International Taxation: Will Europe Ever Be Fit?

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1. An Outdated International Tax System

« There is no such thing as international taxation » (1)

- Tax is at the core of sovereignty – consent to tax/
- Tax is primarily a domestic matter
- International tax is recent (1920’s – League of Nations)

and mostly limited to bilateral tax relationships:

  - Double tax agreements based on Models (OECD/UN) – near 3500 DTAs
  - Aimed to eliminate double taxation
  - Subsidiary to domestic legislation (taxing rights not created by DTAs)

- With historically limited tax cooperation

« There is no such thing as international taxation » (2)

- Multinational economic groups are dealt with in bilateral treaties…

…but on a common principle: the Arm's Length Principle

  - The ALP does not consider MNEs as economic groups but looks at each legal entity
  - It is a transaction based principle: each transaction must be priced at market price (as if the entities were independent)

- The Principle contradicts the theory of the firm
  - Synergies and rents are not considered separately

An Outdated International Tax System…

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- Globalisation and financiarisation have put the system at a test
- First efforts in the late 70’s to avoid use of tax havens
- Combination of agressive tax planning and tax competition in the 80’s-90’s has resulted in disconnecting location of profits and location of activities (the tax haven issue)
- Lack of cooperation has facilitated agressive tax planning and lack of tax administration enforcement (including on individuals – bank secrecy
- In 2010: EUR 2 Tn of US MNE’s profits located in Cayman and Bermuda

…hard to change

- Domestic legislation is constrained by tax treaties because of hierarchy of norms
- Tax treaties take time to negociate (3 to 5 years) – extremely technical with little political attention
- The ALP is imbedded in tax treaties and its interpretation is based on consensus: hard to change
- The ALP dates back to 1928 but was explicited in the 1995 only (lag with globalisation) at a time where it was starting losing relevance
- No political interest in changing the system (« It is what it is »)

Without any EU dynamic

- Tax being at the core of sovereignty is to be rules by unanimity
- EU members have contradictory interests from high tax countries to tax havens (unanimity gives they key to the latter)
- Historically, little progress on legislative agenda: parent-subsidiary directive; interest royalty directive
- Ruding Report (1992) with no follow up
- EU fundamental freedoms limit member states capacity to protect their domestic systems – EUCJ decisions dismantled many domestic safeguard/anti-abuse mechanisms (Cadburry Schweppes…)
- EU is vulnerable to tax avoidance: No internal borders without external borders

2. 2008-2021: the International Tax Reform

Failed attemps in the 1990's

- G7 Lyon: mandate to the OECD to right a Report on tax competition
- « Tax Competition: a Global Issue », 1996
- OECD Harmful Tax Practices Forum and EU Code of Conduct Group (part of the Tax Package of Monti)
- The « failure »
  - US withdraws support in 2001 (Bush: « no tax havens, just tax hells »)
  - EU Savings Directive (co-existence)
  - Limitation of HTTP/CoCG work: strengthens tax competition
  - « Imperialistic » approach of OECD listing

The Global Financial Crisis and the Reform

- 2008 Global Financial Crisis and émergence of the G20 at Leaders’ level
- Series of leaks and scandals: Liechtenstein scandal, Luxleaks, HSBC leaks, Panama Papers, Pandora’s Papers, Paradise Papers…
- G20 mandates to the OECD to
  - End Bank secrecy
  - Establish automatic exchange of information
  - Address Base Erosion and Profit Shifting
- Agree a 2-Pillar solution to
  - Address the tax challenges of the digital economy (Pillar 1)
  - Establish a global minimum tax (Pillar2)

Global Progress has unlocked EU legislation

- Global governance and level playing field
  - Global Forum on Transparency and Exchange of information for Tax purposes (163 members)/ Multilateral convention with 150 signatories
  - Inclusive Framework on BEPS Implementation (142 members)/Multilateral instrument with 100 signatories
- A new archiecture
  - Exchange of information on request, including financial information (bank accounts, trusts)
  - Common reporting standard (automatic exchange of information)
  - BEPS 15 Actions: bridging the gaps between sovereignties (hybrids, interest deduction, transparency of tax rulings), fixing international rules (treaty abuse, permanent establishment definition, substance requirement for transfer pricing rules), increasing transparency (CBCR…)
- EU legislation implements: DAC/ATAD

3. The 2 Pillar Solution

BEPS Deficiencies, US Tax Reform and 2-Pillar Solution

- BEPS delivered patches to the international tax system but failed on
  - Action 1: no agreement to address the tax challenges of the digital economy
  - Transfer Pricing: limited substance requirements to realign profits with activities, with limited onshoring of activities from 0 tax jurisdictions to… Ireland
- 2017 US Tax Reform
  - Debate on Destination Based Cash Flow Tax (DBCFT)
  - Global Intangible Low Tax Income (GILTI) : a global minimum tax
  - Base Erosion Anti-avoidance Tax (BEAT): vote of non confidence against the ALP
- EU debate (and failure) on Digital Service Tax by fear of US trade retaliation and because of poor policy design (unilateral transaction tax)
- The 2-Pillar Solution is negociated from 2018 to 2021 (ups and downs with Trump; decisive progress under Biden)

Agreement on 8 October 2021

- A 2-Pillar Solution agreed by :
  - 137 countries representing near 95% of the world economy
  - Only 4 countries missing from the Inclusive Framework on BEPS (Keny, Nigeria, Pakistan, Sri Lanka)
- « Historic » success of the G20 :
  - « Reconciling the middle class with globalisation (Biden)
  - Stabilising the international tax system
- Ambitious implementation timeline: entry into force in 2023

PILLAR 1 – Addressing digitalisation and transfer pricing challenges

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- A **quantitative scope**: EUR 20 bn (10 bn after 7 years) and profitability of 10% – i.e. focus on the winners of globalisation (the winner takes it all… scope covers more than 75% of MNEs profit (finance and extractives are carved out)
- A **new nexus**: based on turn over (EUR 1 M, down to EUR 250 K)
- A **new taxing right (amount A)**: 25% of the excess return will be allocated to the market jurisdiction based on revenue sourcing
- **New tax certainty mechanisms** (Amount B on distribution activities; dispute prevention and dispute resolution mechanisms)
- **Commitment to removing DST**

PILLAR 2 – A Global Minimum Tax

- Drawing on GILTI, the GlOBE rules provide for:
  - A 15% Effective Minimum Tax
  - Scope: MNEs above EUR 750 M (only one sectorial exemption: shipping)
  - Jurisdictional blending (average effective rate per jurisdiction and not worldwide average as GILTI)
  - Based on financial consolidated account with few adjustments
  - A substance based carve out: 5% of payroll and physical assets (starting with respectively 10% and 8%)
  - Refundable tax credits/subsidies not impacted
  - A three-tier mechanism
    - Income Inclusion Rule (IIR)
    - Under Tax Payment Rule (UTPR)
    - Qualified Domestic Minimum Top Up Tax (QDMTT)
- A Subject To Tax Rule (STTR) at 9% for developing countries

4. Has the System Been Stabilised?

PILLAR 2: A Successful Implemention…

- Pillar 2 does not need universal implementation to have an impact: enough of a critical mass of countries
- US failed to implement Pillar 2 (IRA replaced Build Back Better); China does not want to implement Pillar 2 (Turning manufacture China into Innovation lab is based on tax exemption)
- But the EU adopted Pillar 2 in December 2022: IIR as of 1/1/2024 and UTPR in 2025 – EU is the critical mass of headquartered companies for IIR and as a market for UTPR
- Many other countries follow: UK, Japan, Canada (G7 –US), Indonesia, Switzerland (Constitution change – vote on 18 June), UAE…

PILLAR 2: …with a significant impact

- Fiscal impact is significant: EUR 240 Bn annually, even though hard to know about the allocation (depends on impact of QDMTT)
- Impact on tax planning is likely to be massive, especially combined with BEPS1.0 and with US tax reform
- Cost of compliance is high with high degree of complexity and integrated information systems
- Limited negative impact on investment (2% according to UNCTAD)
- Need to rethink policies on free zones and other tax incentives

PILLAR 1: Mission not yet accomplished

- Pillar 1 architecture was agreed on 8 October 2021: it means that all « signatories », including the US, agree that the current system does not allocate taxing rights properly
- Many important technical features remained to be agreed: elimination of double taxation (who pays?), safe harbours (is the new taxing right in addition to existing rent taxing rights or not?), modalities of tax certainty (arbitration is taboo).
- Pillar 1 requires a Multilateral Convention
    - On-going (late)negotiation with uncertain outcome (US hesitant, India demanding)
    - Even if signing by year end, ratification unlikely (2/3 majority in US Senate is required)
- « Amount B », most likely, low profile outcome

5. Next Steps

What's next? Short term

- Do US Tax Incentives comply with Pillar 2? On-going negotiation… Important that the EU does not cave: IRA tax incentives may not all qualify for P2 exemption
- Pillar 1 unlikely to be implemented immediately : who will win the blame game? US if treaty not signed; others if treaty signed
- Manage a period of turbulences until next US tax reform (likely in 2026 when Tax Cut and Jobs Act expires)
- Chinese position largely aligned with the US with specific provision on multinational companies in the early stage of their international development: will China hold to consensus?
- Developing countries are very frustrated: too little for them, too complex, ambivalence on tax incentives

What’s next? Mid-term

- Failure of immediate Pillar 1 implementation will trigger unilateral measures (DSTs) in emerging and developing countries, with trade tensions with the US
- Risk of UN/OECD competition with more unilateralism/fragmentation
- EU will face a new round of pressure to move to DSTs. Two (difficult) options:
  - No agreement because of Germany, Nordics and Ireland reluctance: Europe looks weak
  - Agreement with the US on a non discriminatory DST: but a non clever European tax on the Europeans
- Potential tension for UTPR implementation in 2025 (US pressure on Europe, but need for unanimity to change date)

What’s next? Long term

- Hindered tax competition but will CIT rates converge to 15%? (open question but i don’t think so)
- New architecture of transfer pricing (more destination based with unitary taxation) will be put in place eventually but unclear when and how (US will probably originate it)
- Need for simpler rules for developing countries, and more taxing rights to enable domestic resource mobilization (task for the UN)
- Tax certainty should be pushed by G7 with allies (India)
- EU path to harmonisation unlikely unless a path to build external borders is found

What’s next? Beyond the Pillars

- New global deals unlikely because of current geopolitical fragmentation
- No alternative standard to expect from the “Global South” because of lack of convergence China/IBSA
- G7 could possibly agree common approaches but US always unreliable (Executive cannot commit Legislative branch)
- Hopefully, previous agreements will hold as G20 legacy work
- New work areas:
  - Global mobility of workers (EU action is possible)
  - Harmful tax practices for individual taxation (exit taxes, minimum tax…)
  - Tax policy: capital taxation
  - Shipping taxation (on CO2 emissions)?

Thank you!

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