The Unhelpful Myth of Tax Certainty

OECD International

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One key component of the OECD's Pillar One proposal to reallocate taxing rights from producer to consumer nations is the promise that businesses and governments affected by this change will be able to achieve something called "tax certainty". But what exactly is "tax certainty"? In this Talking Points piece, Peter A. Barnes looks at whether it is possible to achieve certainty in any aspect of business, let alone in the complex world of international taxation, and suggests a more productive way forward.

In high school or college, most tax professionals took a physics course and learned about the Heisenberg Uncertainty Principle. In simple terms, the principle states that it is impossible to determine accurately both the *position* of an object and its *speed*. You can determine one or the other, but not both.

Trust the science.

A comparable uncertainty principle applies to tax. We may know how a specific tax law or regulation will apply to a fixed set of facts, but we cannot be sure the same result will apply if the facts change even slightly. And often we are not certain – really certain – how the law applies to even a fixed set of facts. Or which piece of the tax law will apply.

This universal truth of the tax world should be widely accepted. Three centuries of tax jurisprudence proves it. Tax certainty is simply not achievable.

But there is growing frustration about tax uncertainty and a growing demand to "fix it". In case you missed it, 22 November 2022, was proclaimed "Tax Certainty Day" by the OECD. That was a day "to take stock of the tax certainty agenda and move towards further improvements".

In 2019, the OECD published a progress report on tax certainty. And the OECD touts tax certainty as a major benefit of the Pillar One initiative for taxpayers and tax administrators.

The OECD is not driving the pursuit of tax certainty on its own initiative, but rather responding to the demands of taxpayers. Business executives argue that a lack of tax certainty hampers investment because companies cannot accurately project the tax costs of investments and therefore misjudge investment decisions or refuse to invest at all.

Of course, it is better when taxpayers know the tax costs of their decisions. But "certainty" suggests a standard that is not achievable for tax or any other area of business activity. And the pursuit of the elusive certainty prevents the tax world from seeking realistic goals.

Background

There is no expectation that non-tax facets of business decision-making will be stable or certain. Labor costs and labor supply always vary. Raw material costs and availability fluctuate daily and cannot be fully mitigated by long-term supply agreements or hedges. Distribution costs, rents, utilities and all other expense amounts are always changing, sometimes for the better and sometimes for the worse.

Yet business executives do not expect certainty with respect to these costs, nor do they fail to make new investments because of this lack of certainty. Changes in cost levels require businesses to adjust. But there is no howl of protest about the pain of uncertainty in these other areas of business to the same extent that tax provokes that reaction. The OECD has not yet declared a "Labor Cost Certainty Day".

There is a difference, of course, between business uncertainty created by changing markets and uncertainty created by changing or imprecise government rules. But that is just a difference in the source of the uncertainty, not justification to complain loudly about the latter while routinely accepting the former.

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The Expectation of Tax Certainty

What is it about tax that creates this unusual expectation of certainty? And does it matter, or are complaints about tax uncertainty just a nervous tic by people who should know better?

Tax, to the delight of many of us who work in the field, consists of rules and numbers. Perhaps we trained as accountants, or even mathematicians. Or we approach tax from a background of religious education, where we are taught that following the right precepts yields a dependable outcome.

With this mindset, tax offers an attractive promise: study (or write) the rules with sufficient thoroughness, learn the facts – the real facts – about the taxpayer's activities, and you can stir the law and the facts together to yield a specific number that represents the tax liability.

In this way, the exercise resembles the work of a scientist. And in the simplest cases, tax certainty may be achievable. An individual US taxpayer in the highest marginal bracket who earns USD 100 more will pay USD 37 additional in federal income taxes, assuming no other elements of their tax profile changes.

But very few cases are simple. No matter how many pages the IRS writes in regulations on a topic, practitioners will immediately speak at conferences and send in comment letters complaining that *their* question is not answered in the guidance.

The lack of certainty arising from tax rules is mirrored in the other primary source of uncertainty: the facts.

Taxpayers are responsible for determining their facts and reporting the consequences of those facts on tax returns. But in many cases, the facts that a taxpayer believes are true and that form the basis of a return are simply not true when tested. For example, a "low-risk distributor" may bear lots of risks for warranty expenses or foreign currency fluctuations. The owner of intellectual property may not pay for (and therefore will not own for tax purposes) important improvements to their IP.

Does the Lack of Certainty Matter?

The uncertainty caused by imprecise and incomplete tax rules and pesky facts that are not true (or are interpreted differently by taxpayers and tax auditors) are not a bug in the system: they *are* the system.

And, I would suggest, we should embrace that truth. Accepting that there will always be tax uncertainty – instead of chasing the myth that we can achieve certainty if we just work a little harder – opens a useful dialogue. Consider three elements of that dialogue.

First, a willingness to embrace uncertainty lets us debate the utility of longer and more detailed tax laws and regulations. New regulations routinely run to hundreds of pages. While some length is unavoidable, it is useful to consider whether more statements of broad principles and fewer efforts to cover every alternative would be an improvement.

The contrast between Generally Accepted Accounting Principles (GAAPs) as followed in the United States (with lengthy and detailed rules) and International Financial Reporting Standards (IFRS) as followed in most other jurisdictions (with more statements of principle and fewer specific rules) is instructive. Over a period of years, the reported income for a business will generally be quite similar, albeit with annual fluctuations. Could the same result be true for tax guidance?

Fewer detailed tax rules would require the IRS to police taxpayer misbehavior with more audits and more thorough audits. But that would be positive for US tax administration in any event, and the USD 60 billion or so in additional funding provided to the IRS for the coming decade may help with tax enforcement.

Second, accepting that there will be tax uncertainty focuses attention by both taxpayers and tax administrators on how to work cooperatively to minimize disputes and resolve them when they arise. This, of course, is a significant part of the OECD's tax uncertainty agenda. But pretending there is a potential for certainty leads to a misallocation of resources.

For example, advanced pricing agreements (APAs) to avoid transfer pricing disputes are an important tool for taxpayers and tax administrators. But APAs will never cover more than a miniscule percentage of the potential transfer pricing cases. APAs are extremely demanding on the resources of tax administrators. Would it be better to have fewer APAs and redirect those government resources toward auditing and resolving the highest value cases? Governments, including the US government, feel obliged to provide tax certainty to taxpayers seeking that certainty, even if it represents a poor use of limited resources.

The same weakness applies to the International Compliance Assurance Program (ICAP), advanced by the OECD and adopted by the United States and many other jurisdictions. Under ICAP, a multinational company and tax administrations perform an early audit, with the goal of addressing potential tax exposures and resolving them quickly. The taxpayer gets "certainty," but is this a good use of limited government resources? Probably not.

Once governments and taxpayers accept the existence of tax uncertainty, they can focus resources on quicker, more comprehensive dispute resolution through the appeals process within the IRS and more resources for mutual agreement procedures under tax treaties. Globally, accepting the reality of tax uncertainty may lead other governments to invest more resources in mutual agreement procedures as well.

Third, dropping the goal of tax certainty should allow both taxpayers and tax administrators to focus on “good enough” tax compliance. This is already a reality – it just is not discussed. No taxpayer follows section 905(c) of the Internal Revenue Code slavishly; it cannot be done. The wording of section 905(c) requires taxpayers to notify the IRS on an item-by-item basis any time there is a change in foreign taxes paid after the filing of the initial return. For any significant multinational taxpayer, that would require many, many notifications to the IRS and/or amended returns each year. Taxpayers and IRS examiners use workarounds to avoid that burden – and the result is “good enough”.

Similarly, the detail required to comply completely with the US’s foreign tax credit basket rules is rarely available to large taxpayers, because accounting systems do not capture all the required data. Abuses should never be tolerated. But “good enough” is what we have, and all that we can achieve.

Under contract law, “substantial compliance” generally is considered sufficient to prevent an award of damages, even if a party does not perform exactly as promised. In the tax world, we can likewise accept “good enough” in most situations. But that requires both taxpayers and tax administrators to forgo “certainty”.

The next time you hear a taxpayer complain about a lack of tax certainty, or a tax administrator promise to provide tax certainty, call out the hypocrisy. Businesses are not provided certainty in other areas of their operations, so why should tax be expected to reach a higher standard? And tax systems are incapable of providing certainty in administration.

As tax professionals, let’s drop the unhelpful myth that we can achieve tax certainty and pursue more modest but achievable goals to improve tax compliance and administration.