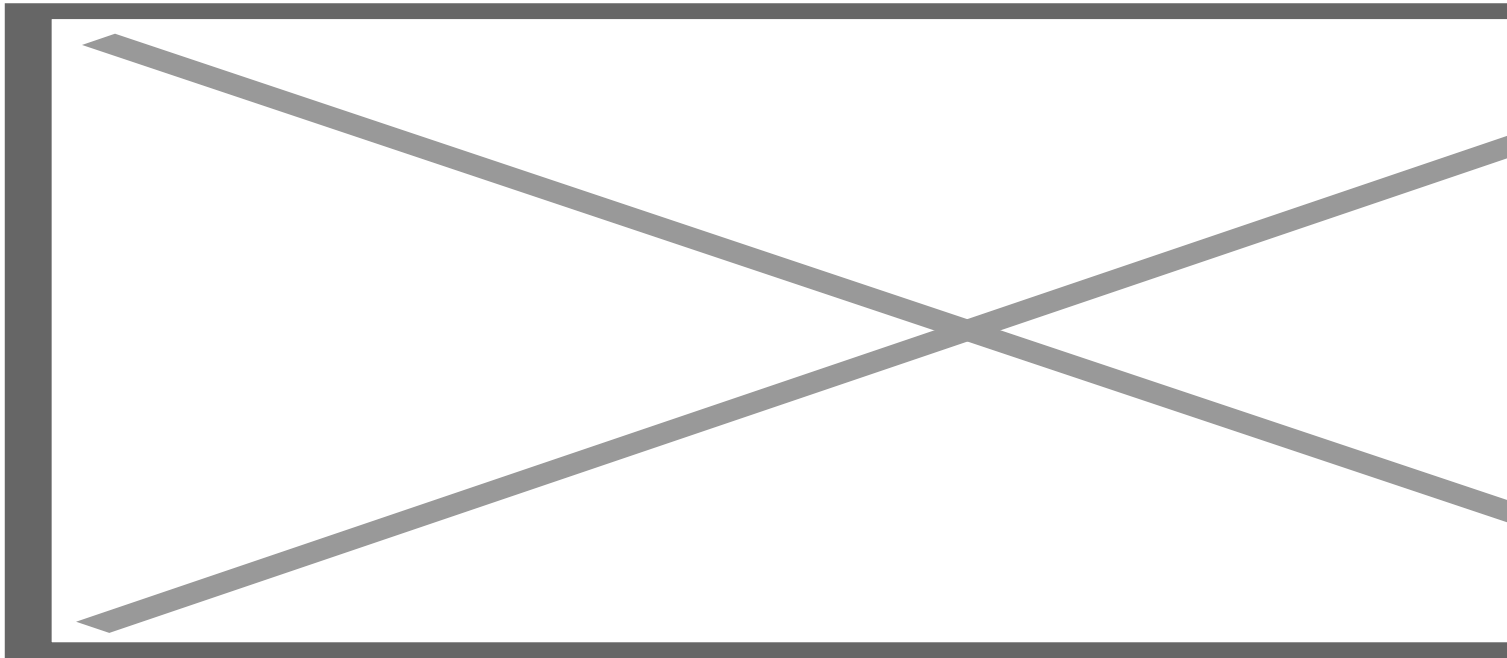


The new age of tax transparency

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Conrad Law sets out the key features of the new age of tax transparency and looks at the impact on tax audit risk management for multinational enterprises.

Multinationals enterprises (MNEs) have always faced a multitude of different transparency and data disclosure requirements as the international tax environment evolved to deal with the new globalized way of business. Over the last few years, the pace of change of the transparency debate and requirement has significantly quickened. This has a direct impact to the global tax audit and controversy landscape, with the volume of tax audits and disputes expected to continue to rise as a result.

Tax administrations around the world have continued to demand for more, and more readily accessible, information from MNEs. Whereas the tax administrations already have the power to request taxpayers to produce all records, more information than ever before are now available in the hands of the tax administrations that can be used in data analysis and subsequently as part of tax audit challenge material against the taxpayers.

This article provides an overview of some key recent changes in the world of tax transparency and suggests how MNEs should act in light of the increase in tax audits and controversies.

Tax Transparency Initiatives

Global Tax Transparency Initiatives

The early initiatives for “transparency disclosure” was largely industry-focused and voluntary, with the key forerunner being the Extractive Industries Transparency Initiative (EITI) that dealt with transparency over payments made by participating oil, gas and mining companies to governments and government-linked entities, as well as transparency over revenues by those host country governments. Such voluntary initiatives were then followed up by various mandatory regimes, such as the European Union’s disclosure rules for large extractive enterprises and logging industry enterprises in the Accounting Directive and Transparency Directive.

At the heart of the new transparency developments is Action 13 of Base Erosion and Profit Shifting (BEPS) project of the G20 and OECD. In this respect, the Final Report on Action 13 recommends that MNEs should prepare transfer pricing documents comprising of three documents: a master file, jurisdiction-specific local files and a country-by-country report (CbCR). Countries are required to implement CbCR requirements as one of the BEPS minimum standards.

Standing alone, the disclosure of the global revenue and profit allocation of the Action 13 initiative including the CbCR reporting may be intended to serve as a “risk assessment tool for the tax administrations”. Practically, tax administrations will now be in an unprecedented position to obtain a global picture of where the MNE’s profits, tax and economic activities are reported. This information will enable tax administrations to assess transfer pricing and other BEPS risk better than ever before, to use the reported information to perform data analytics and therefore to initiate tax audits.

Regional Tax Transparency Initiatives

The drive for tax transparency has also attracted significant interest from regional organisations such as the EU. An example of a recent transparency measure implemented by the EU was the directive adopted by the Council of Europe in December 2015 requiring all the 27 Member States to exchange information automatically on advance cross-border tax rulings and Advanced Pricing Agreements (APAs) from 1st January 2017.

During the first half of 2016, the Council of Europe further adopted the rules for an EU-wide version of the CbCR that will be consistently applied to all Member States, with countries expected to implement the rules into their domestic legislation no later than 4th June 2017. Shortly thereafter, the European Commission issued draft directive on public CbCR that provides for certain information to be publicly disclosed (e.g. available on the company website) in addition to sharing information with the concerned tax administration. Whether such public CbCR may be implemented (requiring qualified majority approval in the Council of Europe) will remain to be seen.

Jurisdictional Transparency Initiatives

Countries have individually begun taking action to enhance tax transparency too in anticipation of the OECD’s BEPS recommendations. Examples of this include the UK Finance Bill 2016 that introduced the requirement for qualifying large businesses to disclose their tax strategy as it relates to UK taxation. UK even became the first country to approve the public CbCR in its statute books. On the other hand, half-way around the world, the Australian Tax Office (ATO) developed and implemented Reportable Tax Positions schedules in 2015 – to be completed by certain taxpayers – with regards to their detailed tax positions.

Tax Administrations’ Cooperation Initiatives

Once the information becomes available due to enhanced transparency, an effective exchange of information program and cooperation programme will enable the concerned tax administrations to trace and, where necessary, assess cross-border transactions, and these additional information can help support tax administrations

to more effectively assess taxpayer in tax audits. While some of these cooperation initiatives may have started a number of years ago, the last few years have seen solid development of membership and activities in conjunction with the advancement in transparency initiatives.

Global Tax Administrations' Cooperation

In a global context, international standards on the exchange of information among tax administrations have been promoted by the OECD, in particular through its framework of the Global Forum on Transparency and Exchange of Information for Tax Purpose (The Global Forum). The Global Forum is instrumental in drafting a new model treaty, the OECD Model Tax Information Exchange Agreement (TIEA), aimed at ensuring that an agreement concerning information exchange can be reached between OECD economies and the other members of the Global Forum as well as other jurisdictions normally cut from mainstream tax treaty networks. The most visible outcome of this has been the significant increase in number of TIEA inspired by the OECD Model in recent years.

On the other hand, the Convention on Mutual Administrative Assistance in Tax Matters, jointly developed by the OECD and Council of Europe in 1998 to provide all possible forms of administrative cooperation between tax administrations in the assessment and collection of taxes, received a significant boost in the recent years because of renewed interest in cooperation by the tax administrations. As of the beginning of November 2016, the latest version of the Convention has been signed by some 106 countries. This Convention provides the legal framework to implement automatic exchange of information between the tax administrations, as well as the legal framework to implement the automatic exchange of CbCR.

Regional Tax Information Exchange and Cooperation Initiatives

Besides the activities of international organisations such as the OECD, tax administrations tend to form networks on a regional basis. These regional frameworks aim to enhance cooperation among tax administrations more directly, and the building up of effective exchange of information experience between tax administrations will no doubt have positive impact to their further collaboration. Examples of such regional network include the Joint International Taskforce on Shared Intelligence and Collaboration (JITSIC) comprising of 36 tax administrations to deal with anti-avoidance, Study Group on Asian Tax Administration and Research (SGATAR) comprising of 17 Asian tax administrations that cooperate on joint training and experience sharing and the African Tax Administration Forum (ATAF) comprising 36 member countries aiming to develop, share and implement best practices.

Forces in action to further drive tax transparency

In the context of tax transparency, it is worthwhile to note some of the significant forces that are driving its continued development in the last few years.

Public pressure

Whereas, in the past, campaigners against corporate income tax avoidance were either ignored or drowned out, the tide had changed whereby they now find a much more sympathetic ear with the public. The group of external stakeholders has widened too and now also include politicians, the media and social justice activist groups/NGOs whose influence in the development of relevant law and regulation can be significant. They often

see direct link between tax and corporate social responsibility, and hence exerting pressure to push for an effective monitoring mechanism through transparency and disclosure.

Public Sector Revenue pressure

The financial crisis has seen tax issues climb much higher on the political agenda, and coincided with increased demand for tax administrations to collect against government budget pressure. Tax administrations can be expected to establish more measures to drive tax transparency in order to facilitate efforts to initiate tax audit challenges, while taxpayer will often be worn down by the ensuing appeal process / uncertainty and come to a settlement.

Transparency facilitated by technological advancement

The advancement of technology has enabled the tax administrations to amass a significant amount of information concerning the taxpayer either at real time or shortly after key milestones e.g. financial year-end. Such aggregation of data sources, together with a new generation of data analytics platforms, are allowing the tax administrations to better identify compliance issues and reap the benefits of transparency when initiating tax audits.

How MNEs should react to new world of tax transparency and manage tax audit risks

The world of tax is therefore very different compared to a few years back. The implementation of new transparency measures globally, regionally as well as nationally, in combination with new tax disclosure requirements will enable tax administrations to scrutinize the taxpayer in a new enhanced way. This will be complemented by increased tax authority resources and new tools intended to leverage on the new data availability. In addition, the drive for transparency through automatic exchange of information will undoubtedly lead to more questions from tax administrations as they gain access to new sources of information such as CbCRs. More tax audits and controversies will arise especially in a transition period where countries may implement the new rules at a different pace. Within this new complex world, the MNE tax function will need to adapt in order to effectively manage the increase of tax audit risks and disputes.

Develop a strong and robust tax risk control framework

Tax audit risks are best tackled at source via the effective control of tax risks in the first place. In this respect, the development of a risk control framework that can identify and manage potential tax issues and risks at an early stage, as well as ensuring compliance with applicable law and be free of material errors, will be of critical importance. A robust tracking mechanism should also be in place to monitor the implementation of tax risk mitigation measures.

Tap into the new environment of cooperative measures

Many tax administrations have propagated cooperative measures e.g. horizontal monitoring, tax ruling, advance pricing arrangement programmes (APA), etc. in order to seek to modernize the relationship with corporate income taxpayers, with a view to more effectively resolve any uncertainty around tax issues. When managed effectively, these measures can provide upside for taxpayers to reduce controversy and tax audit pressure.

Even without formally entering into such a programme, part of the tax audit risk management process should involve pro-active relationship building with the key tax administrations through regular lobbying and engagement, especially in light of increased global enforcement and information exchange across geographies.

Embrace the need to change the tax function

The MNE tax function is forced to deal with a rapidly increasing workload resulting not only from a deluge of new and increasingly complex tax law and other regulation, but also increases in tax audit challenges from tax administrations. Consequently, the MNE tax function must:

- Assess the additional resource (internal and external) that will be required to cope with the increased workload of managing compliance and handling tax audits, and equip itself accordingly.
- Enhance internal processes to manage new ways of cooperation between central and local teams in terms of managing local regulatory developments as well as handling tax issues, tax dispute support and resolution.
- Build linkages to other parts of the organization, not only with respect to tax risk management, but also in securing the proper data support and understanding when handling tax audit responses

Be prepared to deal with the uncertainty

The unprecedented availability of data and information available to the tax administrations and the exchange of information mechanism will give rise to concerns over the inappropriate utilization of such information against the taxpayer:

- Data may be susceptible to misunderstanding and misinterpretation by the tax administrations and initiate tax audits and bring inconvenience to the taxpayers as a result.
- In the context of exchange of information, there may be a risk that countries will fail to reach consensus on the provisions of the multilateral instrument or abuse the provisions of bilateral TIEA.
- There is also a risk that any exchange of information may result in a leak to the press or third parties of business and personal data.

Consequently, the MNE tax function should have a contingency plan in place to deal with the undesirable effects of a more volatile audit and dispute environment.