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The Gathering Storm? The Other Side of the Covid Portal

BY WILL MORRIS

Back in April, in an article on these pages, I quoted from a piece in the Financial Times by the Indian writer, Arundhati Roy: ''*Historically, pandemics have forced humans to break with the past and imagine their world anew. This one is no different. It is a portal, a gateway between one world and the next.*'' While I thought it was a great quote, I did wonder (as did some readers) whether it was a little hyperbolic. Six months on, ''perhaps not'' seems to be the answer.

While for some people, in some countries, life (other than travel) has hardly changed; for many others it looks like it may have begun to change immeasurably, and for the worse. Economic inequality in the developed world, which had begun to narrow, has significantly widened once again. And the triumph of lifting so many of the world's poorest out of extreme poverty, has (according to a recent World Bank report) also dramatically reversed during the pandemic, with an additional 100 million people falling back below the extreme poverty line of $1.90 a day.

We are still, sadly, in the acute phase of the crisis in Europe, the Americas, and the Indian subcontinent, with more societal pain (and economic damage) potentially to come. Most governments are still spending whatever they need to, but it is clear that citizens are already growing tired of restrictions and tensions are rising. And as a result of all of these factors, particularly once we enter into the chronic (post-vaccine) phase of the crisis, based on our experience following the Global Financial Crisis, politics could become more toxic in many countries.

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There is, it seems (yes, Churchill, again), a gathering storm.

Scanning the Horizon

In my last few articles, I have written exclusively about the OECD project. But in this one (with an eye to that storm) I survey a number of international tax trends and see if it is possible to pull together a number of disparate strands in an effort to perceive what may be coming towards businesses in the international tax area. I look at the current state of the OECD project; the onward march of digital services taxes (DSTs) and other unilateral measures; developed vs. developing country issues; transatlantic tax tensions; and, revenue needs, Covid-related measures, and the tax impacts of the pandemic. I can only scratch the surface on all of these issues, but there is also something to be said for scanning the whole horizon, to better discern the nature and potential intensity of the coming storm.

The OECD Digitalization Project

So, first, the OECD project on the taxation of the digitalizing economy. With the October release of the blueprints on Pillars 1 and 2, and the meetings of the Inclusive Framework and G20 finance ministers, which were originally scheduled to approve the ''final agreement,'' we have a better idea of where things stand.

The documents show detailed work that clearly reflects agreement in some areas. But the number of highlighted ''political'' questions still to be resolved shows how far there is to go. For example, Amount A—the profit reallocation provision—is clearly still bedeviled

not just by the issue of whether the U.S. wants a ''safe harbor'' or not. There are issues around the scope of automated digital services and consumer facing businesses; whether to phase in one before the other; the quantum of the reallocation (and whether digital should be higher); how extensive tax certainty (i.e., dispute prevention/resolution) should be, particularly the emotive issue of mandatory binding arbitration; and over Amount B (fixed returns on routine marketing and distribution functions), where a serious expectation gap has emerged between developed and developing countries.

On Pillar 2, countries appear to be closer to agreement, although the unwillingness of some countries to agree that GILTI is a Pillar 2 compliant regime before agreement by the U.S. on Pillar 1 (i.e., digital) has meant the language on this key provision is currently high-level and lacking in detail. However, an examination of the Pillar 2 mechanics reveals very significant areas of complexity (e.g., around accounting and the calculation of the country level ETR), which trouble many countries—not to mention businesses—and then there are unresolved questions of Pillar 2 dispute resolution, and the architecture of an international framework that can require, and enforce, a common interpretation.

None of these issues alone is insoluble, but it will require goodwill and time. We must hope for that, but the current environment is challenging.

The Onward March of DSTs and Other Gross Revenue Taxes

One element of that challenge comes from the onward march of DSTs and other gross revenue taxes. These have increased in number, primarily, but not just, in Europe, over the past year. The day of the recent G20 meeting, the French Finance Minister blamed the U.S. for the failure to reach an agreement, and announced the end of the Franco-U.S. moratorium on the French DST. Presumably USTR will revive its sanctions proposals, and perhaps also announce measures in some/all of the other 10 open investigations. That in turn likely will bring retaliation from the EU, who have also just been empowered to impose up to $4 bn of tariffs on U.S. goods in retaliation for U.S. aircraft subsidies.

On top of this, India and, potentially, Indonesia have with their expanded Equalization Levy, and Electronic Transactions Tax, respectively, imposed much broader-based gross revenue taxes on a wide range of digitally-based transactions. There are also questions around the form of the EU's (so far, vague) May 2020 proposals to impose both a ''digital levy,'' as well as a tax based on ''the operation of large companies,'' to finance its ''own resource'' needs—but it does appear that one or both might be a broad-based gross revenue tax. In short, there seems to be a worrying trend of expanding the scope—with no discernible natural boundaries—of these unilateral, gross revenue-based measures.

To state the blindingly obvious, the growth of taxes that (1) take no account of profit margin (and thus a business' ability to pay) and (2) are outside the tax treaty system and, thus, the reach of existing dispute resolution procedures, will likely lead to significantly more tax tension between countries. In a pre-Covid world this might have provided momentum for agreement at the OECD; post-Covid that might be less likely.

Dissatisfaction of Less Developed Countries

Another example of growing centrifugal forces can be found in relation to less developed countries (LDCs). It's important up-front to acknowledge that this is a very crude term that covers at least three different types of country: large economies, often with some developed country features; smaller economies with significant natural resources; and smaller economies without natural resources. I have referred to the disagreement over Amount B, above, where LDCs would like a relatively high fixed margin, while developed countries would like a much lower one (a replay of BEPS Action Item 10 over ''low-value-adding services''). That probably affects most strongly the third category of country, and explains some of the concerns of the African Tax Administration Forum (ATAF). But Amount A raised some issues for the second set of LDCs, when rewarding the ''market'' as opposed to the ''source,'' threatened the revenues of resource-rich LDCs (hence the Amount A carve-out).

However, even those in the first category (which includes some of the BRICS) who sit outside the OECD also have concerns about the OECD digitalization project. These focus not just on the limited revenue the provisions would raise for LDCs, but also the complexity which could challenge the ability of LDCs to administer both Pillars 1 and 2. This, in turn, explains the interest in not just Amount B, but also the Subject to Tax Rule (STT) in Pillar 2, which prioritizes that rule over the Income Inclusion Rule and allows for withholding (i.e., base protection, rather than topping up the tax of another jurisdiction).

The accelerating discussion at the UN about a proposed revised UN Model Tax Treaty Article 12B on income from automated digital services (either a 3-4% withholding on gross; or, tax on 30% of the share of global profit allocable to a country, based on its share of global revenue), as well as the ATAF proposals on DSTs, again indicate the direction of travel. These developments, taken together with some relatively critical recent comments on the OECD process, raise the question of whether the compromise reached at the Funding for Development (FfD) conference in Addis Ababa in 2015 not to elevate the UN Tax Committee to full intergovernmental status is coming under strain. If so, this could create further issues for the OECD process.

Ongoing Transatlantic Tax Tensions

The transatlantic tax issues (primarily with the EU) also revolve significantly around DSTs and minimum taxes. But those are far from being the only elements of tension. The ongoing state aid cases (albeit based on old planning structures) continue to make the news, and influence politics, especially in Brussels. Additionally, with a new permanent subcommittee on taxation in the European Parliament on ''evasion, avoidance and transparency,'' there could well be more public hearings involving U.S. corporations.

Tariffs (also mentioned above) continue to heighten tensions, and while a potential new U.S. administration might offer the chance for a policy reset, it should be remembered that both in relation to digital, as well as older disputes, there has not been much daylight be-

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tween U.S. administrations of either party stretching back to the 1990s. Perhaps the root of this problem is that these disputes are, in the end, more about competition between Europe and the U.S. than they are strictly about tax. So, if tax is being used as an instrument to further, or suppress, competition, traditional tax policy answers are not going to be sufficient. A broader consensus/agreement/reset will need to be reached.

The Relentless Pressure for Tax Transparency

Another issue linked strongly, but not exclusively, to the EU, relates to the growth in ''tax transparency''. In the five years since the OECD launched Action Item 13 confidential Country-by-Country Reporting (CbCR) to tax authorities, the calls for—and movement towards—greater tax transparency have significantly increased. The European Commission, having already mandated it for extractive companies, and for banks, proposed a limited Public CbCR in 2016 for all businesses, which was promptly blocked by a number of countries, most notably Germany. But, over the intervening period, opposition has waned, and it seems likely that a blocking majority may no longer exist in the EU.

It also seems likely that the EU will expand their original proposal to more closely match the recently adopted provisions of Public CbCR in the Global Reporting Initiative (GRI) standard 207-4, which calls for significant public reporting of tax data. The International Business Council (IBC) of the World Economic Forum in September called for an alternative measure in its sustainability reporting metrics. This standard calls for public reporting of all taxes, not just corporate income taxes, borne (or borne and collected) by a business—in order to give a more holistic picture of a business's overall fiscal contribution. There has also been legislation introduced in the past year in both houses of the U.S. Congress calling for Public CbCR.

It remains to be seen what will happen, and when. But if there is greater tax transparency in the future, then other stakeholders (politicians, the media, NGOs, local country competitors) could use it to argue for increased taxation of MNEs. Without a strategy for discussing what this publicly available data means, businesses will likely face increased headwinds from the media and politicians, as well, of course, from local tax authority auditors.

The Covid-19 Crisis and Tax

And finally, there are the tax effects of the Covid-19 crisis. As mentioned above, moving into the chronic phase (post-vaccine), the economic damage will become much more apparent, especially as significant government support winds down. The language of ''winners and losers'' from the crisis, and the ''K-shaped recovery'' will dominate. Many businesses will find their business models under continuing stress; many others, particularly in the small and medium-size enterprise (SME) sector, will find their balance sheets significantly weakened. Digitalization and automation of services (already a flash point pre-Covid) will likely continue to accelerate, with an impact on unemployment in many sectors. Additionally, governments will need to repair their own balance sheets and the numbers are staggering—just for comparison, OECD Pillars 1 and 2 may raise up to $100 billion worldwide; this year the U.S. has already spent over $3 trillion on Covid stabilization and relief. Admittedly much can be done with ultra-low-cost borrowing, but it has already been made clear that taxes will play a part in the mix—and foreigners, MNEs, and solvent businesses (which will often be one and the same) will be in the direct firing line.

Any Shelter from the Storm?

I have, very briefly, attempted to describe the storm gathering on the other side of Arundhati Roy's portal, and quite a storm it will be. Finding shelter will be difficult, but there are certainly things that business can be doing, right now, to prepare:

- Businesses should continue to support tax multilateralism, even if the success of Pillar 1 seems in the balance. Perhaps smaller ambitions, or less complex projects, or cooperative endeavors with LDCs, for example, might rebuild confidence and bring countries that currently seem to be splitting apart back together again. But businesses need to support a process which still favors net taxes and treaty-based dispute resolution over one that doesn't.
- To preserve multilateralism and head off further uncoordinated unilateral action (DSTs, etc.), the issue at the heart of the ''digital'' debate—how to equitably tax the profits of businesses able to operate remotely without physical presence—needs to be addressed. That will certainly require flexibility from both business and governments. But even more importantly, it will require the articulation of a clear principle as to why this is necessary, and why any solution proposed is appropriate. As Amount A (and Pillar 1) has expanded, that principle has gotten lost. Nevertheless, without a solution to the underlying issue, it will fester, and what is, in many ways—at least in terms of quantum—a relatively minor issue, could bring the whole multilateral structure crashing down (remember that Archduke in Sarajevo?).
- While there is some skepticism about some of the grander corporate pronouncements on sustainability and stakeholder capitalism, including on tax, businesses are going to need to lean into this trend, or risk being overwhelmed. Post-Covid, public and political anger could focus on businesses that treat themselves as (profitable) islands unrelated to the society around them. And in those circumstances, greater tax transparency could prove a very attractive stick with which to beat them. The irony is that many businesses pay significant amounts of tax (income tax and otherwise) and also make great products or provide services that people want and which improve their lives. Greater connectivity with stakeholders, and telling that positive story should actually be good for the bottom line—done well.
- And, finally, businesses should prepare to pay more tax. This truly is a case where the only alternative to bending is breaking. So, businesses should begin to think (not yet offering, perhaps, nor ''bidding against themselves'') about how taxes could rise in the least damaging way. Next year (or the following) should governments begin to raise taxes, businesses should also be ready with ideas. Because of the totemic significance of the corporate income tax, this will likely involve some increases in rates (but even there it might be pos-

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sible to balance those with the removal of complexity; or of particularly arduous provisions, for example around expense allocation). But more importantly it could involve new thinking around, for example, carbon taxes, which also link to other growing concerns around climate change, or around the taxation of property.

A storm is coming, and trying to ignore it, or hoping that it can be held back, or convincing yourself that you alone will not get hit are not viable strategies. However, that said, there is much that can be done. But this is not a next-year project. It needs to start now, because the leading edge of the storm is already here, the wind is beginning to blow, and it has a ways to go yet.

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