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Policy Brief

Taxation to the rescue?

A tax reform to support EU economic recovery post-COVID-19

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#Corona
#Taxation
#BEPS

The COVID19 – crisis puts a strain on public households in the EU, not only because of necessary rescue packages, but also due to a drop of tax revenues in the face of an economic downward spiral. A European tax reform to support the economic recovery without putting an extra burden on companies is thus in strong need. One solution is to secure corporate taxes that formerly slipped through public budgets due to tax avoidance. In this Policy Brief, Pola Schneemelcher argues that the EU must now focus on the already proposed international minimum tax rate. Member states will not be able to implement it on their own; consensus at international level is necessary, but noncommittal. A legally binding solution can therefore only exist at EU level.

Introduction

When the Corona crisis struck and its economic damage became obvious, costly rescue packages were quickly put together across the EU. While these measures are absolutely necessary, they certainly put a strain on public budgets. This burden is further aggravated as tax revenues drop during an economic downward spiral, with struggling companies, a deteriorating labour market and falling demand. Thus, a European tax reform to support the economic recovery through increasing fiscal revenues without putting any extra burden on companies or households is a must.

One idea in this regard is to get a firm hold on corporate taxes that previously slipped through treasury nets due to tax avoidance. However, this asks for action at EU level to be effective and there is no prospect of such a reform so far. History shows that political agreement on a European tax reform is hard to reach and a lengthy process, since it requires the backing of each member state ("unanimity principle"). But there is already an interesting proposal at a wider international level, which promises to generate tax revenue by setting a floor on tax avoidance. This so-called "Two Pillar Approach" introduced by the OECD and the G20 Inclusive Framework (IF) is not only ready for settlement, consent internationally is also likely to lead to swifter agreement among EU member states and final translation of the proposed measure into EU law.

In the following we will therefore first look at why a European solution is necessary and define its contours if it is to support economic recovery (part II). We find that the international approach at hand has all the features required to combat tax avoidance and secure revenue for public budgets while likely to facilitate agreement at EU level as well (part III). Finally, a perspective is given on what needs to be done at European level to progress this solution as quickly as possible (part IV).

The EU during the crisis

Taxation to the rescue?

The Corona crisis is hitting European economies hard: forecasts estimate a GDP drop of 7.5% in 2020 and only provide pessimistic growth projections going forward. Simultaneously, the unemployment rate is expected to shoot up to around 9% in 2020 with total employment shrinking by 4.5%. Naturally, this affects European public finances through ambitious rescue packages and fiscal transfers on the one hand, and through a sharp decline in economic activity on the other: The EU's aggregate government deficit is expected to reach 8.5 % in 2020 and the public debt-to-GDP ratio could rise to up to 95% in 2020.

The situation in member states' budgets is aggravated by a general slump in tax collection. Due to a fall in activity and output, the most severe decline in revenue is expected to come from corporate taxes. As companies hit the buffers, unemployment rises and wage bills drop. This again leads to a sharp decline in social security contributions and personal income taxes. Simultaneously, the subsequent collapse of private consumption causes a decline in revenues from indirect taxes such as Value Added Tax (VAT). However, when it comes to taxes, forecasts remain vague. But we can expect them to suffer a double whammy: member states have to finance rescue packages and deal with higher public debt, while tax revenues fall in the face of an economic crisis and rising unemployment. Thus, the lack of tax yields may become a long-term problem standing in the way of economic recovery in the EU. A tax reform which (1) generates more corporate tax revenues (2) without placing an additional burden on ailing companies is thus vital.

Why a European solution?

The most straightforward way to generate fiscal revenues without raising corporate tax rates is to (a) combat tax avoidance to secure revenues that have so far slipped through the hands of treasury ministers and (b) effectively tax digital business models. The former is decisive, because even before the crisis, European member states suffered massive damages due to tax avoidance with annual losses of around EUR 46 billion (before Brexit). An effective tool to secure these revenues will thus cushion the devastating effects of costly anti-COVID-19 measures on national budgets.

The latter matters, because Covid-19 has led to increased profits for digital companies. An OECD report published on April 15th points out that "the tax challenges of the digital economy will become more prominent in a post-pandemic environment" as digital business models can easily switch to home office routines and also increase profits now that the whole world requires digital services. It is therefore necessary to ensure effective taxation of digital companies in order to capture these extra profits.

Combating tax avoidance and effectively taxing digital business models are closely intertwined: while multinational enterprises (MNEs) in a globalised world can shift their profits to low tax jurisdictions to avoid paying taxes in general, digital business models, which strongly rely on intangible assets (e.g. algorithms, software), can challenge international tax rules at a wholly new level (see Box 1).

Box 1: Understanding the Problem

The current tax system is based on the - arguable - premise that multinational companies are taxed where value is created. According to the OECD Model Tax Convention, this location is defined as a permanent physical establishment (or the "nexus"), which is the tax presence of a company in a state or jurisdiction, e.g. the headquarters of a company. A globalised world and ever digitising economy now call this model into question, because:

(1) Value creation through intangible assets such as software or algorithms rarely requires a physical headquarters in the country where a multinational company is economically active. They can operate remotely.

(2) Activities such as the collection or processing of data that increasingly contribute to value creation do not constitute a permanent establishment under current tax law. Rather, they are defined as routine or auxiliary activities that fall outwith value creation. Accordingly, many countries have no possibility of taxing earnings generated by multinational enterprises that are, in fact, economically active in their jurisdiction.

(3) Multinational enterprises can also shift profits to subsidiaries established in low-tax countries, thereby minimising their fiscal burden in a high-tax jurisdiction. This is because the profit allocation rules (recorded in the OECD's transfer pricing guideline) feature the so-called arm's length principle. According to this principle, the price charged for transactions within a company, the „transfer price", must reflect the market price that independent parties would have paid for similar transactions. Since intangible assets like algorithms are usually unique structures and their value is hardly comparable to other intangible assets in the market, transfer prices can be set arbitrarily.

For more information, see our paper "Tax me if you can".

Alas, national measures against tax avoidance have proved ineffective in the past. On the one hand, because multinational enterprises (MNEs) can, as we have seen, easily switch to low-tax countries as soon as one member state tightens its tax laws. On the other hand, international peers have already threatened counter-measures, e.g. high import duties on goods from the member state in question, when they fear a competitive disadvantage for their goods and services due to a national tax reform (e.g. the recent tax dispute between the US and France). In this respect, and albeit tax policy traditionally resides in the realm of national competences, an effective, legally binding tax reform to combat avoidance and contribute to economic recovery can only exist at EU level.

Furthermore, a common regulatory approach in the EU would be less of a burden for troubled MNEs. Up to now, companies must comply with different tax regimes in every European member state where they are economically active. This creates administrative costs and makes the single market less attractive for production and investment. Common rules would financially relieve businesses, including those hardest hit by the crisis.

What would a common European strategy look like?

However, a common European tax reform to fight the damage wrought by COVID-19 is unlikely to see the light of the day any day soon. Historically, the EU has already made some effort to partly harmonize the different national tax regimes. One example is the so-called Common

Consolidated Corporate Tax Base (CCCTB).[1] Another would be the common tax on digital services, the so-called Digital Service Tax (you can find the in-depth analysis in our paper). But until now, the implementation of these European initiatives failed due to political disagreements among member states and, finally, the unanimity principle.[2]

At the same time, there is a proposal at international level, the so-called “Two Pillar Approach” (see part III) introduced by the OECD and the G20 Inclusive Framework (IF)[3], which could be an important step towards higher tax revenues and a common, legally binding European solution in support of economic recovery. This is because:

1. it offers a hands-on approach to secure revenues by drawing a floor underneath tax avoidance through an international minimum tax rate,
2. it proposes new rules for the effective taxation of digital business models, and
3. as non-binding consent on international level has often been translated into legal acts in the past (e.g. the EU’s ATAD directive), international consensus could trigger common reforms at EU level.

The “Two Pillar Approach” as a solution for Europe?

The genesis of a solution

The aforementioned “Two Pillar Approach” proposed by the OECD/IF at the end of last year marks the peak of international efforts to fight so-called “Base Erosion and Profit Shifting” (BEPS)[4]. Already in 2013, the “Action Plan on Base Erosion and Profit Shifting” (BEPS Action Plan) was published and declared war on tax avoidance. One of its focal points was the effective taxation of the digital economy. The OECD/G20 BEPS project then published preliminary conclusions in 2015 in the BEPS Action 1 report: (1) Intangible assets play an increasingly important role in all economic sectors. Thus, the tax system must fit the economy as a whole and a solution ring-fenced around digital business models is inadequate. (2) As the use of intangible assets facilitates BEPS, the adaptation of existing tax rules to a new digital reality must go hand in hand with the fight against tax evasion and profit shifting. (3) The reform of the international tax system must display the basic paradigm that profit is taxed where value creation takes place. These three premises can be seen as the basic prerequisite for international consensus. As a result, member states agreed to find an adequate solution within the OECD/IF framework before the end of 2020.

A solution was presented in the form of a Policy Note last year which introduces two pillars: Pillar One focused on the allocation of taxing rights and was initially meant to acknowledge the US wish to grant market jurisdictions - i.e. countries where consumers and users of digital services are located - a greater share of the pie. It contained three possible solutions to complement and go beyond the arm’s length principle. Pillar Two helped meet the EU’s wish for an efficient instrument against tax evasion and profit shifting. These proposals were later combined into a “Two Pillar Approach” with a consistent “Unified Approach” for Pillar One and a minimum tax (“GloBE”) for Pillar Two. In late January 2020, the OECD/IF published another statement, concretizing these twin pillars:

1 In short, the CCCTB consists of two steps: in a first step, companies in the EU can file a single tax notice for all its European activities (instead of one for each member state as before). In the second step, the so consolidated tax base is allocated between the member states in which the company is economcially active. The allocation takes place through an apportionment formula. Each member state can then tax its portion according to its national rate.

2 Following Art. 113 & 115 TFEU, all tax decisions taken at European level must be endorsed by all the member states.

3 The OECD/G20 Inclusive Framework on BEPS (Inclusive Framework) is a group of 137 countries and jurisdictions, who multilaterally negotiate international tax rules.

4 Intentional reduction of tax bases through cross-border movement of profits to low-tax jurisdictions in order to avoid taxes in countries with regular tax rates.

- The Pillar One proposal (or “Unified Approach”) aims to revise the permanent establishment definition and adapt current profit allocation rules to the digital economy. What Pillar One in fact does is to extend the concept of permanent establishment to ill-defined “consumer-facing businesses” with a significant economic (no longer physical) presence in a jurisdiction: where a business is economically significant as measured by its turnover relative to the size of the targeted market. The allocation of profits then follows a three-step approach[5] which combines old and new profit allocation rules.
- The Pillar Two (or “GloBE”) proposal is mainly seen as a backstop for Pillar One, generating allocatable tax revenue by setting a floor underneath tax havens. The proposal allows countries to tax the foreign income of indigenous companies if the effective overseas tax rate falls below a certain minimum. The country of the parent company therefore levies additional taxes (“Income Inclusion Rule”). If a company is not subject to this rule, payments made to foreign subsidiaries based in low-tax jurisdictions are only deductible as costs to a limited extent (“Tax on Base Eroding Payments”). For both rules to work, a targeted test is necessary to find out if a company’s effective tax rate falls short of the negotiated minimum tax rate.

How can this help the EU?

At first glance, both pillars seem to combine different criteria which are of utmost importance for the EU to generate revenue for a swift economic recovery: Pillar One could help reaching consensus within long-running debates that were in the EU’s crosshairs even before the Corona crisis, namely fair taxation of the digital economy, and skimming off taxes on the rising profits of digital companies. Pillar Two could potentially drain tax havens of their allure and secure a solid tax base which is essential for governments compelled to take ad hoc measures costing hundreds of billions of euros. Consensus within the OECD and international peer pressure could finally lead to the translation of both pillars into EU law.

While both pillars display decisive flaws, the analysis shows that Pillar One in particular is not sufficiently developed yet. First, both pillars contain a multitude of blurry definitions, most of which still need to be fleshed out in what can be expected to become a fierce political debate. But Pillar One stands out as regards inaccuracy. For example, it lacks a proper definition of key concepts such as “consumer-facing businesses”. In its January statement, the OECD/IF tried to remedy incomplete definitions through more detailed, non-exhaustive lists narrowing down the concepts, but always with the caveat of expanding them again later. Here, the OECD/IF risks ring-fencing the scope of the measure while simultaneously opening loopholes for tax evasion. For Pillar Two, the final minimum tax rate is still to be decided. Second, both proposals are highly complex and thereby risk significantly complicating the international tax system as well as creating new loopholes. But again, Pillar One is the main issue here. The numerous carve-outs and the combination of existing rules and new rules could mean continued tax avoidance and also heavy administrative burdens for both companies and the tax authorities.
Consequently, even the OECD’s own forecast assumes that its international redistribution effects will be small and the gains of the Unified Approach are disproportionate to its complexity. Tax revenues stemming from Pillar One will thus do little for European public budgets.

5 A fixed, deemed percentage of non-routine profits (i.e. profit share exceeding a certain profitability threshold or the profit left over when all functions within the company have been allocated a routine profit) is allocated to the market states through formula apportionment. Here, factors such as the turnover achieved in the market state or intangi ble assets („Amount A“) are taken into account. Part of the profit classified as routine profit (i.e. combined profit from controlled transactions) is then distributed based on existing transfer pricing rules. This so-called “Amount B” repre sents profits generated through marketing and sales activities. Last but not least, another part of the routine profit can be added to the aforementioned, but only if the company carries out additional business activities in the market state („Amount C“).

In contrast, the (optimistic) impact analysis of the OECD has shown that the second pillar will generate a "significant amount of additional tax revenue" worldwide. The only missing piece in the puzzle: a tax rate in concrete numbers. But existing examples of the income inclusion rule (such as the European CFC rules) and the tax on base eroding payments (such as the US BEAT) have already proven to be effective as such. Thus, a minimum tax rate would limit losses through profit shifting (which includes tax avoidance of digital business models) and guarantee higher revenues. As such, it is the prerequisite for Pillar One.

Conclusion & Outlook - What needs to be done

As the analysis shows, Pillar Two must be the EU's priority, but consensus has not yet been reachedt. Thus, the proposal's translation into EU law remains a matter of speculation. But history has shown promising examples in this regard. International peer pressure has often pushed reluctant member states to change their minds on a critical topic. Therefore, three things must be done at European level to get reluctant member states on board, speak with one voice in international negotiations and enable a quick solution to support economic recovery post-COVID-19:

- Pillar Two must be prioritized in international negotiations. In order to find common ground among member states (especially as regards a specific minimum tax rate), the impact analysis announced by the Commission must be published as soon as possible. Apart from this, member states already in favour of Pillar Two need to increase peer pressure at OECD level.

- The OECD/IF initially announced it would continue the process as planned despite Corona. In May, however, it rejected this plan and pushed the decision into 2021. In contrast, EU executives made the issue a strategic priority in the Corona crisis. As there is no comparable solution at EU level at hand, member states now need to stick to this and insist on a timely resumption of international negotiations.

The fair and effective taxation of digital business models remains an issue that is crucial for the EU. Although Pillar One should not be prioritized in the fight against Corona impacts, the EU must stick to its plans and continue working on the topic, namely include it in the already existing formula apportionment proposal in the framework of the CCCTB.

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