Trade Union Advisory Committee to the OECD
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TUAC

Public consultation on the Pillar One and Pillar Two Blueprints

Comments by the TUAC

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Introduction

TUAC welcomes the opportunity to contribute to the OECD consultation on Pillar One and Pillar Two Blueprints. This publication follows the November 2019 consultation on a proposed unified approach to address the tax challenges of the digitalisation of the economy, and the December 2019 consultation on Global Anti-Base Erosion proposal.

The present consultation focuses on the technical aspects of the Blueprints, leaving aside key features which, according to the consultation document, should be resolved by a high level political process. This is regretful. Limiting consultation to technical aspects favours tax consultants and tax lawyers. It does not allow other representative stakeholders to the broader policy orientation and general design of the Blueprints.

The political and economic landscape have significantly evolved in the past twelve months, in particular in the light of the financial impact of the pandemic. As governments are preparing their recovery, it is important for the Inclusive Framework to strengthen its legitimacy and to consult widely with a view to ensure that international tax reform meets public expectations. On the general design of the Blueprints, our recommendations are as follows:

A decoupling of the two Pillars. Reaching an ambitious agreement under Pillar 2 should be treated as a priority as this would limit tax competition between countries and help raise tax revenues. More work is needed on Pillar 1, including to address complexity and impact.

Ensuring a robust agreement on Pillar 2 would also give countries the breathing space towards a global excess profit tax in addition to a more fundamental reform of the current international taxation rules.

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General comments

The proposed new rules would have a twin objective:

- to target large and highly profitable MNEs that benefit from the current gap between tax rules (designed for brick and mortar businesses) and the disruptive business model of the digital economy (Pillar I); and
- to resolve the old issue of harmful tax competition by creating a defensive legal framework allowing government to set a minimum taxation benchmark for MNEs through a global minimum tax rate (Pillar II).

Achieving agreement on pillar 2 to help raise revenues to finance the recovery

The TUAC response to the 2019 public consultations argued that revised allocation rules must go hand in hand with global efforts to stop the tax rates competition. Pillar 2 can address long-standing issues around the under-taxation of international businesses and mutually harming "tax competition".

Meanwhile, the COVID pandemic has brought a new sense of emergency. As governments will be looking at ways to finance the recovery, an OECD-led reform must bring in the short-term realistic prospects of a better fight against corporate tax avoidance. Pillar 2 offers the most promising prospects in this regard. According to the impact assessment, a minimum rate as low as 17% could already bring an increase of 3 to 5% of global corporate tax revenues, amounting to USD 74 to 125 billions. (see TUAC comments on the impact assessment).

An agreement on an effective minimum tax rate at global level is urgently needed. to be effective, the minimum rate should be set at 25%, in line with the effective tax rate observed across OECD economies. Setting a minimum well below the average rate does not respond to public demand for tax justice. Aligning the rate to those of tax havens (10-15%) would have an inhibiting effect on the amount of tax revenues that could be raised. Beyond that, Pillar 2 should ensure:

- Exceptions and carve outs are limited to the strict minimum, such as institutions that have a social purpose. All activities and in particular patent boxes must be fully included within the scope of the reform.
- Lowering the threshold. The OECD impact assessment report concludes that lowering the threshold would not substantially increase revenues. But it would make a big difference to curb unfair tax competition. The proposed EUR 750 million threshold would indeed exclude the vast majority of multinationals from the scope of Pillar 2.
- Sufficient consideration is given to source countries in the implementation of Pillar 2, including to the places where economic activities are taking place.

Focussing Pillar 1 global excess profits

The narrow scope and complexity of pillar 1 remain of concern. More work remains to be done in order to achieve a reform with tangible impact.

At the outset we regret that Pillar 1 does not aim at addressing the under-taxation of digital activities front on, but rather to limit the objective to reallocation of revenues. In its cover statement to the Blueprint, the Inclusive Framework recalls that the pandemic makes the need for a solution even more compelling: “the time will come when governments will need to focus on putting their finances back on a fair and sustainable footing”. It appears however that the vast majority of corporate profits of highly digitalised multinationals will continue to be taxed according to the current, ill-adapted, transfer pricing rules. Their under-taxation will therefore not be addressed.

Ensuring under-taxation is fully addressed is also needed in the short term to prevent further trade tensions to exacerbate. For a number of countries, a central question is whether Pillar 1 can lead to sufficient tax revenues to refrain from moving toward unilateral or regional digital services taxes. If Pillar 1 does not deliver on that front, the likelihood of new and expanding DST will increase, and for a cause.

Even within the narrower objective of reallocation of profits, Pillar 1 could be considerably improved. The initial mandate of Pillar 1 is set out in the March 2018 OECD “interim report” is to address: (i) the inappropriate nexus as companies are able to conduct an economic activity without physical presence; (ii) the heavy reliance on unique and highly mobile intangible assets; and (iii) the value of data and users’ participations.

These concerns calls for a fundamental review of the corporate tax rules and a reform of the transfer pricing rules, shifting from self-serving and complex arm length’s principle to unitary taxation. The Blueprint for Pillar 1 needs further improvement to meet these challenges, including addressing:

- The instability created by untested concepts such as “consumer-facing business” could encourage further accounting manipulations;
- The low and arbitrary nature of the reallocation ratio: a small portion of an MNE profits would be concerned, after out-of-scope revenues have been set aside;
- The counter-productive natures of the many tests and de minimis rules to isolate in-scope revenues from other revenues. Key sectors of the economy such as financial services are also excluded from the scope. Additional features, for instance setting aside the new taxing right in case transfer pricing rules already apply which may further reduce these estimations.

Moving ahead, and with a view to address under-taxation in a digitalising economy, it is essential to improve the proposal toward the creation of global excess profit tax. In this regard, the consultation draft refers to a “profit escalator” proposal to apply a formula based on the profitability of the group (#524). Such “profit escalator” would indeed lead to an increased effective taxation of companies generating higher returns in market countries (e.g. monopolistic rents). This is particularly relevant at a time when highly digitalised businesses have largely benefitted from the pandemic. A refocus on profitability may bring a much welcome diversion from scoping issues, which appear to be the most problematic aspects of the Blueprint.

Specific remarks – Pillar One

I. The activity test to define the scope of Amount A

The notion of "consumer-facing businesses" introduces untested concepts and excludes business-to-business activities from the scope of Amount A. Whilst no rationale is given for this policy choice, the implementation of this reduced scope may lead to complex and perhaps arbitrary assessments by tax authorities. This is evidenced by the lengthy considerations that the Blueprint is giving to the numerous products and services that will fall within both consumer-facing and B2B categories.

As the scope and reallocation of Amount A is limited, the current transfer pricing rules will continue to apply to the vast majority of profits. Instead of addressing the complexity of the arm length principle, Amount A will in fact add a layer of new rules without addressing the weaknesses of the existing architecture. Different regimes will co-exist, often within the same company group, creating considerable complexity and uncertainty.

The Blueprint also leaves significant space for exceptions. Any exemption must be justified by clearly defined social objectives, such as responding to the needs of developing economies. This could be the case of natural resources to the extent that a shift of taxing rights to market jurisdictions may deprive developing economies from much needed resources. However, the rationale for excluding financial services from an additional taxing right is not supported by evidence. The text makes the very bold assumption that the financial sector is adequately governed by existing transfer pricing rules. Yet, on the basis of public country-by-country data, a recent study estimates that European banks are strongly engaged in profit shifting and tax planning[i].

The proposed "safe harbour" rule would create additional uncertainty. The Blueprint optimistically believes that tax certainty offered by Amount A will constitute an attractive choice for MNEs. The safe harbour will in fact increase regulatory arbitrage, as companies will elect the regimes which are most suitable to their corporate tax strategy. Furthermore, whilst governments will be expected to withdraw their unilateral digital services taxes, there is no guarantee that Amount A would, as a compensation, raise sufficient revenues from US based companies.

II. Design of a specific Amount A revenue threshold (in addition to a global revenue threshold) to exclude large MNEs that have a de minimis amount of foreign source in-scope revenue

The identification of a domestic or home market is of key importance for workers. A number of obligations to the workforce are indeed attached to the nationality of the controlling undertaking. A clear and stable definition is needed, paying particular attention to consequences beyond the taxation field. For instance, bringing excessive importance to headquarters without due regard to where the workers are located would further encourage regulatory arbitrage and hence support unfair labour competition. Corporate law, and in particular the real seat principle, offers interesting avenues for reform as it seeks to tie the place of decision-making to where economic activities are genuinely carried.

III. The development of a nexus rule and IV. The development of revenue sourcing rules

As described by the OECD in its March 2018 report, the current requirement for physical establishment is an important tax challenge of the digitalisation of the economy. The rules are ill-adapted as many MNEs are able to generate profits from a remote location. Yet, the modified nexus rule proposed by the Blueprint will apply only to a small portion of an MNE profits, after out-of-scope revenues have been set aside. The requirement of "plus factors" for CFB activities comes as an additional restriction to the application of a new taxing right.

This means that the requirement for a physical presence will remain the norm for highly digitalised businesses. A major driver for their under-taxation will therefore remain unaddressed. In contrast, the Blueprint contains valuable proposals for revenue sourcing rules, which in fact provide interesting indicators to identify value creation. These indicators could constitute a good starting point for a discussion on an improved nexus.

V. The framework for segmenting Amount A

Already in November 2019, TUAC expressed concerns about calculating profits on the basis of segments based on business lines. Parent companies are already presenting segmented accounts as annexes to the consolidated accounts. These segments are being determined at the sole discretion of the company. A particular choice of segmentation is often made in order to present results in a favourable light. As segmentation can have an influence on the overall level of taxation, more arbitrary and self-serving business decisions will be taken for the purpose of aggressive tax planning. The risk of manipulation would be particularly pronounced if regional profitability is allowed, thereby defeating the primary purpose of trying to determine profit at group level.

As the Blueprint is now putting forward an even more complex and limited scope of application for Amount A, the questions of business segmentation has become even more acute. Recognising the potential complexity of segmenting business lines, the Blueprint proposes to use proxies in the form of fixed percentage. This is opening the door to arbitrary decisions, without guaranteeing simpler enforcement. Geographical segmentation is of particular concern. This would greatly undermine the calculation of profits a group level.

VI. The development of a loss carry-forward regime that would ensure that Amount A is based on an appropriate measure of net profit.

Loss carry-forward regime can be a significant source of tax savings, and as such the differences between differing national approaches are exploited by MNEs. Such regulatory arbitrage can result in intra-group restructurings, with adverse impact on employment. A consistent approach to loss carry-forward regime throughout a company group may therefore be helpful. However, strict rules must be put in place to ensure that tax liability is not unduly reduced. In particular, allowing MNEs to report losses for an unlimited period of time and/ or for an unlimited amount would lead to abuse, thereby defeating the whole purpose of a consistent regime.

VII. The scope and relevance of possible double counting issues arising from interactions between Amount A and existing taxing rights on business profits in market jurisdictions.

The Blueprint suggests not to apply Amount A where the company is already subject to transfer pricing rules in the marketing jurisdiction. This proposed safe harbour runs against the very idea of Pillar 1, which is to address the deficiencies of the current rules in the digitalising economy.

The risks of double counting arise from the incoherent juxtaposition of different tax regimes. The only way to address such incoherence is through the adoption of a long lasting reform, based on unitary taxation and reallocation of profits through a set of balanced criteria.

IX and X. Amount B

Amount B seeks to respond to national concerns about the weaknesses of the current transfer pricing rules by assigning a minimum amount of returns to marketing jurisdictions. Rather than addressing the weaknesses of the current international tax architecture, Amount B therefore adds another layer of complexity to the current rules and constitutes a potential source of arbitrary decisions and disputes. With a unitary taxation system, whereby the profits of a group of company would be determined globally and allocated in accordance to balanced repartition keys, the need for Amount B would disappear. Such reform would be simpler to implement and reflect more accurately the economic reality of multinationals.

XI. The development of an early tax certainty process to prevent and resolve disputes on Amount A

Stepping up dispute prevention and resolution is a logical response to the introduction of moving concepts and arbitrary proxies. According to the Blueprint, Amount A may only be used by a country if it also commits to a dispute prevention process. An MNE may decide to reject the outcome of the process. If the MNE agrees to it, the outcome will be binding even on non-participating jurisdictions. Such process raises questions of tax sovereignty and fair representation of all interests in the panel. Furthermore, the choice of arbitrators and other procedural safeguards needs to be clarified. Finally, the Blueprint pays no attention to the excessive reliance on secrecy in dispute resolution processes. Workers and other stakeholders that may directly suffer from aggressive tax planning will not have access to the proceedings.

Specific remarks - Pillar 2

The swift adoption of a minimum tax rate at global level is a priority for the trade union movement. The following comments focus on applicable rate, scope, tax base and fair treatment of all countries as these are key elements of design to secure a strong reform.

I. Introduction and executive summary

A differentiated treatment of US based MNEs is proposed under Pillar 2. Like Pillar 1, no clear rationale is given to justify such safe harbour, which will give rise to discrimination.

The upcoming US administration has announced proposals to strengthen GILTI, including in particular raising the effective rate of taxation to 21% and jurisdictional blending. Further discussions are required in order to achieve a convergence of rules, building on the strongest features of both systems.

II. Scope

According to the Blueprint, a EUR 750 million threshold will be introduced so as to align Pillar 2 with the scope of the country-by-country reporting. The OECD impact assessment report concludes that lowering (increasing) the threshold would not substantially increase (decrease) revenues. However, considering the fundamental importance of Pillar 2 in reducing tax competition, such high threshold would still be counter-productive.

With the current threshold the vast majority of MNEs would indeed be excluded from the scope of the reform. The issue of compliance costs for companies must be put on an at least equal footing with societal interests. In particular, workers need to ensure that profit shifting to low tax jurisdictions is curbed so that liquidities remain within the business for the benefit of employment and long-term investment. Furthermore, there is the issue of a level playing field, because tax avoidance by MNEs continues to disadvantage companies that operate only domestically. The EU annual accounts Directive is applicable to MNE groups with an annual turnover of EUR 40 million and 250 employees[ii].

Exemptions must be justified by clearly defined social objectives. Such would be the case of financial institutions that have a clear identified social protection objectives, such as retirement and pension schemes. The case of investment funds is, however, less clear cut. A distinction should be established between retail collective investment vehicles and private pools of capital such as private equity and hedge funds. There may be ground to apply a tax neutrality principle to collective investment vehicles[iii]. It is an entirely different story for private equity funds and hedge funds. Because of its overreliance on debt finance and the opacity of its governance arrangements, private equity should be considered as a business at risk of aggressive tax planning of debt finance and therefore fully covered by Pillar 2.

IV. Carry-forward and carve-out

Considering the fundamental importance of Pillar 2 in reducing tax competition, the tax base should be as wide as possible so as to capture all economic activities. The Blueprint suggests carving out routine activities from the scope of Pillar 2, including tangible assets as indicators of substantive activities. Such carve out may however legitimise tax competition including in high tax jurisdictions (e.g. patent boxes). The OECD impact assessment estimates that pockets of low-tax profits in high tax jurisdictions could reach USD 350 billion, a considerable amount that should come within the scope of the minimum tax.

VI. Income inclusion and Switch-over rules and VII. Undertaxed payments rule

Indeed, as the right to "tax back" can be applied up to the minimum rate it is important to ensure that the rate is set at an equivalent level to the average OECD effective tax rate. The minimum effective rate should be set at 25%.

Fairness towards all countries is an important aspect of Pillar 2, especially towards developing economies which are very reliant on corporate tax revenues. Granting priority to an income inclusion rule implies that international taxation rules do not treat source and residence countries on an equal footing. It also raises practical questions of implementation and double taxation as, in the recovery context, source countries are likely to unilaterally applying measures to protect their own tax base. The Inclusive Framework should therefore urgently reflect on appropriate solutions to achieve a fair balance of revenues among residence and source countries.

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[i] Fatica, S. and Wildmer G. (2020) How much profit shifting do European banks do?, Economic Modelling, Volume 90, 2020, Pages 536-551, ISSN 0264-9993, https://doi.org/10.1016/j.econmod.2020.01.026.

[ii] Article 3.7 of EU Directive 2006/43/EC

[iii] It can be argued that the asset manager of a retail collective investment fund has a purely passive portfolio approach to the invested companies (they do not intervene in the management of the companies) and that the portfolio composition is diverse by sector (and hence by debt funding needs).