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Global Tax Reset

The changing world of tax

The history

To look at the history of international business taxation is to get a better glimpse into the scale of the Global Tax Reset. Most of the rules governing taxation of multinational business date back to the 1920s, a time when a relatively small number of companies operated across international borders. In today's information age, the landscape is very different and advances in shipping and digital technology make it far easier for even small companies to trade across country borders. As the number of companies operating internationally grew throughout the twentieth century, the tax systems that governed their operation also began to develop in both complexity and inconsistency. International taxation today is essentially a complex web of individual country tax laws and bi and multilateral trade agreements between nations. Unsurprisingly, elements within the framework have become outdated and are no longer suited to the realities of today's global business economy.

Sovereign debt and business reputational risk

Ultimately a country's tax structure is designed to support its economic objectives and priorities. Furthermore, post the 2008 recession, a number of countries have faced pressure to address high levels of sovereign debt. As a result governments may seek to increase their country's base of revenue through tax legislation.

At the same time there has been increased public pressure on governments and political pressure on businesses to prevent large multinational companies from using the complexity of the existing global tax system to reduce overall tax rates (albeit legally). This trend has been greatest in the UK, Australia, and a number of European countries frequently focusing on large multinationals with low effective tax rates, including many based in the US. This media coverage, particularly for consumer businesses, creates a new and significant brand risk for businesses that operate globally.

A new paradigm

In 2013 the G20, which is comprised of the most powerful world economies, engaged the OECD to address perceived inequities and inconsistencies in the global tax landscape. This became the Base Erosion and Profit Shifting (BEPS) Actions. Since then, the G20 has endorsed the OECD's 15-point action plan to modernize the principles underlying today's international tax landscape and to develop a consistent framework for countries to base their tax legislation upon. At the core of the G20/OECD's project is:

- Eliminating tax mismatches such that all income is taxed
- Aligning profits with value creation
- Increasing consistent levels of transparency with tax authorities
- Implementing change in a coordinated fashion

The confluence of the G20/OECD's efforts, combined with the changing perspective of taxation, increased sharing of information between tax authorities in different countries, and the pressure on governments to collect additional tax revenues, are culminating in sweeping changes to tax laws and treaties. This is triggering a complete Global Tax Reset for businesses with worldwide operations. While some of the proposals will be seen as increasing tax risk and bringing greater complexity, ultimately having a consistent tax platform is important to global businesses. The alternative is individual country measures, such as the UK Diverted Profits Tax, which creates inconsistency and potentially uncertainty.

Key areas the Global Tax Reset will impact

The G20/OECD's recommendations are contingent upon countries enacting legislative changes to their tax laws and revising their treaties with other jurisdictions, however there are two key areas that are likely to be significantly impacted and businesses should start evaluating now to mitigate risk – compliance and business model.

The Global Tax Reset is a new age of international tax consistency and sharing of information with and between tax authorities.

Compliance

A central component of the G20/OECD's proposal is Country by Country (CbC) reporting and a CbC template containing standard items to be disclosed by country to all tax authorities where the multinational has operations. A core expectation is that this is a standard to be adopted consistently and will take effect in 2017.

The G20/OECD has also recommended that businesses provide a "master file" detailing transfer pricing policies for all categories of inter-country transactions related to a business and a "local file" that discloses and analyzes the activities that are taking place in each country. For the master file and local file, while jurisdictions may choose to implement these recommendations as prescribed it seems likely that some, like China, will opt to incorporate elements alongside their existing transfer pricing requirements.

Historically, tax collaboration at the governmental level most often occurred bilaterally between two countries through treaty and disclosure requirement negotiation. In contrast, in the Global Tax Reset environment, local country legislation will to a far greater extent stem from a collective conversation among nations around minimum standards and best practices. In this regard, the Convention on Mutual Administrative Assistance in Tax Matters which has more than 80 country signatories and continues to grow is a useful precedent, and one of the potential options for government to government exchange of CbC information. Other options are using the bilateral tax treaty network, and the transparency-driven Tax Information Exchange Agreement network.

Businesses need to think about how they will gather the information required to comply with CbC requirements and start running simulations on 2013 and 2014 data now to identify gaps and issues. Organizations that operate decentralized models or those who have grown by mergers and acquisitions may find this process difficult and time consuming if their technology systems have not been fully integrated as transactions occurred.

In principle, CbC reporting should provide tax authorities with a higher level of understanding of businesses' global supply chains. For businesses, this means a possible increase in tax controversy, the potential for breeches of confidential commercial information, and a road map for future tax legislation that could trigger higher overall tax liabilities.

Compliance challenges

The tax law changes resulting from the OECD's work will introduce a host of new issues and challenges for business. With new regulatory rules being introduced more or less simultaneously across many jurisdictions the volume of change puts pressure on the agility of businesses to modify their systems and processes in a timely manner and increases the risk of inadvertent non-compliance. Companies who operate decentralized business models may be particularly vulnerable to this.

In addition to increased compliance risk is the impact of these changes on the organization's effective tax rate (ETR). This could present management with a material issue that needs to be disclosed to investors and ultimately impacts profitability.

To identify areas of concern many businesses are choosing to run simulations on data from prior years. This allows them to identify specific areas of concern based on their organization's global footprint, operating model and strategic choices. They are evaluating business and treasury model alternatives as well as developing compliance strategies when vulnerabilities are identified.

Business model

Companies will need to look at both their business model and the financing of operations as a result of the BEPS proposals. The changes around financing, transfer pricing and the definition of taxable presence may require adjustments to the business model in order to comply with the new requirements or thresholds. Resulting systems changes may require a long lead time.

Most multinationals' financing strategies are intertwined with their cross border activities. They frequently have complex financing strategies, often driven by legacy M&A activity. This will be challenged on two key fronts. The first will look at the structure of intra-group financing and try to eliminate the use of entities or instruments that are viewed differently in the lending and borrowing territories – the 'hybrid' mismatch. The second action will be to look to restrict interest deductions to more closely align with external finance costs of the group. Historically intragroup finance costs and external charges are often quite different for a variety of reasons.

Traditionally, transfer pricing has been evaluated at the transactional level. In a Global Tax Reset world, the entire global supply chain for a business will be more likely to come under scrutiny. Going forward, Tax Authorities will seek to tax the profits where the value is added within the supply chain which may yield different results compared to the historical transactional standard.

Companies operating in industries where research & development plays a critical role in the business strategy may be impacted by the new treatment of intellectual property regimes. Rules related to intellectual property are also expected to change and those changes will likely increase the importance of functionality (as opposed to passive provision of capital) on profit allocations with regard to intangibles. If intellectual property plays a central role in value creation in an organization these changes could significantly impact the company's ETR and should be evaluated.

Businesses in a growth mode who are engaged in M&A due diligence activities need to be cognizant of the changes the Global Tax Reset is ushering in and consider how this may impact the attractiveness of potential deals.

If business model changes are required, organizations should initiate activities now because strategic shifts notoriously have long time horizons for implementation. Realignment of people, processes and systems on a global scale to match new strategic choices is a significant undertaking for most large and geographically dispersed organizations.

Responding to change

The scope of the G20/OECD's activities is broad and sweeping. It has sought to cover nearly every aspect of global business. As a result, the Global Tax Reset will impact many industries in different ways. In the Life Sciences and Technology industries the focus will likely be on intellectual property which plays a central role in value creation. In supply chain intensive industries such as Manufacturing, the focus will weigh heavily on transfer pricing arrangements.

Businesses should reflect on how the Global Tax Reset is likely to impact them based on their global footprint, operating model and strategic priorities, and should prioritize which aspects of the G20/OECD guidance and recommendations to pay particular attention to over the next 12 to 18 months.

The Global Tax Reset is a new age of international tax consistency and sharing of information with and between tax authorities. It is time for companies to look ahead, scenario plan, and take action. Companies are already beginning to report on the expected impact, and as it affects profitability, stakeholders will increasingly press for more details. Tax Directors need to be ready to respond.

For further information, visit **www.deloitte.com/reset**

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