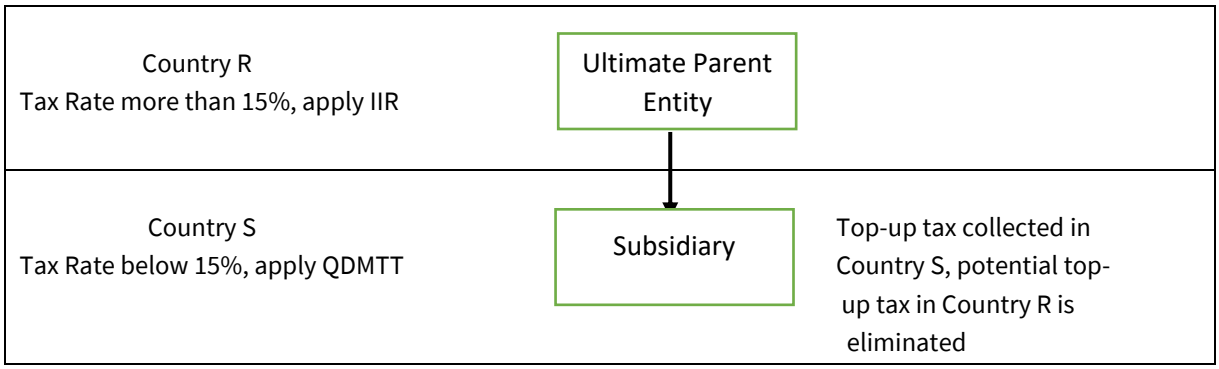


Illustration 3 The Qualified Domestic Minimum Top-up Tax (QDMTT)

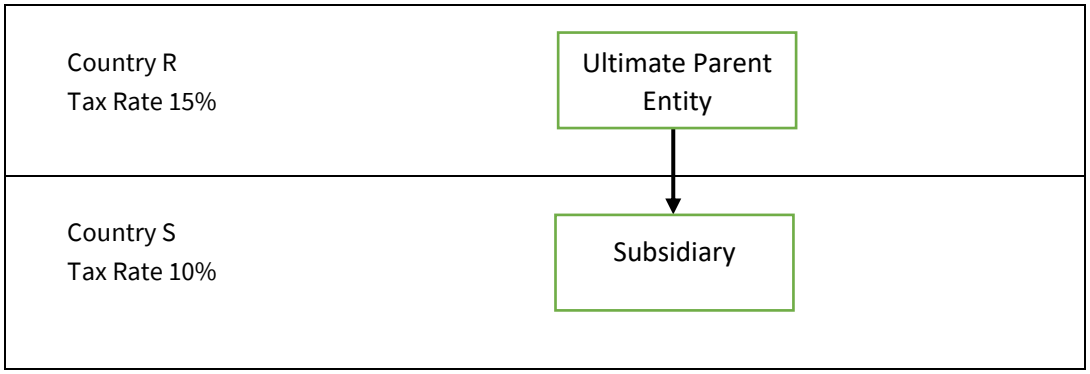
Substance-Based Income Exclusion Carve-Out

The Substance-Based Income Exclusion Carve-Out (SBIE) rule is a critical component of the GloBE framework in terms of domestic tax systems. This feature serves to exclude specific income from the calculation of the top-up tax, which diminishes the effect of GloBE on low-taxed entities that fall within its purview and that possess substantial income generated from physical presence or other forms of substantial economic activity (OECD, 2020). The extent of the reduction in the top-up tax is contingent on the level of tangible investment and payroll allocated by the in-scope entities within the source country (OECD, 2020). By incorporating this mechanism, the GloBE framework ensures that taxation is applied in a manner that prioritizes economic substance.

In essence, if an entity falls under the purview of GloBE rules and operates within a low-tax jurisdiction, its taxable income subject to top-up tax may be reduced by the SBIE rule, based on the presence of tangible assets or payroll expenses. SBIE will be utilized to reduce GloBE income to generate excess profit. The amount of top-up tax will be calculated by multiplying the excess profit by the top-up tax percentage (OECD, 2020).

The OECD explains that the SBIE permits jurisdictions to "continue to offer tax incentives that reduce taxes on routine returns from investment on substantive activities, without triggering additional GloBE top-up tax" (OECD, 2020). Ultimately, the SBIE will be set at 5% of the carrying value of tangible assets and 5% of payroll costs, but during a transition period of 10 years, the applicable rates are 8% and 10%, respectively (OECD, 2020).

The overall operations of SBIE and its calculation are illustrated as follows.



Assume:
GloBE Income UPE = 100
Tangible asset Subsidiary = 62,5
Payroll expense Subsidiary = 50
Therefore,
SBIE = (8% x 62,5) + (10% x 50) = 10
Top Up Tax Percentage = 15% - 10% = 5%
Excess Profit = GloBE Income – SBIE = 100 – 10 = 90
Amount of Top Up Tax = 5% x 90 = 4,5

Illustration 4 The Substance-Based Income Exclusion Carve-Out (SBIE)

Qualified Refundable Tax Credit

A Qualified Refundable Tax Credit (QRTC) is a tax credit that can be refunded to an entity in the form of cash or a cash equivalent within four years of the entity satisfying the eligibility requirements specified by the country that grants the credit (OECD, 2020). A qualified refundable tax credit will be treated as income, whereas the non-qualified refundable tax credit (NQRTC) will be regarded as a reduction for the covered tax liability (OECD, 2020). A QRTC excludes any tax creditable or refundable in accordance with a Qualified Imputation Tax or a Disqualified Refundable Imputation Tax (World Bank, 2021).

Tax Incentives Policy

Tax Holiday

1. Definition and Explanation of Tax Holiday

Countries grant tax holiday in an attempt to attract Foreign Direct Investment (FDI) and/or sustain economic growth (Muyaa, 2018). Developed countries usually provide financial incentives such as grants, subsidized loans, and loan guarantees. Meanwhile in developing countries, it is common to provide tax holiday (UNCTAD, 2000). This is mainly because developing countries frequently lack the same capital-providing choices (UNCTAD, 2000). Tax holiday is imposed by general investment laws, tax legislation, or industry-specific legislation, or it is negotiated with the host government.

Tax holiday may be granted depending on where the investor's operations take place, such as inside specially designated "zones" (for example, special economic zones and export processing zones) (Muyaa, 2018). Nevertheless, some countries offer tax holiday regardless of whether the investor is located within a designated zone. On average, the tax holiday is granted to pioneer industries or startups (Muyaa, 2018). This might be connected to a country's investment policies, such as the development of a new industry or new products or the expansion of an established industry (Muyaa, 2018). Furthermore, tax holiday can be targeted to particular sectors/industries or activities. In most instances, the country's goal would entail the development of specialized skills and the employment of its citizens.

Tax holiday provides full or partial tax exemptions (Easson, 2001). Full exemption, where an investor is exempt from both corporate income tax and withholding tax on dividend distribution, is unfavorable, especially for developing countries. This is because the host country not only gives up current tax revenues, but also offers an incentive for investors to repatriate profits rather than reinvest them. This outcome may undermine the intended purpose of tax holiday. On the other

hand, partial exemption provides a lower rate and is generally easy to administer. However, the main challenge arises when determining which income qualifies for the lower rate, especially for enterprises that generate income from multiple types or sources.

2. Advantages and Disadvantages of Tax Holiday

Tax holiday have the apparent benefit of simplicity from the perspective of both the enterprise and the tax authorities (Easson, 2001). If no tax is payable during the holiday period, no formalities should be required, and no compliance or administrative expenditures should be incurred (Easson, 2001).

Most studies have determined that a short tax holiday is rarely advantageous in attracting investment other than short-term projects (McLure, Jr., 1999). The short tax holiday is most valuable to short-term investments that may be anticipated to provide a quick return and are consequently quite effective in attracting investment in export-oriented sectors (Laukkanen, 2018). It is common for an enterprise to receive a tax holiday in one country and, when it expires, to relocate its whole business to another country that is ready to provide a new holiday. As a result, the host country's benefit may be highly restricted. A longer tax holiday is certainly to be a more effective inducement, but it raises the cost to the host country in terms of revenue foregone. That cost cannot be estimated in advance, nor is it connected to the amount of the investment or to the advantages that are supposed to flow to the host country.

Furthermore, the tax holiday is particularly vulnerable to manipulation and provides opportunities for tax avoidance and abuse (Muyaa, 2018). Expenditures are deferred until after the holiday period ends; hence the existence of the tax holiday may actually act as an obstruction to new capital investment. Instead of expanding current activities, new companies are founded to receive additional tax holiday. In certain circumstances, businesses are transferred to related companies, and a new tax holiday is claimed (Muyaa, 2018). As a consequence, despite their popularity, the tax holiday is among the least effective and efficient forms of tax incentive (McLure, Jr., 1999).

Tax holiday are also susceptible to transfer pricing schemes in which MNEs shift income to tax holiday entities. MNEs have a solid incentive to shift income from taxpaying to tax holiday entities and shift deductible tax costs from tax holiday entities to taxpaying to lower corporate tax payments (McLure, Jr., 1999).

3. Tax Holiday in Indonesia

In Indonesia, the tax holiday is regulated under Minister of Finance Regulation Number 130 of the year 2020. The tax holiday is intended for pioneer industries in specific sectors that have extensive linkages, provide high-added value and externality, introduce new technology, and provide strategic value for the national economy. The following sectors fall under the tax holiday category: upstream metal, oil and gas refinery, petrochemicals, basic chemicals, pharmaceutical materials, electromedical equipment, electronics or telematics equipment, machinery, robotics components, power plant machinery, motor vehicles, vessels and trains, aircraft and supporting activities, agriculture, economic infrastructure, and digital economy.

The tax holiday grants a 100 percent reduction in CIT for a minimum investment of IDR 500 billion and a 50 percent reduction for a minimum investment of IDR 100 billion. The period is between 5 and 20 years, depending on the investment value.

Research & Development (R&D) Tax Incentive

1. Definition and Explanation of R&D Tax Incentive

Innovation is commonly regarded as a cornerstone of sustainable economic growth and prosperity, as well as fundamental to business success and to the development of emerging economies (Arginelli, 2015). Tax incentives targeted at promoting R&D in creating valuable intangible assets and accumulating knowledge seem to play a critical role in stimulating innovation (Arginelli, 2015). R&D tax incentives may be utilized to enhance investment attractiveness.

Actual R&D activities to develop intangible assets can be referred to as input activities, while the activities of exploitation of the intangible assets can be referred to as output activities (Arginelli, 2015). Tax incentives for input R&D activities, such as tax credits calculated in relation to the input R&D activities carried out. Other input R&D activities tax incentive is additional deductions in connection with actual R&D costs incurred, which are sometimes provided regardless of the location of the output of the R&D activities. This policy is primarily intended to make the country more appealing to innovators by encouraging knowledge-based capital investment, expanding local skills, and attracting foreign direct investment (Arginelli, 2015).

The application of low effective tax rates to income derived from the transfer and/or direct use of intellectual property constitutes a tax incentive for output R&D activities under IP box regimes (Arginelli, 2015). With output R&D activities tax incentive, governments do not explicitly encourage the establishment of R&D but rather its exploitation, as only successful innovations are rewarded (Spengel et al., 2022).

Focusing on the output activities of the R&D process will allow countries to be more competitive in attracting corporate mobile capital (Laukkanen, 2018). Theoretically, to qualify for the output R&D activities tax incentive, it is sufficient for a company to have control over the relevant intangible assets, which can be purchased or licensed from third parties, without the need to engage in risky and time-consuming input R&D activities (Arginelli, 2015).

2. Advantages and Disadvantages of R&D Tax Incentive

R&D tax incentives can be used to incentivize R&D investment or to increase location attractiveness, but they are also frequently prone to profit-shifting opportunities. Most studies indicate that input R&D activities tax incentives effectively increase R&D expenditures (Appelt et al., 2016). Utilization of R&D tax credits helps to achieve product innovations in SMEs (Labeaga et al., 2020). Evidence suggests that tax incentives in input R&D activities may enhance the transfer of knowledge among researchers (Arginelli, 2015).

However, studies do not provide conclusive information regarding the overall effectiveness and efficiency of the R&D tax incentives. Positive spill-over effects may result in higher social benefits even when the tax forgone is greater than the increase in R&D investment (Parson & Phillips, 2007). Studies indicate that the long-term effects of R&D tax incentives are typically greater than their short-term effects and that R&D tax incentives focused on small and medium-sized enterprises (SMEs) are usually more effective and efficient than those aimed at large corporations (Baghana & Mohnen, 2009).

In general, input R&D activities tax incentives promote the creation of valuable intangible assets. In contrast, output R&D activities tax incentives support the goal of promoting the efficient and effective use of newly created intangibles, particularly where it applies to the profits deriving from the direct use of the intangibles, in addition to the transfer of the intangibles to third parties (Arginelli, 2015).

However, input R&D activities tax incentives do not always result in an increase in the taxable income, productivity, or employment of the country that offers such incentives. Valuable intangibles created in the country providing generous input to R&D activities tax incentives might be transferred overseas or employed in the production process in another country (Arginelli, 2015). Input R&D activities tax incentives may be less efficient than output R&D activities tax incentives since they tend to reward projects that may never result in any valuable outcome for intangible assets (Arginelli, 2015).

On the output R&D activities tax incentive side, the disadvantage will be determining who should benefit the most from the tax incentives. It has been observed that output R&D activities tax incentives do not result in any real economic spill-over (Arginelli, 2015).

Moreover, the OECD BEPS Action 5 Final Report classified certain existing specific tax regimes as harmful tax practices, including IP box regimes without a substantial activity requirement (OECD, 2015). The IP box regime did not necessarily require a nexus between the tax incentive and R&D activities within one country (OECD, 2015). As output R&D activities tax incentive, the IP box regime is often ineffective in increasing R&D investment (Spengel et al., 2022).

3. R&D Tax Incentive in Indonesia

In Indonesia, the R&D tax incentive is regulated under Minister of Finance Regulation Number 153 of the year 2020. The R&D tax incentive is intended for taxpayers that engage in their R&D activities and collaborate with domestic R&D Institutions. R&D activities are limited to the focus of themes and topics of R&D based on the National Research Master Plan.

R&D tax incentive allows additional deduction of up to 300% of expenditures incurred in specific R&D activities in Indonesia, which will be levied over the following years.

DISCUSSION

What Tax Incentive Should Indonesia Choose?

The implementation of Pillar Two will have an impact on a country's tax incentive policy. According to research from World Bank, tax holiday, zero CIT rates, or any other tax incentives that reduce the ETR below 15% are incompatible with Pillar Two (World Bank, 2021). In order to protect the tax base, Indonesia needs to evaluate and reform its tax incentive regime. Therefore, Indonesia needs to implement a tax incentive policy that aligns with the principle of Pillar Two. By introducing such a policy, Indonesia can foster economic growth while remaining compliant with international tax standards. Among the various options available, providing tax incentives specifically for R&D activities emerges as a promising solution.

Based on Global Economy data, R&D expenditure in Indonesia from 2016 to 2020 was only below 0,3 percent of GDP. The average R&D expenditure was 1,3 percent. This indicates a relatively low investment in R&D activities compared to other countries. Such a low level of expenditure may have implications for the country's ability to innovate and drive advancements necessary for economic growth and competitiveness in the global market. The data can be seen in the chart below.

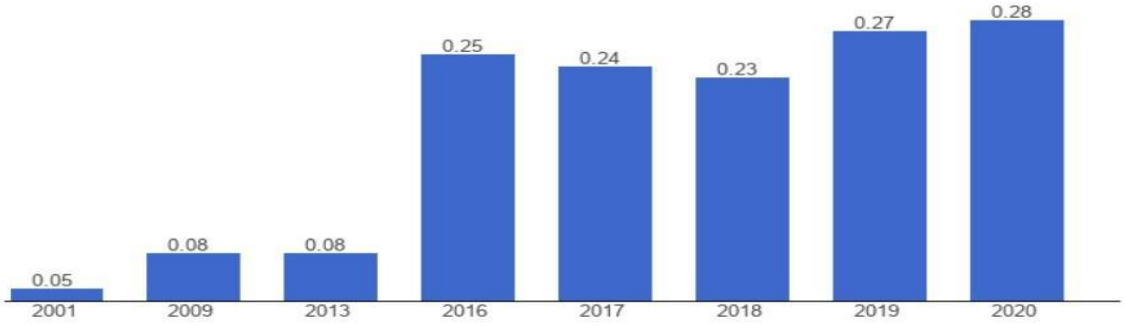


Chart 1 R&D expenditure in Indonesia

Source: https://www.theglobaleconomy.com/Indonesia/Research_and_development/

Tax incentives for R&D can be a viable option for Indonesia due to several compelling reasons. First, empirical research finds that increasing R&D activities by one percent of GDP increase economic growth by 0.32 percent to 1.18 percent (Akcali & Sismanoglu, 2015). Encouraging R&D through tax incentives stimulates innovation and technological advancement within the country. By providing tax incentives, the government incentivizes companies to create new products, services, and processes. The employment of newly created intangibles for the production and provision of new products, services, and processes generates positive externalities, such as the creation of new markets and, therefore, additional economic growth.

Second, the importance of innovative activities is accentuated during an economic crisis, as persistent R&D performers seem to survive crises better than their competitors (Spengel et al., 2022). In that sense, high R&D intensity acts as a form of insurance against future economic downturns. Therefore, it is of primary importance for governments to provide a healthy environment to R&D-performing firms in general and hold tools ready to strengthen R&D in times of crisis, such as the current COVID-19 pandemic.

Third, R&D tax incentives can bolster Indonesia's position as a regional hub for innovation and attract global talent (Arginelli, 2015). By offering attractive tax benefits to R&D-focused companies, Indonesia can entice multinational corporations to establish research facilities within the country. This influx of expertise and investment would foster knowledge transfer, enhance local capabilities, and create a vibrant ecosystem conducive to research and innovation.

Furthermore, tax incentives for R&D can have multiplier effects across various sectors of the economy. Increased R&D spending stimulates demand for inputs, such as specialized equipment, infrastructure, and skilled labor, leading to more investment and positive spill-over effects. Additionally, the commercialization of intangibles from R&D can result in the growth of supporting industries, productivity, and increased tax revenue in the long run (World Bank, 2021).

Between the two types of tax incentives in the R&D sector, input R&D activities tax incentives are particularly well-suited, especially in the form of tax credits. Unlike IP box regimes, tax credits directly target R&D investment, ensuring a more direct link between the incentive and the desired outcome. Governments can direct tax credits towards specific R&D priorities by establishing clear criteria and guidelines. This targeted approach enhances the effectiveness of the incentives and helps align R&D activities with national innovation goals. Furthermore, IP box regimes can be

susceptible to exploitation for tax avoidance purposes, manipulating their IP income to maximize tax benefits without necessarily undertaking substantial R&D activities.

How are Tax Incentives to be Pillar-Two Compliant?

R&D tax credits may either be implemented as a volume-based investment tax credit or an incremental tax credit (European Union, 2014). A volume-based investment tax credit is computed as a fixed percentage of qualifying R&D investment expenditures incurred in a current tax year. Alternatively, an incremental investment tax credit is computed as a fixed percentage of qualifying R&D investment expenditures in a year in excess of the relevant tax year.

The concept of Substance Based Carve-Out (SBIE) is rooted in the notion of tangible substance and actual activity within a jurisdiction. This suggests that R&D tax incentives can play a more important role in aligning with the SBIE concept. One particular type of R&D tax incentive, known as the R&D tax credit, holds significant potential, especially when structured as a volume-based credit that allows capital and payroll expenses as eligible expenditures. By incorporating capital and payroll expenses into the calculation of the tax credit, the R&D tax incentive aligns with the fundamental principle of the SBIE. The R&D tax credit serves as a powerful tool in this regard, as it not only incentivizes companies to allocate resources towards R&D activities but also rewards them for their tangible investment in capital and workforce.

Moreover, to truly align with the Qualified Refundable Tax Credit (QRTC) criteria, the R&D tax credit can be structured to provide a cash or cash equivalent refund within four years. This means that companies engaging in R&D activities can receive a direct financial benefit through a refund, which can be reinvested in further innovation or used to bolster their financial position. The compliance of the R&D tax credit with the principles of QRTC offers several advantages.

First, it ensures that companies are not merely receiving tax credits that can only be used to offset future tax liabilities. Instead, they can receive a direct benefit, which can be particularly valuable to fuel their R&D activities, hire a talented workforce, and invest in necessary equipment or infrastructure. Second, it can attract investment because of compliance with Pillar Two, fostering economic growth, technological advancement, and competitiveness globally.

If the R&D tax incentive can be classified as a QRTC, the ETR will be above GMT even though the statutory tax rate in the country is lower than GMT. This indicates that adopting R&D tax incentives that are compliant with Pillar Two have a significant impact on tax incentive policy. Indonesia may grant tax incentives in the form of lower tax rates than GMT, as well as R&D tax credits. Also, by incentivizing R&D activities, the Indonesian government can still attract investment, encouraging innovation and stimulating economic growth.

The illustration of the R&D tax credit as QRTC is shown below.

		X Corp
GloBE Income	(A)	1.000
R&D Tax Credit (QRTC)	(B)	150
Adjusted GloBE Income	**(C=A+B)**	**1.150**
Tangible Assets	(D)	200
Payroll Expense	(E)	100
SBIE	**(F)**	**26**

Excess Profit	**(G=C-F)**	**1.124**
Tax (10%)	(H)	100
QRTC Added Back		150
Total Covered Tax	**(I)**	**250**
Effective Tax Rate (ETR)	**(I / G)**	**22,24%**
Top Up Tax		**0**

Illustration 5 R&D tax credit

Explanation:

1. Assume that the GloBE Income of X Corp is 1.000
2. R&D tax credit is 50% of SBIE (tangible asset and payroll expense), so 50% of (200+100) is 150
3. Because the R&D tax credit complies with QRTC, it is added back to the GloBE Income. So, the adjusted GloBE Income is 1.150
4. SBIE is 8% of tangible assets and 10% of payroll expense = (8% x 200) + (10% x 100)
5. Therefore, excess profit is the GloBE Income minus SBIE = 1.150 – 26 = 1.124
6. Assume CIT rate is 10%, below the GMT, so tax is 10% x 1.000 = 100
7. QRTC is re-added because it was previously subtracted, so the covered tax is 250
8. ETR becomes 22,24%, more than GMT, so there is no top-up tax

CONCLUSION

In light of the recent international tax developments, particularly the introduction of Pillar Two, it is crucial for Indonesia to re-evaluate its tax incentive policy. The implementation of Pillar Two, which aims at address Base Erosion and Profit Shifting (BEPS), necessitates a thorough examination of existing tax incentives to ensure their compatibility and effectiveness within this new framework. Among the various options available, the author argues that the Research and Development (R&D) tax incentive, explicitly focusing on input R&D activities, emerges as the most favorable choice to align with the requirements of Pillar Two.

By incorporating Pillar Two into its tax incentive policy, Indonesia can demonstrate its commitment to international tax standards and strengthen its position as an attractive designation for foreign investment. As the world becomes increasingly interconnected, it is vital for Indonesia to adapt its tax framework to global consensus, enhancing its reputation as a responsible global player.

Among the various types of R&D tax incentives, the focus on input R&D activities proves to be particularly advantageous for Indonesia. A well-designed input R&D activities tax incentive can encourage companies to invest in innovation, leading to the creation of high-skilled jobs, the transfer of advanced knowledge, and the growth of a vibrant ecosystem for research and development.

However, implementing an R&D tax incentive requires careful consideration and design. Clear guidelines, proper monitoring mechanisms, and robust enforcement are essential to prevent abuse and ensure tax incentives are directed towards genuine R&D activities. Collaborative efforts between the government, industry stakeholders, and research institutions are necessary to

establish a comprehensive and practical framework that maximizes the benefits of the R&D tax incentive.

Nevertheless, it is also essential that the government considers non-tax factors to improve Indonesia's investment attractiveness, including the general business environment, investment in infrastructure and people/skills, and effective public administration.

REFERENCES

Akcali, B.Y., & E. Sismanoglu. (2015). *Innovation and The Effect of Research and Development (R&D) Expenditure on Growth in Some Developing and Developed Countries.* 195 Procedia – Social and Behavioral Sciences.

Appelt, S. et al. (2016). *R&D Tax Incentives: Evidence on design, incidence and impacts.* OECD Science Technology and Industry Working Papers.

Arginelli, Paolo. (2015). *Innovation through R&D Tax Incentives: Some Ideas for a Fair and Transparent Tax Policy.* World Tax Journal.

Baghana, R, & P. Mohnen. (2009). *Effectiveness of R&D Tax Incentives in Small and Large Enterprises: Analysis of Enterprise Data in Québec.* 33 Small Business Economics.

Easson, Alex. (2001). *Tax Incentives for Foreign Direct Investment Part II: Design Considerations.* Bulletin IBFD.

European Union. (2014). *A Study On R&D Tax Incentives Final Report.* Working Paper N. 52

International Senior Lawyers Project (ISLP). (2022). *A Guide for Developing Countries on How to Understand and Adapt to the Global Minimum Tax*. International Institute for Sustainable Development and International Senior Lawyers Project.

Labeaga, J.M. et al. (2020). *Does Persistence In Using R&D Tax Credits Help To Achieve Product Innovations?* Working Papers Department of Applied Economics II of Universidad de Valencia.

Laukkanen, A. (2018). *Chapter 5: Special Economic Zones: The Acceptance of Tax Incentives in the BEPS World in Tax Incentives in the BEPS Era.* Books IBFD.

Lillo, F. De., (2020). *Chapter 1: Introducing Pillar Two: Towards a Global Minimum Effective Tax Rate in Global Minimum Taxation?: An Analysis of the Global Anti-Base Erosion Initiative.* Books IBFD.

McLure, Jr, Charles E. (1999). *Tax Holidays and Investment Incentives A Comparative Analysis*. Bulletin IBFD.

Muyaa, Emily. (2018). *Chapter 2: Tax Holidays in Tax Incentives in the BEPS Era.* Books IBFD.

Parson, M, & N. Phillips. (2007). *An Evaluation of the Federal Tax Credit for Scientific Research and Experimental Development.* Canada Department of Finance Working Paper.

Obuoforibo, B. et al. (2020). *Global Minimum Taxation?: An Analysis of the Global Anti-Base Erosion Initiative.* Books IBFD.

Organisation for Economic Co-operation and Development (OECD). (2020). *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS.* OECD Publishing.

OECD/G20. (2015). *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report.* IBFD.

OECD/G20 Base Erosion and Profit Shifting Project. (2021). *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy.* OECD Publishing.

Spengel, Christoph, Barbara Stage, & Daniela Steinbrenner. (2022). *R&D Tax Incentive Regimes – A Comparison and Evaluation of Current Country Practices.* World Tax Journal.

The Global Economy. (2023). Retrieved May 12, 2023, from https://www.theglobaleconomy.com/Indonesia/Research_and_development/

The Global Economy. (2023). Retrieved May 12, 2023, from https://www.theglobaleconomy.com/rankings/research_and_development/#:~:text=Researc

h%20and%20development%20expenditure%2C%20percent,67%20countries%20was%201.3%20percent.

United Nations Conference on Trade and Development (UNCTAD). (2000). *Tax Incentives and Foreign Direct Investment: A Global Survey.* UNCTAD.

World Bank. (2021). *The Global Minimum Tax: from agreement to implementation." Overview booklet. Information and Communications for Development*. World Bank.