COVID19: The Challenges for International Taxation

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Introduction

Except for the unprecedented health crisis, the COVID-19 spread has generated the biggest economic and financial shock of the century across markets and cross-borders.[1] The preventive and reactive mechanisms developed by national governments and international and supranational organizations to respond to the crisis give in turn rise to a plethora of tax questions.

It is critical for businesses to understand how the various measures adopted impact on the tax systems and how these have transformed to react to the shock. As such, they will be able to ensure tax compliance while also taking advantage of any relevant tax incentives. Such exercise is particularly challenging, taking into account the complexity of the measures and the various levels in which they have been/are being developed: international, EU and national.

This article seeks to point out some of the most pressing tax questions arising in the new-normal and to propose an approach for a possible response. In particular, this article focuses on the issues of transfer pricing and of permanent establishment for international taxation purposes. It concludes that careful documentation and a case-by-case approach shall be essential for multinationals, and not only, to mitigate tax risks. It also concludes that a way out of the crisis demands a long-term and coordinated approach at supranational level.

Major Tax Questions

To face the health and economic crisis, national governments introduced lockdown measures, prohibiting or largely limiting manufacturing activities, restricting transport and imposing rigid and long quarantine periods for physical persons. For multinational enterprises, the new restrictive context for the performance of business activities questions their established transfer pricing policies. In addition, there is a clear risk for recognition of borderline permanent establishments at the place where employees have been restricted to (tele)work.

Transfer Pricing

To begin with the transfer pricing issue, the arm's length principle remains key. Transfer Pricing policies must ensure compliance with the arm's length principle, even under the present exceptional circumstances. Multinationals' main challenge though is to evidence through their transfer pricing documentation that registration of losses or low profits is due to the COVID-19 crisis, i.e. not due to transfer pricing manipulations. To this end, enterprises must:

- Have appropriate documentation in support of the economic results registered and reflecting the current conditions through the use of proper comparable data;
- Perform appropriate transfer pricing adjustments to justify the re-distribution of functions, activities and risks among the various entities of the group, taking into account the impact of the crisis to the supply chain.

In this light, multinationals should also take all necessary actions to safeguard the substance of their operations in all jurisdictions where they extend their activities, e.g. by employing substitute local directors where possible.

Permanent Establishment

As regards the permanent establishment question, clarifications have been given by the OECD. Specifically, the OECD focused on whether a dependent agent permanent establishment can be considered to exist at the place of work where employees are required to stay and work away from the original place of employment or from their domicile during the crisis[2]. In fact, under the restrictions imposed, many enterprises with cross-border activities have had to manage employment relations with frontier workers, unable to return to their residence place and/or to implement smart working with the effect that the place of employment be transferred at the employees' domicile.

The OECD explained that in principle a permanent establishment[3] cannot be considered to qualify at the so-called home-office. This is especially because such temporary mode of work has been adopted for the sole purpose of complying with specific restrictions imposed by national legislators under conditions of force majeure.

Considering the above, it is crucial that enterprises limit any changes to their tax strategies to what is strictly required to comply with the current restrictions. In any case, each and every enterprise should assess the tax treatment of employees and activities on a case by case basis, to ensure that all relevant facts and circumstances are duly considered.

Looking Forward

The economic crisis extends, however, much beyond the individual enterprise. It affects the whole-of-the-economy, in the short, medium and long-term. This is then the much bigger challenge for legislators and policy-makers.

Staying at the direct short-term implications and the more negative forecasts for the future would be fatal. Instead it is high time for a common, long-term tax planning aimed at properly supporting the most vulnerable enterprises and promoting investments and entrepreneurship in the EU. In this respect, it is worth noting a position paper published by BusinessEurope on behalf of EU businesses[4]. This paper calls Member States to channel investments in strategic areas, enhance movement of capital in the single market, incentivize the services market and strengthen the supply chain.

Indeed, a concrete relaunching of the EU economy requires structured tax incentives, especially for SMEs and with a purpose to guaranteeing liquidity. Such a structured plan should take duly into account the probable significant reduction of tax revenues for the coming years as well as the disproportionately high tax compliance costs for SMEs.

According to BusinessEurope, in brief, Member States should:

- Cut down taxes on employment, including social contributions and on capital, including corporation tax;
- Take action to eliminate double taxation;
- Promote digitalization and simplification of tax systems, especially in terms of VAT to facilitate investment and trade;
- Introduce tax incentives, e.g. tax credit, for entities/physical persons investing in corporate capital.

To conclude, such considerations should be reflected in the practical implementation of the EU response to the crisis. Such EU response should also be appropriately coordinated with the OECD at the international level. As the OECD had duly underlined, the way forward should be multilateral and based on cooperation[5]. Specifically, the aim should be the harmonization of tax systems in order to (i) preserve the achieved, yet still fragile, equilibriums, (ii) modernize tax cooperation and (iii) address the tax challenges of digital economy.

[1] OECD, OECD Interim Economic Assessment Coronavirus: The world economy at risk (Paris, 2 March 2020), https://www.oecd.org/berlin/publikationen/Interim-Economic-Assessment-2-March-2020.pdf

[2] OECD, OECD Secretariat Analysis of Tax Treaties and the Impact of the COVID-19 Crisis (Paris, 3 April 2020), https://read.oecd-ilibrary.org/view/?ref=127_127237-vsdagpp2t3&title=OECD-Secretariat-analysis-of-tax-treaties-and-the-impact-of-the-COVID-19-Crisis

[3] Art. 5 of the Model Tax Convention on Income and on Capital: Condensed Version 2017, https://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm

[4] BusinessEurope, Businesseurope Proposals For A European Economic Recovery Plan (30 April 2020), https://www.businesseurope.eu/sites/buseur/files/media/position_papers/businesseurope_recovery_plan_final_30_04_2020_v2.pdf

[5] OECD, Tax and Fiscal Policy in Response to the Coronavirus Crisis: Strengthening Confidence and Resilience (Paris, last update 15 May 2020), http://www.oecd.org/ctp/tax-policy/tax-and-fiscal-policy-in-response-to-the-coronavirus-crisis-strengthening-confidence-and-resilience.htm