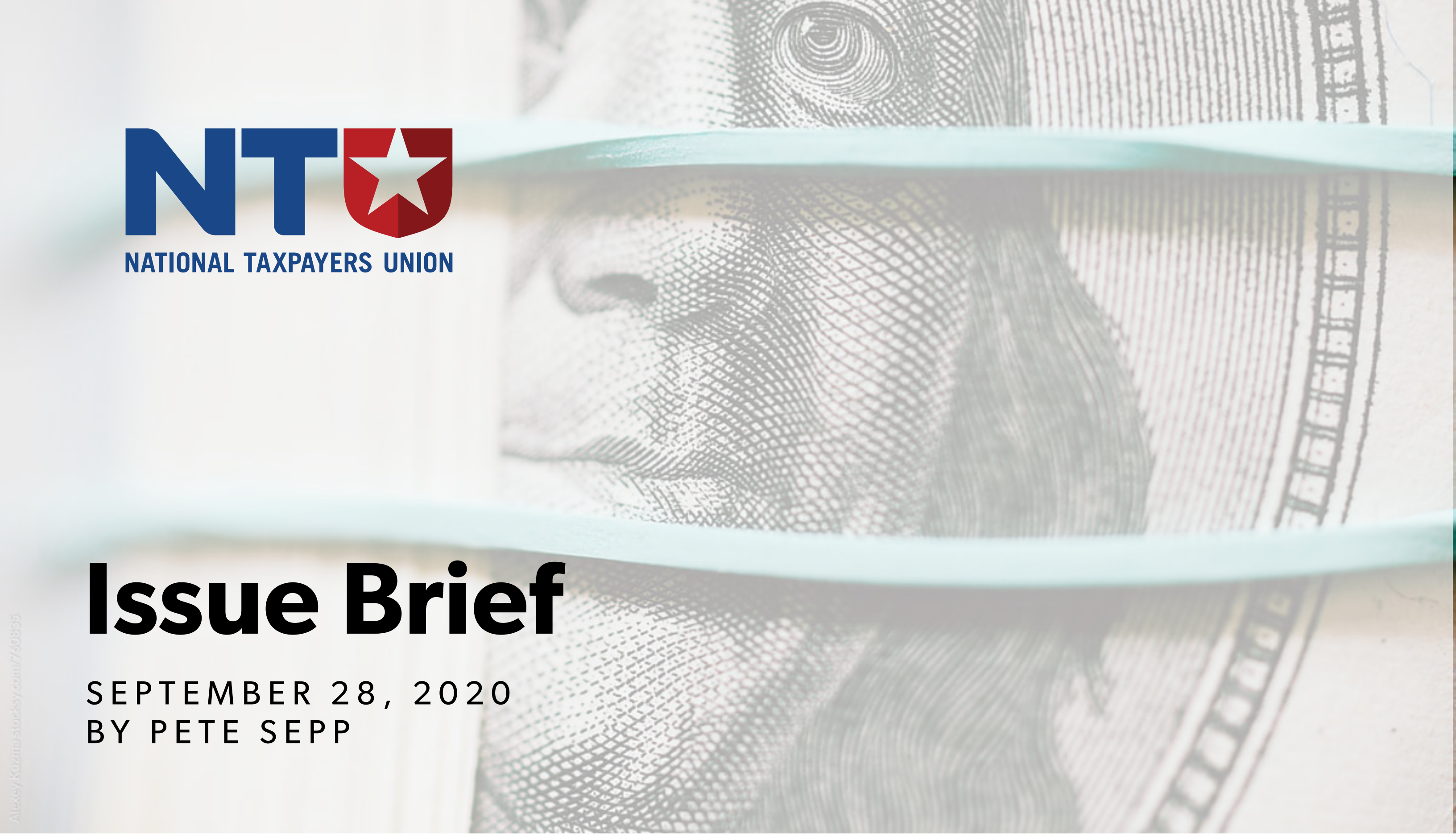

NATIONAL TAXPAYERS UNION

Issue Brief

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Shaky "Pillar 2" Tax Scheme from Overseas Could Crush Economic Recovery

The worldwide economy is attempting to find its footing and crawl out of a deep hole. Yet, a leaked draft plan for globally based taxation aimed at U.S. consumers and businesses demonstrates just how quickly a recovery could be sent reeling backward again.

As reported in Bloomberg Tax late last month, a confidential draft for leading tax officials of the Organization for Economic Cooperation and Development (OECD) surrounding "Pillar Two" of its dual-pronged approach shows ominous signs of the arbitrary, capricious, and administratively complex nature of global tax schemes that NTU has been warning about for several years. "Pillar One," which attempts to carve up multinational companies' receipts under a new definition of tax nexus and profit, suffers from operational flaws of its own. But "Pillar Two," which attempts to levy a global minimum tax on this ill-defined base, was regarded as the less technically difficult half of the plan (though from a revenue standpoint, more lucrative for participating countries).

Key Facts:

The OECD's "Pillar Two" global tax plan looks to be a way to threaten and punish successful American businesses that operate internationally.

The secretive process being used by the OECD means that uncertainty clouds many companies' forecasts, which is particularly harmful economically in a time of global health crisis.

Transparency and public engagement need to be at the forefront of this process, and making sure that Pillar Two policies aren't abusive and discriminatory would be a good step toward protecting American taxpayers.

Until recently, that is, when the leaked Pillar Two draft illustrated just how formidable the challenges are ahead. The problems start with transparency. No one outside of OECD member governments – not the practitioner community, the press, nor taxpayer advocates – has had the opportunity to examine in-depth and formally comment on significant details of where discussions were headed since late 2019. Nine months later, now we know why. For example:

1. **Why Not Choose GILTI?** The Pillar Two draft punts on the critical question of whether OECD's rules could simply mirror, with some adjustments, the Global Intangible Low-Taxed Income (GILTI) regime originally created in the Tax Cuts and Jobs Act of 2017 and finalized recently in IRS regulations. U.S. Treasury representatives have long contended that unilateral actions from the European Union, OECD, or other nations would be counterproductive in addressing whatever concerns foreign tax officials had expressed about U.S. multinational companies supposedly not paying their "fair share" of taxes around the world. Indeed, it could be argued that GILTI, having established a new minimum corporate tax, was designed to quell other nations' fears of "stateless income" going "untaxed".

   The fact that the Pillar Two draft continues to leave this question open may be a sign that OECD's leadership sees an opportunity for a bigger revenue grab in the current COVID-fueled downturn than initially anticipated. Ultimately this is a self-defeating approach, as multinationals will price this uncertainty into their reinvestment, rehiring, and other business plans for the future.

2. **Devils in the Details.** The draft also avoided taking a detailed stance on how to integrate provisions affecting minimum tax burdens a company might have to pay in its base country (the so-called income inclusion rule) versus the difference between the effective and minimum rate in other countries where that firm has subsidiaries (the so-called under-taxed payment rule). Integrating these rules is key to avoiding situations that would amount to double taxation of the same income – a huge challenge for tax administrators and even more so for taxpayers. The draft states that Pillar Two will give priority to the income inclusion rule over the under-taxed payment rule in transactions, but *how* it will do so remains a major question. For nearly the past three years, U.S. policymakers have had to address somewhat similar quandaries in designing GILTI rules, which will likely bring years more of private letter rulings and litigation before they are regarded as a stable component of tax administration. Such complications should serve as a cautionary tale to those who believe OECD's exercise will provide any further clarity to the international tax picture.

3. **Clashing Administrative Priorities.** Longstanding practical compliance issues with a global tax regime remain considerably distant from being resolved in the draft. July 31 comments from the Global Federation of Insurance Associations (GFIA) to OECD illustrated several ways that problems could arise. Under Generally Accepted Accounting Principles in a given country, the income from certain investment assets that are commonly held within long-term insurance policies is classified as revenue, whereas under separate criteria known as the International Financial Reporting Standard it may not be. This has a direct bearing on whether some companies' operations would fall under the new global taxation threshold of 750 million euros of "revenue."

The situation outlined above is analogous to the age-old subject of debate over the difference between "book income" and taxable profit of a company. Indeed, it is as current as proposals from presidential candidate Joe Biden and Senator Elizabeth Warren to radically shift the basis of corporate taxation toward the former concept and away from the latter. But the Pillar Two draft appears nowhere closer to designing a workable book income-based system of taxation than Biden or Warren. Jeff Hoopes, an accounting professor at the University of North Carolina, drily observed about the OECD draft, “the simple version of taxing book income is supposed to simply take this value and tax it. Looking at this 252-page document suggests that what started as allegedly simple will never survive and stay true to the simple proposal.”

Another problem is the tendency of many taxpayers to “overcompensate” with respect to vague laws out of fear that tax authorities could conjure up noncompliance issues from very thin air. As GFIA’s comments to OECD put it:

> Even where the ordering of the rules is clear, there could be cases where it would be very difficult to determine whether income is taxed below the minimum rate. This is especially so, where payments between independent parties are concerned. The payor may then be required to ascertain whether the recipient’s ETR [effective tax rate] is above the minimum taxation rate. Given the practical difficulties of that exercise they may be inclined to apply withholding tax just to be on the safe side. This again could lead to double or triple taxation.

Such a prospect of massive additional tax burdens would have predictable ripple effects. In the case of insurance, affordability and accessibility of coverage would be impacted. This is especially true with “reinsurance” for catastrophes like natural disasters, a type of coverage whose capacity depends on spreading risk across the globe.

Of course, OECD has provided revenue and investment impact estimates of its proposals as they have taken shape (at a combined annual estimate for both Pillars of $100 billion). On the other hand, too little serious modeling has been conducted to pinpoint the long-term damage that OECD’s approach could have on various areas of the economy – whether global insurance, or information technology, or any other affected industry for that matter. Analysis of this type would not be impossible, but without an ongoing, robust public engagement process, it is doubtful OECD has adequately considered undertaking it.

Pillar Two attempts to give some clarification on various other issues, such as hinting that a company will need to meet minimum tax rates on a county-by-country basis as opposed to globally or using a blended rate. But here again, details remain short. Jesse Eggert, a Principal with KPMG and former OECD advisor, told Bloomberg Tax:

> How complicated the system ends up being depends on a lot of things, including how many countries enact income inclusion rules, how many enact under-taxed payment rules, what simplification options end up being available, and how blending ultimately works. Until all those things are known, it’s difficult to know how complicated all of this ends up being.

In these uncertain times, knowing is more important than ever for businesses and their customers. The dual prospect of $100 billion in tax increases from a multi-country framework and untold millions more in compliance costs cannot bode well for a fragile economy that has just recently shown limited signs of returning to better health. The global pandemic continues to wax and wane in various parts of the world. Markets everywhere are attempting to adjust to fluid conditions. Are OECD’s planners totally oblivious to the fact that their proposals would amount to the largest global tax on businesses and consumers in history … even as OECD member governments have enacted desperate stabilization policies that could be undermined by such a tax?

At least some countries' leaders appear to be concerned that the direction of global taxation, which initially was aimed at U.S.-based tech firms, could be backfiring. Last month, U.K.-based media sources reported that the Chancellor of the Exchequer was considering repeal of a home-grown British Digital Services Tax (DST) whose concepts hew toward those of larger multinational projects like OECD's. Sources told the Daily Mail that Chancellor Rishi Sunak had concluded the tax, which falls on American companies, was "more trouble than it's worth" – especially after these same companies predictably began announcing they had no choice but to pass along the costs of the levy to consumers.

Although the Exchequer's office has since walked back these reports, NTU and its allies around the world have consistently warned public officials to expect unintended consequences from ill-advised DST schemes. This has even extended to the U.S. domestic level, where several states are attempting to install DSTs or their close cousins.

John O'Connell, Chief Executive of the U.K.-based TaxPayers Alliance, was kind enough to offer the following assessment of his country's DST and other onerous tax burdens exclusively to NTU for purposes of this Issue Brief. His conclusion—his country's Treasury should be embracing, rather than backing away from, repeal of the DST:

> Consumers can't win. If they drive to the shops, they're whacked with fuel duty and parking levies. And now a digital sales tax will simply increase the cost of online purchases. It's especially concerning now, as internet shopping has been a lockdown lifeline for millions of shoppers. Longer term, it will be damaging to the economy and distort decision making by innovative businesses. These measures must be seen off.

At the same time, seeing off the OECD's worst taxing impulses will be important as well. U.S. leadership is key. Given past bipartisan concern in Washington over single-nation or multinational tax plans that target U.S. companies, mustering Democrats and Republicans to speak with a unified voice on this issue is no pipe dream. NTU and its research arm, National Taxpayers Union Foundation, have made numerous recommendations for how such a voice may articulate itself, even if it comes from various quarters in Washington:

1. A joint resolution of Congress expressing opposition to revenue-raising ploys from other countries that are intended to single out and punish U.S. companies. Treasury negotiators should be encouraged to stand firm with their OECD counterparts against rash or harsh tax actions that could impede a worldwide economic recovery.
2. Serious consideration of how the Executive Branch could wield Section 891 of the Tax Code, which allows a President to order higher tax rates on foreign firms from countries whose tax policies have discriminated against American companies.
3. Utilization of the formal dispute process offered through the World Trade Organization – a process the United States has often employed successfully.
4. Inclusion of strong "national treatment" standards in trade agreements that would ban what amounts to tax protectionism via DSTs targeted at U.S. companies.

The temptation of all governments – within U.S. borders and overseas – for moving beyond short-term relief measures and responding to budget shortfalls for the next fiscal year will be to raise taxes first, preferably on "outsiders," and worry about pesky spending reductions later. This attitude, now becoming visible in European countries and elsewhere, only raises the stakes of the debate over Pillars One and Two.

Whether out of more selfish concerns over American governments missing out on revenues, or smarter concerns over American competitiveness and taxpayers' rights, U.S. officials can ill afford to ignore the tax threats beyond our shores. This is the case not only for Congress, but also the Trump Administration, which should refuse to be a party to any tax-hiking scheme.

One practical step should be to restore transparency and stakeholder engagement in the further development of Pillars One and Two – two principles which OECD had heretofore largely embraced but has recently made a low priority. Equally troubling is that there are currently no concrete plans at OECD to comprehensively assess the financial and compliance burdens of the proposals until after they are approved (possibly as soon as next month). Backward-facing tax policymaking is rarely a formula for success.

For their part, taxpayers everywhere should beware of events rapidly taking shape at the OECD's headquarters in Paris. They should also bear in mind the principle an NTU-led coalition expressed more than two years ago: "In a global economy, labor, investments, and trade can flow across boundaries to the benefit of everyone, provided governments don't attempt to overtax or overregulate them." There are no truer words today.

About the Author

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