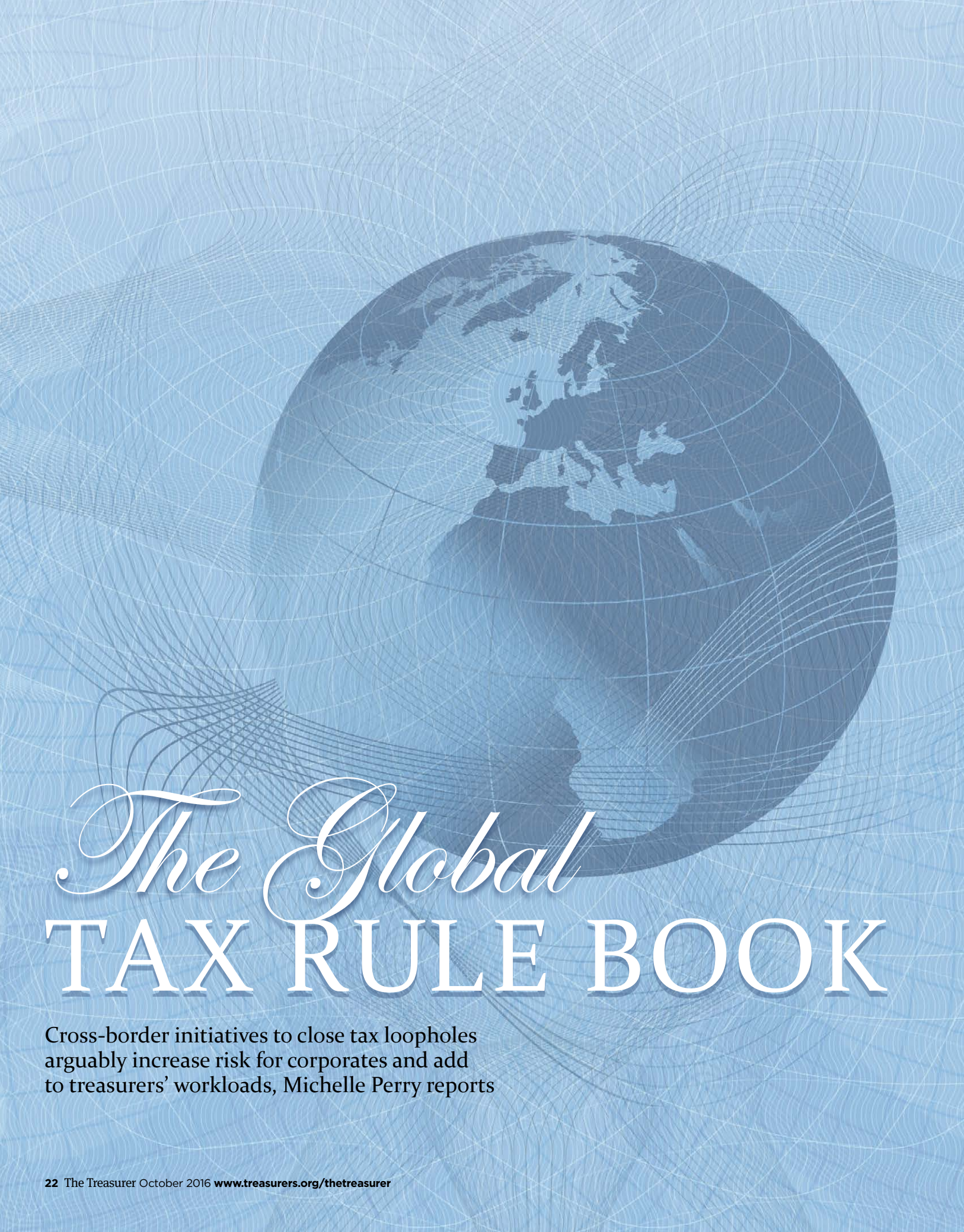

The Global TAX RULE BOOK

Cross-border initiatives to close tax loopholes arguably increase risk for corporates and add to treasurers' workloads, Michelle Perry reports

Modern international business practices have long outgrown the global tax rules for which they were intended. Designed in the 1920s, there is little doubt that the global tax framework has exceeded its sell-by date, but forging international consensus to build a new one has been no easy task.

Over the past decade, governments have made attempts to close loopholes in domestic tax laws. Governments around the world, including the UK, have imposed a general anti-avoidance rule. Last year, UK tax authorities introduced the diverted profits tax (DPT) – also dubbed the 'Google tax'. Plans for an EU financial transaction tax (FTT) were introduced in 2013 to "temper irresponsible trading" following the 2007/8 credit crunch, but member states are struggling to reach consensus.

In the background to domestic attempts, G20 nations realised that unless an effort was made to work collectively, multinationals bent on reducing their tax liability would continue to find ways to do so.

The push to reform international tax laws has been somewhat aided and abetted by the media and a growing public awareness and interest in how much tax multinationals like Amazon, Google and Starbucks pay in certain jurisdictions. For their part, multinationals, despite defending their records and doing nothing illegal, have realised that their reputations are at risk and have begun working with authorities to pay more tax.

"Since the 2007/8 financial crisis, the trust in institutions, both government and business, has been eroded," says James Lockyer, development director at the ACT. "People have looked for someone to blame, and tax is the one issue companies have not been particularly transparent about."

With a growing political will to tackle tax avoidance, three years ago, G20 governments and the Organisation of Economic Co-operation and Development (OECD) launched the base erosion and profit shifting (BEPS) project with the aim of curtailing aggressive tax avoidance. The OECD has produced a 15-point BEPS action plan to which, as of July 2016, 85 OECD members have signed. G20 finance ministers, including then UK chancellor George Osborne, endorsed all 15 action points.

"The OECD has created a menu so that governments can pick and choose without being seen as anti-business. It allows governments to change tax laws relatively uncontroversially. And OECD countries mostly have an interest in cooperating on this," says John Cullinane, tax policy director at the Chartered Institute of Taxation.

The temptation to act independently of these kinds of initiatives can be hard to resist. Last month, the European Commission said Ireland must recover €13bn from Apple, a sum it regards as tax avoidance. This kind of breaking ranks is clearly problematic, but the Commission says Apple's arrangements with Ireland amount to state aid. And yet Ireland, the Netherlands and Luxembourg have already agreed separately to close loopholes in their corporate tax arrangements.

Despite the desire to stem the tax leakage from government treasuries, the fall in tax income cannot be entirely put at the door of multinationals' creative tax planning. Since the financial crisis, economic growth has fallen and, with it, the amount of tax due. So governments have been trying to balance the need to ensure they receive the correct amount of tax due, while also making themselves attractive to investment. Many governments, including the UK, have done this by reducing their corporate tax rates, as well as attempting to curb tax avoidance.

"Some countries are looking to lower their corporate tax rate, but broaden the tax base. While wanting to tighten tax law to reduce avoidance, countries are trying to make themselves seem attractive places to invest in," says Matthew Rose, vice president – tax at Seadrill Management Ltd.

With US multinationals among some of the biggest culprits for aggressive tax avoidance, tax authorities there have updated their own tax laws, introducing the Foreign Account Tax Compliance Act (FATCA). The US Treasury has also implemented new country-by-country tax (CbC) reporting laws from 1 January 2016. Other OECD countries are due to introduce CbC reporting – action 13 in the OECD BEPS project – next year.

The UK has already taken action on CbC reporting, meaning that from 1 January 2016, all UK-headquartered multinationals and UK subsidiaries of foreign-owned multinationals are required to provide HM Revenue & Customs (HMRC) with information about global activities, profits and taxes annually for each tax jurisdiction in which they do business. The Treasury expects to raise an extra £5m in tax in the first two years following the introduction of the new tax rule, and an extra £10m in the years thereafter.

"Some companies will already be struggling with it [country-by-country reporting]. It is a disclosure issue, but you have to consider your situation and the picture that it gives. HMRC thinks it will influence behaviour and not just disclosure," says Paul Johns, director treasury and tax at international construction services company ISG plc.

Action points

The UK government has also introduced new measures to deal with hybrid mismatch arrangements – action 2 of the BEPS project – which typically give rise to a tax deduction without a corresponding taxable receipt, or more than one tax deduction for the same expense. The aim is to eliminate the unfair tax advantages and to encourage businesses to adopt less complicated, cross-border investment structures.

The BEPS guidance on action 4 limiting net deductions for interest to

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a percentage of a company's earnings before interest, taxes, depreciation and amortisation (EBITDA) is causing slightly more consternation than other OECD actions. To meet this, the UK would need to introduce a new general rule for restricting interest, which would be a major change to the UK corporate tax regime, but it also runs the risk of capturing companies that do not pose a risk of avoiding tax by benefiting from the measure.

In its latest submission to the government's consultation on capping tax relief on interest on debt, the ACT says: "BEPS is a poorly targeted tool intended to affect global multinationals, but, in fact affecting purely domestic businesses, which have a history of using debt capital to achieve growth and government objectives for development of UK infrastructure."

One of the biggest concerns of BEPS is that companies in multinational groups are increasingly using leverage and interest to avoid tax. However, more often than not, the choice between debt and equity financing within a multinational group are commercial decisions rarely based on pure tax considerations, but on legal requirements, regulatory constraints, contractual limitations and foreign currency implications.

Any company that is thinly capitalised will be heavily impacted by the new rule on capping relief, on interest on debt. It is, however, doubtful there are many companies that are accruing so much interest on debt that it is taking up all of their profits. And if that were the case, experts say, those companies are very likely facing serious problems anyway.

It is worth noting that the amount of tax planning in respect of debt is very different in today's world of record low interest rates compared with that of more than a decade ago when interest rates were in double digits. The opportunities and benefits of structuring debt based on reducing tax through interest relief are far fewer in an environment of historically low interest rates.

The current time frame for the UK to introduce the measure is April 2017 – a plan that many are less than happy about. The ACT has expressed caution at the planned timing, because it would mean that the UK would be "an early adopter" of the tax rule, "which remains under development, and before understanding how trading partners intend to implement the initiative".

The OECD guidance includes the option for countries to consider introducing a group ratio rule in combination with the fixed ratio rule. Depending on the design of such a rule, it could ensure that no restriction arises for domestic groups and stand-alone companies in respect of interest paid to third parties.

A big concern for treasurers is that there will be little consistency in interpretation, application or in the timing of BEPS measures across OECD countries

What is important to note is that few of the measures in the OECD BEPS project are entirely new to the UK tax system. Treasurers and heads of tax at multinationals will already be familiar with many of these types of taxes, such as withholding tax (WHT) and transfer pricing rules.

On BEPS action point 6 on treaty abuse relating to royalty WHT, the UK has announced its adoption of three measures. The first is an anti-abuse measure with immediate effect, to deny treaty benefits when royalty payments are routed through a connected company in a treaty jurisdiction to gain a tax advantage.

The other two measures extend the scope of the WHT regime for royalties to include intangible assets – such as trademarks and brand names. The regime will also apply to royalty payments connected with the activities of a UK permanent establishment of an overseas company.

The DPT, which is similar to BEPS action 13, is a new tax charged at 25% on profits that are considered to be artificially diverted from the UK to a related company with a low tax rate. HMRC updated tax law on this point last year.

"The DPT forces everyone to consider their group transactions and in particular the transfer pricing position, along with any risks and whether they need to notify HMRC. It's not inconsistent with the substance of BEPS initiatives, but it is slightly different," Rose says.

Implementation

Despite the familiarity with the concept of certain types of tax, the workload is not to be underestimated. "It's a mammoth task. All of these new regulatory issues that affect treasury involve data capture and you have to change your systems to manage that," Johns says.

SUPPLY CHAIN IMPACT

The OECD BEPS initiative, and in particular country-by-country (CbC) reporting, is likely to have an impact on some companies' supply chains given that most of the action points required by the BEPS project involve greater transparency through increased disclosure.

What this means in practice is that tax authorities around the world will be able to see exactly where a company makes its profits, how much tax it is paying in each country versus profits made, and how much business activity there is in a particular jurisdiction.

Shared service centres (SSCs) in particular are likely to come in for closer scrutiny by authorities. Over the past two decades, SSCs have become a useful tool in better management of the supply chain. Groups have sought to centralise sales, procurement or finance, for example, to reduce duplication and increase efficiency through reorganising resources and sharing investments between business units.

Often, reducing a group's tax liability – not necessarily corporate tax, but perhaps personal taxes – has been a factor in this decision-making process. Such a decision may have been made for clear commercial reasons, but with CbC reporting, the intracompany charges will be magnified. If a business unit were to show big profits but little activity, then tax authorities will likely question the structure.

The new tax rules will involve a significant amount of work for treasurers in terms of compliance and reporting, and even though some BEPS measures are still under consultation, the direction of travel is clear so treasurers and tax teams can get to work in preparation for what is likely to come.

"My view is that the response to BEPS initiatives may be that many authorities will introduce strong tax laws that could be perceived as taking a sledgehammer to crack a nut," says Rose, who is also a former treasurer and head of tax at Royal Mail.

A big concern for treasurers in general is that there will be little consistency in interpretation, application or in the timing of BEPS measures across OECD countries.

"What companies would ideally like is as much advance clarity on proposed legislation as possible to give time to restructure or reorganise transactions where necessary. Tax authorities need to think about the impacts on companies, but also take into account public perception for action on tax. However, for multinational groups operating in many countries that may introduce a variety of rules at different times, it could result in there not being enough time to restructure everywhere. That's clearly not helpful," Rose says.

Governments are treading a fine line in their desire to increase their tax income, but avoid penalising legitimate business practices and simultaneously ensure they remain attractive to inward investment. It is a balancing act, especially considering all the other huge political and economic decisions facing business over the next few years.

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Michelle Perry is a freelance business and finance journalist