Tax avoidance: a new era

Corporate tax avoidance has been thrust into the mainstream in recent years as governments struggle to manage vast public debts. Public services in many countries have endured ongoing austerity cuts and many consumers had to tighten their belts in the years following the great financial crisis, which inevitably meant focus turned to corporates and their contributions to governments' tax purses.

This culminated in the Organisation for Economic Co-operation and Development (OECD) launching its Base Erosion and Profit Shifting (BEPS) Action Plan in 2012. BEPS refers to "tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations" and is a common strategy among multinationals to minimise their tax bills and maximise shareholder value. The International Monetary Fund estimates that around $600bn is lost to profit shifting every year.

Finalised in 2015, the plan seeks to limit BEPS with 15 specific Actions:

- Action 1: Addressing the Tax Challenges of the Digital Economy
- Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements
- Action 3: Designing Effective Controlled Foreign Company Rules
- Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments
- Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
- Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
- Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status
- Actions 8–10: Aligning Transfer Pricing Outcomes with Value Creation
- Action 11: Measuring and Monitoring BEPS
- Action 12: Mandatory Disclosure Rules
- Action 13: Transfer Pricing Documentation and Country-by-Country Reporting
- Action 14: Making Dispute Resolution Mechanisms More Effective
- Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

The full BEPS Action Plan text can be found here.

The precedent-setting framework is a starting point for global tax coordination and as at January 2018 a total of 78 countries had signed up to the 'Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting' (MLI). As MLI signatories, these countries have committed, as a bare minimum, to implementing four of the OECD’s recommendations: Action 5, Action 6, Action 13 and Action 14.

The UK was one of the first in the world to respond to the OECD's efforts. In April 2017 the government addressed Action 4 by introducing a loan interest deductibility cap (30% of earnings before interest, tax, depreciation and amortisation, also known as EBITDA). Because interest payments are tax deductible, businesses are incentivised to finance their investments using debt. The effect of interest payments reducing tax bills makes it a more attractive method of financing than equity.

As of April 2017, UK businesses can only deduct from their taxable income interest payments worth up to 30% of annual EBITDA (otherwise a Group Ratio Rule can be applied, whereby the cap is calculated based on the net interest expense to EBITDA ratio for the worldwide group).

While it was bold for the UK government to implement Action 4, the change appears to have limited impact in most cases. This is because interest payments equalling 30% of taxable earnings is atypically high and therefore the cap will only affect companies with highly leveraged capital structures, such as those used in private equity buyouts and by real estate investment trusts (also known as REITs).

Calculations show that it is only when a debt-to-earnings ratio of 4:1 is exceeded (using loan or bond interest payments of 7.5% as an example) that a company will begin to breach the debt cap and therefore have to pay relatively small amounts of additional tax, although this may be a significant figure on an absolute basis depending on the size of a company, its profits, its debt burden and the associated interest it pays.

'Google tax'

Another notable development in the UK, which predates the finalisation of the BEPS Action Plan but concerns the exact aggressive tax planning the initiative seeks to prevent, was the introduction of the Diverted Profits Tax (DPT), commonly known as the 'Google Tax', in April 2015.

DPT targets companies, both UK and non-UK tax resident, but not SMEs, that divert profits to related foreign branches and by doing so reduce their tax bill despite the arrangement "lacking economic substance", broadly interpreted as an arrangement that has the sole or primary purpose of reducing tax.

DPT taxes diverted profits at 25%, instead of the lower 20% corporation tax rate, and so is an incentive for corporates to book relevant profits in the UK rather than transferring them overseas. Companies are obliged to notify HMRC of arrangements and transactions that may be interpreted as diverted profits, and therefore may be subject to the DPT.

Europe-wide

Measures to reduce tax avoidance across Europe are already in train. EU member states have agreed to adopt the Anti-Tax Avoidance (ATA) directive, which addresses four of the BEPS Actions by introducing:

1. a hybrid mismatch rule: to prevent double non-taxation of certain income (Action 2)
2. a controlled foreign company (CFC) rule: to deter profit shifting to a low or no tax country (Action 3)
3. an interest deductibility cap: to discourage artificial debt arrangements designed to minimise taxes (Action 4)
4. an exit taxation rule: to prevent companies from avoiding tax when relocating assets, such as intellectual property and other intangible assets (Action 5)
5. a general anti-abuse rule: to counteract aggressive tax planning when other rules don't apply.

European governments including the UK have until 31 December 2018 to transpose these measures into law, with a further 12 months to implement the exit taxation rule.

Additionally, EU member states have passed legislative measures to introduce so-called country-by-country (CbC) reporting (Action 13), under which multinationals with revenue of more than €750m will be required to file reports with their tax authority. These CbC reports will include, among other things, a breakdown of revenues from both unrelated and related parties, profits, taxes paid, as well as a list of all 'constituent entities' by tax jurisdiction and their main business activities. It is the 'ultimate parent entity' of a multinational group that will be expected to file its CbC report in the jurisdiction in which it is resident for tax purposes.

Once again, the UK has been a first-mover in embracing the measures set out in the BEPS Action Plan and has already introduced CbC reporting. This means that all UK multinationals with turnover in excess of €750m should now be filing annual CbC reports with HMRC.

Independently of the BEPS Action Plan and the EU directives it has prompted, Europe has been on the offensive in its efforts to stamp out tax avoidance. In August 2016 the European Union ordered Apple to pay an unprecedented €13bn (£11bn) in back taxes to Ireland after it was ruled that an arrangement between the iPhone manufacturer and the Irish tax authorities constituted illegal state aid. Apple had been levied 0.5% under the deal instead of the country's 12.5% corporate tax rate. In December 2017 the Irish government reached an agreement with the technology giant for the money to be paid into an escrow account, despite the country refuting the EU's assessment of Apple's tax treatment.

Further, at the time of writing, it is expected that the EU will introduce an additional directive specifically targeting Google, Apple, Facebook, and Amazon, by levying a 2 per cent tax on their revenues rather than their profits. This is to circumvent the manipulation and obfuscation of profits when they are diverted to offshore business entities. Whether this anticipated directive is passed or not, it is clear that Europe will no longer stand for tax avoidance perpetrated by multinationals.

While most OECD and G20 countries outside of the EU intend to bring their own measures into force, governments must determine how the OECD's BEPS guidance will impact their existing tax and legislative regimes before the potentially drawn-out process of enacting relevant laws. Also, the BEPS Action Plan is a set of recommendations and while MLI signatories are committed to at least four obligatory Actions of the 15 set out in the Plan, how these are fulfilled in practice, and how business activities and intangible assets are seen to contribute value for the purpose of apportioning profit, is expected to differ from one country to the next.

A risk perspective

The issue of tax avoidance broadly falls into two risk categories: compliance risk and reputational risk.

From a compliance perspective, it is critical that multinationals abide by the tax laws of the countries in which they operate. This will require a close watch on how different countries adopt changes in response to the OECD's recommendations.

Europe and the UK in particular have ambitiously spearheaded changes to their tax regimes and these should be seen as a benchmark for future developments. At the very least, multinationals in the UK and their internal audit functions should:

- be familiar with their obligation to report to HMRC any activity that is likely to be interpreted as profit diversion and may be subject to DPT
- be aware of any impact that the interest debt cap may have on their tax liabilities and future capital structure
- understand the requirement to submit CbC reports to HMRC

- be preparing for the additional rules that will be imposed upon them under the ATA directive that have not already been implemented by the UK government

More fundamentally, at the heart of the BEPS framework and the legislation that is being enacted around it is the principle that multinationals should apportion profits to where economic activity occurs, and value is created, and be taxed accordingly. How this is interpreted by the European Commission as it cracks down on multinationals remains to be seen, as its decision to pursue Apple is something of a test case. However, now more than ever, businesses must understand their tax strategies, how tax is avoided and whether this avoidance is a side effect or primary motive of how business activities are structured in the group.

Some chief audit executives (CAEs) are likely to see demand from the board/audit committee for an assurance that there’s a clear tax strategy in place and that the compliance function has and continues to take into account all of the recent and upcoming legislative changes, and how they will affect the business.

CAEs who expect tax avoidance to feature in their upcoming audit plans would do well to answer the following questions:

1. does the business engage in BEPS and does it understand in what ways it does so?
2. are there legitimate reasons for exploiting any loopholes other than to avoid tax and what are they?
3. what loopholes are being exploited and are these going to be closed under the ATA directive?
4. is a tax strategy in writing or is it something that is understood verbally among senior management?
5. what is the official position on the company's tax strategy and does this reflect reality?
6. is the business compliant with changes already made by the UK government in advance of the BEPS Action Plan being finalised (i.e. debt cap, DPT, CbC reporting)?
7. can the compliance function provide evidence that the business will be compliant post ATA directive?
8. are measures in place to monitor and respond to relevant tax law developments at a country-by-country level, whether related to the adoption of the OECD's recommendations or otherwise?
9. if the company is engaged in BEPS, is there an established risk appetite for the reputational damage the company may suffer if details of its tax strategies are exposed by the press.
10. does internal audit have a role in reviewing the CbC report before it is submitted to HMRC?

Further reading

ATA directive

HMRC's guidance on CbC reporting

The debt cap

DPT