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In this issue...

Base Erosion and Profit Shifting

Is your organization ready for the global tax reset?

It is being called a global tax reset, the biggest change to international tax principles in a generation. In October, 2015, the Organisation for Economic Co-operation and Development (OECD) released its final package of measures for its 15-point Action Plan on Base Erosion and Profit Shifting (BEPS). The new rules will affect more than the tax practices of organizations with multinational operations—they will have broad-based business and operational impacts. Determining an organization's response, therefore, will need to involve more than the tax department; it will also require the input of the C-suite and the board of directors.

The OECD was asked by the G20 countries to develop its BEPS Action Plan in 2013, amid political and activist concerns in many jurisdictions that not all organizations were paying what was publicly considered to be their "fair share" of tax in all of the jurisdictions in which they operated.

BEPS is a multi-lateral exercise to modernize what is perceived as an outdated and complex international tax framework that is no longer suited to today's global business economy. Its purpose is to eliminate tax mismatches, align profits where value is created, and enhance transparency for tax authorities across the global landscape. It is, effectively, a global tax reset.

For organizations with multinational operations, BEPS and the global tax reset is much more than a tax issue—it is a business issue.

According to the OECD, governments have been losing at least 4 - 10 percent of global corporate tax revenues—or $100 billion - $240 billion—per year because of base erosion and profit shifting. The impact has been particularly damaging for developing countries.[1]

BEPS will require countries to give up some sovereignty and agree in some areas to level the global tax playing field. To date, business organizations have generally been supportive of BEPS, believing that a global approach is better than individual countries taking their own uncoordinated unilateral actions, which could increase the likelihood of double taxation.

[1]Financial Times, "Plans unveiled to crack down on corporate tax avoidance," October 5, 2015.

However, since countries will want to retain their competitive ability to attract multinational businesses—something normally done through tax policy—there will still be tax competition in a number of areas even after the implementation of BEPS.

For organizations with multinational operations, BEPS and the global tax reset is much more than a tax issue—it is a business issue. The new rules could potentially impact profitability, the effectiveness of business models, competitive positioning, increase public and investor scrutiny, and, ultimately, possibly affect share prices. Since different organizations have different business models and operating structures, the BEPS rules may impact one organization differently than another, with a result that some organizations will likely face greater adverse effects than others even among their own peer group. This could be particularly important to the board, since there may be a greater impact on their organization's earnings per share and share price relative to its competitors if it has taken greater advantage of tax planning opportunities.

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And some further complications: a number of countries did not wait for the BEPS rules and have unilaterally enacted rules of their own. For example, the UK has enacted a Diverted Profits Tax, which is distinct from corporation tax and, therefore, falls outside the UK's existing bilateral tax treaties; similar measures were implemented in Australia, but with a lesser scope. In addition, several jurisdictions, including France, Chile, and China, have introduced rules disallowing tax deductions for certain payments if the recipient of the payment has not been subject to a certain minimum amount of tax. Some tax authorities have also started assessing and auditing organizations as though BEPS and other proposed rules had already been enacted and had the force of law.[2]

Assessing the impact

Companies should determine the potential impact of the new rules and, if possible, how that impact compares to that of their competitors. Companies must also determine what actions they need to take to manage their tax load and risk levels and adjust their business structures to remain competitive. In many cases, the steps organizations will need to take to address operations under the new rules will impact more than just their tax groups; they are also likely to affect legal, treasury, financial reporting, operations, information technology, the C-suite, and the board. Many organizations will also likely need to develop a public relations and communications strategy for key stakeholders to explain the impact the new rules have on them and how they will respond.

From a tax perspective, certain tax planning structures may no longer be effective under the new rules.

Additional issues companies will need to manage may include:

- **Increased transparency, reporting, and compliance.** The BEPS rules will create an increased tax compliance and reporting burden. In addition, country-by-country reporting on transfer pricing will come into effect in late 2015 or 2016.[3] The new rules will increase transparency and compliance costs—and that increased transparency will likely result in a greater number of tax disputes. That, together with the increased aggressiveness of some tax authorities in other areas, will likely result in greater costs being incurred to fight reassessments to avoid double taxation.

- **Reputational risk.** Another key business concern, especially for companies operating in the consumer and resource sectors, are the risks to their brand and reputation that could arise if they attract public criticism for their tax policies. Increasingly, shareholders and analysts are also questioning management about the organization's tax strategies and policies.

[2] A discussion of BEPS-related and other tax developments in various jurisdictions is provided in the Deloitte publication, *World Tax Advisor*.

[3] Transfer pricing refers to the price of goods and/or services sold between entities that are under common control.

- **Commercial substance in certain jurisdictions.** Under transfer pricing rules, organizations are required to have appropriate levels of commercial "substance" in jurisdictions commensurate with the level of income and nature of the operations in the jurisdiction. Under the new rules, some organizations may need to increase their commercial substance in some jurisdictions. If so, these organizations will need to involve their human resources function as they relocate people. Companies that are required to change their operating model to minimize the negative impacts of the new transfer pricing and BEPS rules may also need to make changes to their information technology platforms to address the operational changes and meet their new compliance obligations.

Directors need to understand the new rules' impact on the organization's tax rate, business model, financial statements, and share price.

Issues for the board

Given the widespread impact of the new rules, directors will want to ensure that they understand the potential impact on the organization's effective tax rate, business model, financial statements, and share price, and how that compares to the expected impact on their competitors. They will also need to understand what changes may need to be made to the organization's business model and/or financing strategies and, if so, what are the options and related costs.

Because there will be a risk that the organization's tax strategies may be misunderstood or create a potential for activism, boards will want to ensure that those strategies are aligned with the overall risk appetite and public image that the board has set for the organization. Boards may also want to query management about whether it is prepared to defend the organization's tax practices, and what the potential financial and reputational impact of activism might be on the organization.

Since the new rules may affect many areas of the organization's operations, boards will likely want to reassess whether or not they are getting enough information from management about the organization's tax practices for them to fully understand all of the potential operational, technical, and reputational risks associated with them.

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"BEPS and the whole global revolution around tax is a significant business issue for enterprises with multinational operations. It presents the potential for reduced profitability within existing business models and generally means increased public and investor scrutiny over corporate tax affairs. The impacts on business models vary from corporation to corporation and it may or may not impact your competitors and their related share price in the same way."

An investment analyst's perspective

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What should boards consider when it comes to tax issues?
Tax is now an issue of sufficient weight that boards need to pay attention to it and I think it is recognized that it is increasingly important that boards set the right tone on tax strategy—a tone that's both prudent and sustainable. Boards also need to understand the developments occurring at the OECD and the G20. They have to be prepared for what is coming in future because it's not easy to make major changes to tax approaches in a short timeframe, particularly for larger, multinational organizations with complex operations involving heavy tax planning.

Ideally, boards should have sufficient expertise to understand tax strategy and its implications, particularly for long-term profitability and value. But if that's not the case, the board should obtain the specialist expertise they need to properly evaluate the organization's tax strategy, either from the company's outside tax advisors or, if necessary, the board's own outside experts.

The ICGN recommends that boards consider setting a tax risk appetite.
As a starting point, the ICGN believes a board ought to have a proper discussion about its risk appetite in relation to tax policy and tax transparency.

Until recently, tax is something that many boards may not have thought about as involving risk, other than regulatory risk or the risk of tax authorities taking certain actions. Today, there's a broader constituency in relation to tax issues, which means there are broader risks involved, including reputational risk or the risk of incurring the scorn of stakeholders or investors.

So, it's prudent for boards to consider not just the current state of play in relation to tax, but also the likely future tax developments, particularly those on tax transparency.

The basic principle that's emerging is that companies will find it difficult to justify engaging in transactions or arrangements that look largely or wholly driven by tax considerations. Long-term investors and other stakeholders want to ensure the company is taking sensible decisions, because they see tax practices as potentially being a risk for companies focusing only on short-term profitability.

Another recommendation is for companies to disclose information about their tax practices.
The ICGN is suggesting that companies disclose appropriate information on their tax practices through public disclosure, while also being mindful of commercial sensitivities. Through good disclosures, companies can help ensure they protect their reputation, while poor disclosures or no disclosures at all will likely raise questions about the company and its tax practices.

A starting point would be to disclose a description of tax risk appetite. Boards might also disclose a clear description of their role in overseeing tax policy—how the board or audit committee engages in that role, the type of consultation they undertake, and the considerations they have.

A third step might be to put together public statements about the company's approach to tax issues in terms of tax commitments. Investors are looking for a commitment to comply with the spirit as well as the letter of the tax laws, which will give them some comfort that the company is taking this seriously and they have the right type of attitude. A leading practice of some organizations is to discuss how their tax payments match up with where revenues are generated, either in a general or specific sense depending on how competitively sensitive that information may be.

What are the concerns of investors and other stakeholders?

Tax is very much a key issue for long-term investors and various stakeholders, who are focusing on the role of the board and the board's commitment in terms of tax transparency and fairness. They're looking for boards to develop policies around that and to publicly disclose those policies and how the board engages with and uses them. One key issue is tax fairness, which is the basis of most of the agitation on tax issues. The basic principle investors and stakeholders are concerned about is that a company is not using community resources without making an appropriate contribution through the local tax system. In a sense, it is an extension of corporate social responsibility and also ensuring a continuing licence to operate.

Investors and shareholders know there's a lot of agitation in society about the position of corporations and their tax strategies and tax transparency, which may not necessarily reflect well on the reputation of companies. What they are concerned with is whether companies have tax strategies that are both effective and sustainable—meaning they will ensure that the organization's reputation is protected and that it can take its place in wider society where tax is obviously a critical issue.

If a company's reputation is damaged, investors are also concerned about the time and effort required by management to correct that situation or deal with it. For example, the companies that were called before the Australian Senate inquiry into the issue of tax shifting no doubt had to spend enormous amounts of time preparing for those hearings and defending themselves and their tax practices. From a shareholder's point of view, they would like companies to be ahead of that.

Going forward, what should boards expect?

This is a rapidly moving issue that is not going go away and, in fact, the attention to this issue is almost certain to increase significantly. So it is very important that boards keep on top of developments since they and their companies may need to respond quickly.

Governments are trying to improve their revenue bases and that will have implications for a company's operations on a country by country basis, as well as implications for a company's positioning in each country. While that's an important concern, a much greater one is the growing pressure on companies and their boards to engage in tax behaviors that are seen as reasonable and reflect the nature of their businesses and where their businesses are creating value and obtaining revenues. That's really what is driving this issue.

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