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Tax strategy for the long term
Is your company getting it right?

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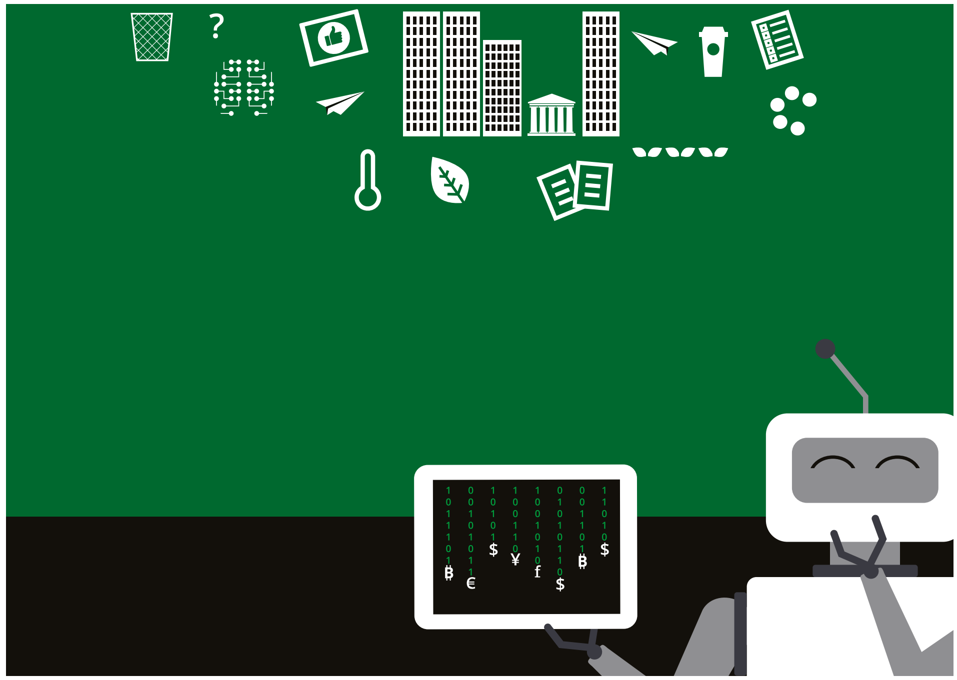
Once considered just another part—and cost—of doing business, tax has become a high-priority agenda item for both the C-suite and the board. Even amid decreasing corporate income tax rates in the United States, the sheer number and range of changes in government tax policies warrant close attention, certainly for senior leaders of multinational corporations (MNCs) and for most enterprises doing business internationally.

Concerns now extend well beyond achieving financial targets to include managing reputational risk, weathering increased scrutiny from media and activist organizations, and addressing the impact of tax on everything from business models to investor communications. Stakeholder interest in tax matters has also increased. Given this heightened profile, organizations should be consciously shaping their tax strategies and involving senior executives, the board, and more specifically, the audit committee in the process, along with the finance and tax functions.

The pace of change in government tax policies adds complexity to this inherently technical area. Those policies remain a work in progress as tax authorities grapple with the effects of digitalization, new business models, new methods of accessing talent, and globalization. When you consider that today's tax codes rest on frameworks formulated more than 100 years ago, the magnitude of the changes and their potential to have a long-term impact become clear.

What's driving change?

The impetus for many recent changes can be traced back to the 2008 global financial crisis, which forced a number of countries to introduce significant budget-cutting measures. At the same time, there was a growing perception that MNCs were using tax planning to erode the corporate tax base because international tax law had not kept pace with the increasingly globalized and digitalized economy. The G20/ Organisation for Economic Co-operation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) project[1] set out to address these concerns by increasing transparency and curtailing international tax planning. This led to unprecedented legislative tax changes around the world, a number of which are outlined on page 3.



Technology stands among the primary drivers of change in tax policy, as it does in many facets of business. Tax practices within and between countries were developed when Industry 4.0, artificial intelligence, cryptocurrencies, blockchain, data analytics, and robotics were barely imaginable. Rapid adoption has left governments playing catch-up even as those technologies and the practices they enable continue to evolve.

Consider the challenge that the digitalization of business poses with respect to tax matters. Taxation, historically and of necessity, seeks out and draws from value; that is, global transfer pricing systems generally aim to tax value where it is physically generated. Therefore, business models that generate value from data prompt questions: Does the value that should be taxed reside in the data itself? In the processes that analyze or otherwise add value to the data? In selling the data? In the technologies that house and manipulate the data? And where, exactly, are each of these processes, activities, or technologies physically located?

The OECD has been seeking consensus on these fundamental questions of how value should be defined and taxed. Unfortunately, agreement on how digitally developed value and digital transactions should be taxed has proven elusive. No fewer than four views of the matter have emerged: Some countries believe that current tax law can address digital matters. Others believe that specific legislative changes are needed to address them. Still others believe that the issue extends beyond digital considerations and that a broader revision of tax laws is needed. And a fourth group has yet to decide which approach is best.

As the OECD continues its work in this area, the importance of reaching a global consensus cannot be overstated. Each country taking unilateral action could result in chaotic complexity, double taxation, and impaired cross-border trade and growth. As of this writing, the OECD was contemplating three approaches:

- A "digital permanent establishment" with allocations of profits made to jurisdictions based on criteria such as number of users in the member country
- A return to jurisdictions-based approaches, taking into account the value of marketing intangibles
- A minimum tax approach, along the lines of the US Global Intangible Low Taxed Income (GILTI) regime, coupled with a secondary approach applicable to companies parented in jurisdictions without a corporate income tax or that do not adopt the minimum tax.

The latter two approaches would apply to all businesses and not just those operating in the digital economy.

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Unprecedented change in taxation

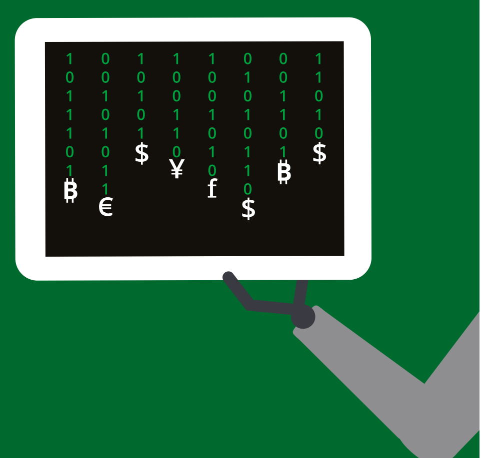
The OECD's BEPS project has introduced a number of actions guided by the principles of coherence, substance, and transparency. Initiated by the G20 in 2012 and now expanded to 124 countries, the BEPS project stemmed from perceptions by some that many MNCs were not paying their "fair" share of tax and were engaging in legal tax arbitrage.

Some of the actions now being implemented include:

- Global Country by Country Reporting, which calls for detailed reporting of corporate taxpayers' foreign operations to be shared with tax authorities around the world, thus increasing transparency. Generally, 2018 is the first year for tax authorities to exchange information.
- Global transfer pricing guidelines with more detailed global and country reporting and a focus on allocating income to those countries where activities are performed and economic substance[2] is present. Generally, 2017 was the first year of reporting, but the new guidelines have been applied by many countries to open cases dating from 2015.
- A multilateral treaty instrument, signed by 84 countries as of November 2018, to swiftly implement the BEPS-related changes into existing treaties and prevent using treaties for tax avoidance. This initiative is expected to impact over 2,000 bilateral tax treaties starting in 2019.
- Automatic global sharing of local-country tax rulings among tax administrations, applicable from 2016 and in the European Union from 2017.
- A harmonized global approach to patent box incentive regimes, generally applicable in 2016 through 2021.
- Eliminating mismatches in country tax laws applicable to taxation of cross-border hybrid instruments and entities; countries are implementing anti-hybrid rules into local legislation with various effective dates from 2017.
- Restricting the deductibility of corporate interest expense starting in 2019 in the European Union, 2018 in the United States, and 2017 in the United Kingdom.
- Greater domestic taxation of offshore income, known as controlled foreign corporation income, effective on various dates and in 2019 in the European Union.

The following specific developments have occurred beyond the BEPS project:

- EU Anti-Tax Avoidance Directives 1 (effective in 2019) and 2 (effective in 2020–2022) implementing certain measures described above and further measures, including a General Anti-Abuse Rule; a tax intermediaries directive to increase reporting requirements as of July 2020, with some retroactive application; and European Parliament TAX3 Committee work related to financial crimes, tax evasion, and tax avoidance.[3]
- A 2018 EU proposal (not yet adopted) to tax digital companies using a temporary measure pending global consensus in this area: a 3 percent tax on specified sources of gross income.
- US tax reform in 2018 reduced the federal corporate rate from 35 to 21 percent and introduced exemptions for dividends from foreign subsidiaries and other measures, including:
  - A Global Intangible Low-taxed Income regime that taxes earnings above certain thresholds in foreign subsidiaries on an accrual basis at an effective rate of 10.5 percent for 2018 through 2025 and 13.13 percent thereafter
  - A Foreign-Derived Intangible Income regime that taxes foreign income above certain thresholds at 13.13 percent for 2018 through 2025 and 16.41 percent thereafter[4]
  - A base erosion and anti-abuse minimum tax, which offsets the benefit of certain payments to foreign-related parties and ensures that the US payer is subject to at least a 10 percent liability (5 percent for 2018 under certain transitional rules) on taxable income, computed without regard to the related-party payments.
- Inspired by the 2010 US FATCA, the Common Reporting Standard (CRS)/Automatic Exchange of Information calls for financial institutions to automatically advise a customer's country of residence of any accounts opened; 49 countries adopted the CRS in 2017, another 52 in 2018, and seven more are slated to do so in 2019–2020.[5]



Deloitte conducted its fifth annual BEPS survey in 2018 to gauge MNCs' views of the evolving tax landscape.[6] Key findings of this survey of 447 participants from 39 countries include the following:

- 86 percent agree or strongly agree that tax structures are now under greater scrutiny by tax administrators than a year ago.
- 49 percent agree or strongly agree that country tax authorities are becoming increasingly aggressive in tax examinations.
- 91 percent believe that additional transfer pricing reporting requirements resulting from BEPS will substantially increase their corporate tax compliance burden.
- 48 percent are concerned about the lack of domestic guidance on BEPS-related legislative changes, and only 21 percent expect consistency in interpretations of new transfer pricing guidelines by tax authorities in various countries.

These responses highlight the need for organizations to take a strategic, multidisciplinary approach to changes resulting from tax-related government initiatives. In the past, this might not have required the attention of senior management and the commitment of organizational resources, but the new environment now requires both to support long-term success.

The US Supreme Court case of Wayfair versus South Dakota epitomizes the rapid change in the tax arena and its impact on business models. In this case, the Supreme Court determined that simply selling into a state may constitute nexus in the state for a company and thus create a tax obligation to that state. This decision has prompted many organizations to revisit their taxation practices in individual states. In the past, they may not have had sales tax or other tax obligations in a state where they did not maintain a physical presence.

The BEPS project has focused on increasing transparency and curtailing international tax planning. The work regarding the digital economy is focused on reaching agreement among countries on the allocation of taxing rights. Consensus continues to be a challenge across the European Union and globally; some countries have already introduced unilateral measures to tax the digital economy and more intend to do so, potentially leading to double taxation.

While some base-broadening initiatives will result in an increase in tax liabilities, governments are striving to attract and retain investment and create jobs through reductions in corporate tax rates, accelerated depreciation allowances, and other incentives. The average corporate tax rate in OECD countries fell from 32.5 percent in 2000 to 23.9 percent in 2018.[7]

Changes in tax policy present opportunities for corporate leaders, including the board, to take a more proactive approach to tax policy discussions. Policy makers generally seek business leaders' input and certainly consider it. They realize that organizations understand their businesses and the operational and financial impacts that changes in tax policy can have on individual companies and entire industries. Business leaders are positioned to help policy makers visualize what would and would not work from a practical business and industry perspective, so it's useful for them to share those perspectives with government in the early stages of policy development and thereafter.

Active engagement with tax policy makers by executives and board members can also help gauge where tax policy may be headed. The board should confirm that management is actively assessing potential legislative developments at the regional, national, and provincial or state levels and considering alternative responses. Inputs to scenario planning should take into account potential changes to tax laws and their likely impacts.

Deloitte research suggests that changes in tax policy are having a significant effect on organizations (see sidebar). As in any situation characterized by rapid change, competing interests, and unsettled rules, uncertainty prevails. And uncertainty means risk.

Tax-driven risks

Risks resulting from the foregoing developments can be broadly characterized as financial risk, disclosure risk, and reputational risk.

Financial risk arises when tax authorities could prevail in challenging an organization's position, with potential impacts on cash flow, earnings, and other accounts. If a material transaction is challenged and the company's position is not sustained, financial consequences ensue.

Disclosure risks may arise around how clearly the sustainability of the organization's tax policy or effective tax rate is conveyed and uncertainties related to tax assets and liabilities.

Tax-related reputational risk varies in its forms and across organizations. For example, the media or activist groups may portray a company as underpaying taxes, not paying its fair share, paying lower rates than private individuals or smaller businesses, or avoiding taxes.

Management should conduct assessments of tax-driven risk and associated risk-return tradeoffs and establish explicit tolerances. Senior executives and the board should discuss these risks and tradeoffs and approve the related risk tolerances. These practices are occurring more frequently given that these issues often impact the broader organization and thus fall within the board's risk oversight responsibilities.

Beyond enterprise-specific risks, there are macro-level risks if tax authorities fail to develop a coordinated approach in this new environment. There's significant risk of highly uncoordinated, unilateral action being taken around the world, which could lead to multiple levels of taxation without offsetting relief. That would almost certainly have a negative effect on specific businesses as well as the global economy.

As part of its risk oversight responsibilities, the board must understand these tax-related risks and confirm that management has recognized and addressed them. The board's involvement with tax strategy also extends beyond that, particularly regarding longer-term considerations.

Overseeing tax strategy, policy, and risks

Given digitalization and the increasing role of technology in the future of business, tax matters will extend well beyond near-term financial, reporting, and reputational impacts. The board should ascertain that management has prepared the organization not only for immediate tax changes but also for its intermediate- and long-term impacts. Many boards include this language in their audit committee charter.

Tax considerations are rarely the sole factor in a strategic business decision. Yet they should be factored into decisions involving technology platforms, the control environment, compliance systems, and assurance activities, as well as those involving new business and talent models, new markets, and all third-party relationships. These areas present both opportunities and risks to be analyzed from a tax perspective, even though tax will generally not be the key determinant in the business decision.

The board should also consider the following specific issues that can be influenced by tax matters:

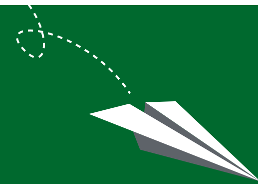
- **Business strategies and models:** Although business strategies and models should not be determined solely by tax policy, changes to the tax strategy should be considered. This is particularly true of marginal projects or those in which depreciation or the deductibility of expenses are affected. However, because taxes follow business models, it is important to analyze tax-related risks and opportunities. More change can be expected as legislation and litigation occur in countries and as disputes between countries are settled. Changes in trade policy, including increased customs duties, can also have a dramatic impact on global supply chains.
- **Systems and technology:** The board should confirm that management has prepared the organization's accounting and financial systems to accommodate changes in tax reporting, payments, data collection and analysis, and other needs emanating from changes to jurisdictional tax policies and the organization's tax strategy. Management should prepare the organization to address future tax changes, which can be expected in response to ongoing digitalization and political pressure.
- **Reputational considerations:** Tax strategy should be considered by management and the board in the context of overall reputational risk management. Senior management and the board need to understand the potential reputation risks associated with the organization's tax strategy. Although an organization's tax function should play a significant role in informing the board, reputational risk should be assessed through an organization-wide lens.
- **Talent models:** Issues involving employment taxes, employee income taxes, and taxes on independent contractors may arise, particularly as the gig economy, crowdsourcing, and talent mobility continue to increase—the notion of taxing robots has even been proposed. As tax laws change, more robust support from the human resources and tax functions may be needed to handle the complexities of employment taxes and, in cases of foreign employees or locations, home-country/host-country income tax issues. Given the widespread use of alternative staffing models, management should closely monitor employee classification criteria, such as varying definitions of independent contractors and part-time employees.
- **Reporting and disclosures:** The increasing emphasis on transparency should prompt the board to work with management to assess voluntary disclosures regarding tax strategy with an eye toward investors and other interested parties. For example, management might discuss the organization's structure and its tax implications or the board's role in contributing to the government's tax policy and any related consultations. The company might disclose all taxes it pays beyond income tax to give the public a clearer picture of its total contribution to the governments and societies of the countries where it operates. Management's goal should be a sustainable tax strategy supported by technology, compliance, reporting, and assurance systems that can accommodate numerous changes in reasonable time frames at reasonable costs. In terms of reporting and disclosures, boards should encourage management to position the organization to proactively respond rather than to react to change.

The board needs a clear line of sight into tax developments and management's responses. This includes understanding the organization's tax history, including the changes to past practices and their impact. This information should be compiled and delivered to the board so it can familiarize itself with the organization's tax audits and the outcomes of any tax litigation. Historical matters can be conveyed to new board members in their orientation materials.

As a practical matter, many boards rely on the audit committee to keep them informed about the organization's tax positions and developments. However, if the board perceives little change in the reporting methodology and disclosures related to tax, it may be time to raise the matter with the audit committee or for the audit committee to do so with the tax, finance, and internal audit functions. Few large organizations remain untouched by the ongoing upheaval in tax policies.

In this rapidly changing and highly technical area, tax expertise in the boardroom will vary significantly or, in some cases, may be lacking. External expertise in the form of written briefings or live presentations on tax changes and their potential impact can be highly valuable to both the audit committee and the full board. The full board should now consider discussing tax regularly to keep abreast of legislative developments and the organization's responses.

As in many areas that were once seen as relatively static, tax strategy and the related technology, administrative, and risk management infrastructure must now be reviewed more frequently, in greater detail, and at higher levels of the organization than in the past. Considering the long-term impact that tax strategies and policies can have on an organization, proactive engagement by the board is clearly warranted.



Questions for directors to ask

- How is our organization's tax strategy aligned with our business strategy? Where do they fail to align? How can management better integrate the two, particularly in terms of long-term tax strategy?
- What financial, reporting, and reputational risks does management associate with our tax strategies? What has management done to evaluate and address these risks and any associated tradeoffs in the short and long term?
- What tax-related expertise is available on the audit committee and board? How can we augment resources in areas where we may be lacking sufficient or specific expertise?
- How can we keep abreast of changes in the government's tax policy and their potential short- and long-term impact on our organization and its operational and financial performance?
- How is management preparing our organization to address the operational and financial impacts of proposed changes to government tax policy? What has been done so far? What remains to be done?

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Endnotes

1 Base Erosion and Profit Shifting, Organisation for Economic Co-operation and Development <http://www.oecd.org/tax/beps/>

2 Additional Guidance Under the Codified Economic Substance Doctrine and Related Penalties (Notice 2014-58), Internal Revenue Service<https://www.irs.gov/pub/irs-drop/n-14-58.pdf>

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5 AEOI: Status of Commitments, Global Forum on Transparency and Exchange of Information for Tax Purposes, Organisation for Economic Cooperation and Development, November 2018 <https://www.oecd.org/tax/transparency/AEOI-commitments.pdf>

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