The tax climate is changing — for the worse

“De-offshorization” — no more Russian business? The Kabulbank scandal — managing a crisis Luxembourg Leaks — no country will be spared
The tax climate is changing – for the worse

In "Looking into the crystal ball of taxation" in the Caymanian Financial Review in July 2012 I expressed some thoughts about the future tax situation. The conclusion back then was that taxpayers would experience tougher days ahead with more conflicts, more burdens, more uncertainty, more tax inspections with adjustments and more court cases. Furthermore, the tax world would be more complex and it would be more expensive to meet the compliance requirements.

Two years after this article appeared, it is quite clear that the tax climate is changing – for the worse. Multinational corporations are exposed to sky-high tax risks, especially in the field of transfer pricing, and the cumulative risks are increasing day by day. The compliance requirements, administrative burdens and requirements for more detailed and thorough documentation continue to apply. The OECD, EU, UN and of course every single country are exerting more pressure on multinational corporations, wanting a bigger slice of the cake. The problem is that the cake is simply not big enough and that once all the tax authorities involved have taken their share there may be nothing left.

The OECD’s proposals relating to Base Erosion and Profit Shifting (BEPS) is just one example which will lead to higher risks, administrative burdens and tax for multinational corporations as all the countries involved will fight harder to protect their own tax base and revenues. The risks associated with double taxation or even situations where corporations will have to pay more than 100 percent in tax will occur more frequently in the future.

Worse to come

The International Tax Review organized the 14th Global Transfer Pricing Forum in Washington on 22-23 September last year and the outcome should be of interest to all tax professionals, CEOs, CFOs, board members and investors. The lecturers included people from the U.S. Treasury Department, ConocoPhillips, the World Bank Group, Fiat, Pepsi and Nissan and the message was clear: the tax climate will be much tougher.

The main message to emerge from the conference was that multinational companies need to be prepared for much tougher times with increasing focus being placed on transfer pricing, more stringent tax authorities and greater demands in respect of documentation. Furthermore, they need to prepare for higher risks associated with incurring punitive taxation and double taxation, time-consuming and expensive court cases and audits that could last for several years and potentially ruin reputations. Not all companies are prepared for future contingencies.

The Treasury Department and the Internal Revenue Service (IRS) in the USA are concerned that certain recent inversion transactions are inconsistent with the purposes of the Internal Revenue Code. In September this year, they placed a new proposal on the table which will probably trigger significant tax on inversion. This will affect corporations in the U.S. if they merge with foreign corporations and move their head offices to lower tax jurisdictions. Since this is a top priority topic for U.S. tax authorities, this proposal could put a stop to such ongoing mergers as the tax incurred could be enormous and the proposal could be applied retrospectively back to May 2014. It is likely that other countries will introduce similar legislation. Unfortunately, not all corporations are aware of these significant challenges and risks and some will probably merge without being aware of the full consequences.

Another change that will affect multinational corporations is the OECD’s BEPS project (Base Erosion and Profit Shifting), which involves companies having to provide documentary proof of the fact that the countries in which value added has actually occurred receive a reasonable percentage of the profits and tax involved. This creates a number of challenges and risks for multinational companies and means that they need to analyze the functions, risks, assets and capital used in each subsidiary and country far more thoroughly than ever before. If they fail to do so, the tax authorities will have the power to make adjustments, assess heavy non-deductible penalties and late interest fees. Furthermore, corporations that do not fully comply with all these requirements may also have trouble avoiding double taxation, as the burden of proof could switch from the tax authorities to the companies concerned.

New and stricter demands in respect of transfer pricing documentation are being introduced in most countries which will result in considerable inconvenience and expenditure for the companies concerned. In addition, the quality of the documentation needs to be better, it needs to be updated annually, and some countries might even require all documentation to be translated into the local language.

Multinational companies are incurring sky-high risks in respect of transfer pricing and the risks are increasing with each passing day. Transfer pricing has become a minefield. Companies are being exposed to the risks associated with long, demanding audits, court cases, substantial tax adjustments, punitive taxation amounting to as much as 400 to 500 percent in some countries which are not entitled to deductions, double taxation, interest on overdue payments, having to pay tax and additional tax before a case has been finally decided and the loss of reputation, etc.
Multinational companies must be prepared for more frequent tax adjustments, often amounting to millions or billions of U.S. dollars. Such adjustments have occurred more frequently during the last few years. The risks associated with transfer pricing probably feature among the top three risks faced by companies and these risks are cumulative because the companies concerned are exposed to such risk factors in perhaps 50, or even 100 different countries and they could risk tax adjustments being made for up to 10 years.

Some companies will experience having to pay tax at a rate of more than 100 percent when operating across national boundaries, because several countries may impose tax on the same income. Alternatively, a transaction will be subject to full taxation in one or more countries and no deductions will be made for the corresponding costs in the other countries involved.

Each individual country will fight much harder than previously in order to protect its own basic tax regime, something that will in turn involve an increased risk of double taxation.

Companies must expect to undergo more thorough, more detailed and more frequent transfer pricing audits. It is no longer a question of if multinational companies will be audited, but of when, how frequently and what the consequences will be.

The tax authorities in the U.S. aim to complete transfer pricing audits within two and a half to three years, but none of the participants at the conference had ever experienced a U.S. transfer pricing audit which had been completed within this deadline. Having the tax authorities hanging over one’s head for years would create a huge administrative and financial burden. The U.S. has also started demanding that companies should report all risky transactions, something that means that companies need to provide more detailed information than previously and to focus on such transactions in all the countries in which they operate.

In September, the OECD published seven reports, which companies will have to comply with in the future, and the OECD, the UN and the EU are all working constantly in order to update their guidelines on transfer pricing. In addition, most countries are strengthening their legislation and requirements. On the international front, far more references are being made to court cases in other countries and it is not uncommon, for example, that the tax authorities in Canada will refer to court decisions handed down in Italy, India the U.S. or other countries. This is something, which is making transfer pricing even more complicated and difficult to follow. These developments are occurring at a rapid pace, which hardly anyone is able to keep up with.

Greater focus will be placed on intangible fixed assets, where such are actually applied and whether or not the transfer or use of such is being priced correctly. This entails a great challenge for the companies involved. Much greater focus will be placed on digital economy.

Considerable differences in OECD and UN guidelines on transfer pricing will create new challenges and a risk of double taxation for the companies concerned.

It is not only those companies which conduct aggressive tax planning, operate with lack of economic substance or are established in tax havens that are most likely to experience far tougher taxation, but every single multinational company will need to be prepared for a worse tax climate.

What needs to be done?

Multinational companies must be prepared to devote significantly greater resources to transfer pricing, documentation and protecting themselves. For example, U.S. tax authorities have started to ask for copies of all e-mails to everyone who has been involved in a transaction, e.g. setting up a company abroad. In some countries, companies may need to keep all e-mails for every single employee for up to 10 years in order to meet this requirement. Failure to comply with this request could legally entitle tax authorities to make adjustments and impose penalties. They are calling for interviews with all the employees who have been involved, as well as with any employees who no longer work for the company in question. It is not uncommon to receive rudimentary lists from the tax authorities containing several hundred questions and just as many follow-up questions. Multinational corporations must be prepared for several restrictions in respect of deductions, which will trigger higher taxation. Companies must be much more proactive than they are at present in order to protect themselves against the risks involved.

Companies must provide much more detailed information than previously about their operations and the risks to which they are exposed in all the countries in which they operate.

An increasing number of countries are introducing new, stricter regulations about transfer pricing and these regulations, which often vary from one country to another. Companies must establish risk assessments internationally so that they can identify and assess where the highest risks are to be found, as well as analyze, minimize and determine what they can and must do in order to reduce any such risks.

Multinational companies must therefore be proactive and prepare to devote significantly greater resources to transfer pricing than is currently the case, and they need to work proactively in order to reduce the sky-high risks which are now associated with transfer pricing and to protect themselves and any assets which they have created.

Unfortunately, not all multinational companies are aware of the major challenges and demands they will be facing, or of the increasing risks that are associated with transfer pricing, not just in one country, but also in all the countries in which they operate.

Conclusion

The tax climate has changed and will continue to change – for the worse. Multinational corporations are exposed to sky-high tax risks, and cumulative risks in all operating countries. They face tax adjustments and penalties amounting to millions or billions of USD; time-consuming disputes and litigation, damage to their reputations and having to pay their tax even if it is subject to dispute. They are not just exposed to these risks in their home countries, but in all of their operating countries. Taxation is a minefield even those corporations that try to be compliant and fulfill all the requirements will struggle. Where will this end? Some might say that it cannot be worse, but it can.