Tax policy and administration: Global trends/June 2012

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Trends

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Shaping the tax system

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Taxes are used as a policy instrument in a variety of ways. The manner in which tax revenues are raised can also distort economic activity. In the light of experience and analysis, a number of principles have come to inform the design of efficient tax systems. But governments, economists and other professionals inevitably disagree about the combination of tax policies that will achieve particular aims, whether that is raising revenue, redistributing wealth or helping regulate behaviour.

This paper, which will be an annual publication with a mid-year supplement, seeks to highlight some of those principles and looks at a selection of the different ways that governments are starting to shape their tax systems. It also considers how the respective tax authorities are administering those systems and the impact that supranational bodies are having on them. The intention is not to be a news sheet merely recording what has happened but rather to identify the key global trends in the development of tax policy globally.

We start by looking at the current status of some of the longer term tax plans that have been announced before turning to specific policy moves.

Our series of *Paying Taxes* surveys with the World Bank illustrated a trend during the second half of the last decade toward a lowering of corporate tax rates and a broadening of the tax base. We consider recent examples and how things are beginning to be clouded by other basic tax policy considerations.

In recent years, there have been frequent discussions among policy-makers, economists, scholars, tax practitioners or even the general public regarding the fiscal revenues weighting between direct tax and indirect tax. The trend has largely been toward more indirect taxes.

Anti-avoidance generally is a key agenda item at the moment for most tax authorities and, consequently, for most taxpayers. While we see increasing collaboration between territories, we also consider moves toward dealing with issues which have set one territory against another, like hybrid entities and hybrid instruments, or extra-territorial tax 'grabs' as with the Vodafone case in India. Some territories seeking to protect their tax base are increasingly turning to the idea of a general anti-avoidance rule but does the experience of those who currently have one suggest problems ahead?

Long term goals

Some territories have publicly set out longer term tax agendas. At one extreme, China formulates its broad economic State Plan every five years. The current one is the 12th Five Year Plan, from 2011 to 2015. The Ministry of Finance (MOF) and State Administration of Tax (SAT) follow suit to formulate their tax plans in the same time span. So they would normally set the objectives, goals and action plans to be accomplished with the Five Year Plan.

Matthew Mui, PwC China's tax policy partner says

"In line with the Five Year Plan, in 2012 the tax focus is likely to be on the pilot programme for VAT to replace business tax in key service areas."

Quite a few territories have considered broad programmes for tax reform and are at various stages of implementation. Compare and contrast some of the drivers and delays experienced. Let's consider the difficulties being experienced by Australia, Canada and the US in introducing reform to the relatively rapid progress made in the UK.

The UK has focused heavily on corporate tax reform following an increased acceptance that it risked being overtaken by other economies in easing tax burdens for businesses. This has been highlighted by the latest PwC and World Bank *Paying Taxes* rankings, with the UK slipping to 18th position in the 2012 league table of 183 economies, down from 16th position last year and 11th place in 2006. The resulting introduction in the UK of ongoing reductions in the main corporation tax rate, a preferential rate for patent profits and a new controlled foreign company (CFC) regime that includes a much reduced tax rate for finance companies is a significant move.

Mary Monfries, tax policy partner at PwC UK, commented "The UK already had a competitive tax system compared to some territories, but the trouble is we need to be right at the top to attract maximum inward investment. Other countries have specific resources or markets that bring in businesses; for us the financial and business environment is the key attraction. The Government's roadmap of corporate tax reforms should make the UK a much more attractive place to do business. We need to make sure though that the current discussions on a possible General Anti-Abuse Rule (GAAR), albeit designed to be targeted at only highly aggressive tax planning, don't bring a level of uncertainty that counteracts this progress."

While Canada is working at eliminating its deficit (see below), the federal government referred in its March 2012 budget documents to ongoing initiatives to reduce the tax burden, and also to the fact that it has achieved a current *Paying Taxes* ranking which shows that it has the 'easiest' regime of any G-7 country. It has been the federal government's longstanding goal to reduce the combined corporate tax rate to 25% in 2012 and it has lived up to its side of the promise by reducing the federal rate to 15%. However to achieve this goal it also needed to rely on the provinces to reduce their corporate tax rate to 10%. This has proven to be difficult for some provinces. For example, Ontario, Canada's largest province, has decided that because of its provincial deficit, it will leave its corporate tax rate at 11.5%, suspending further corporate tax reductions until its budget is balanced - something that could take up to five years.

In Australia a broad tax reform debate has been running for the last three to four years. Although an holistic review was completed by a review panel for the Federal Government in late 2009, the broad debate continues, with a focus on simplification, reducing the number of taxes and enhancing equity and fairness. Apart from bitterly disputed proposals for a new tax on minerals/resources and for a carbon tax, the political reality of a minority government is proving a challenge for progressive reform, and in particular the intention to shift from direct tax to indirect tax has stalled.

Divided control of the federal government effectively has blocked adoption of significant tax legislation in the US since 2010. But that could change after the November 2012 elections, and Congress could act on corporate tax reform. There is general agreement that the US corporate tax regime is not competitive in the global economy, but a need to reduce federal budget deficits from current levels will probably require that any corporate tax reform must be revenue neutral, that is, not add to the federal budget deficit.

The increasing tendency for tax policy makers to set out longer term goals should be applauded as it helps you with your global tax strategy. You'll probably want to also consider the relative tax compliance and reporting burdens imposed in particular territories. The confidence multinationals like yours gain from a country that sets longer term goals tends to contrast markedly with the position in countries which 'chop and change' their tax policies. This is especially worrying in relation to those countries that are showing a greater tendency toward making changes retrospective in nature. It will surely have an impact on the levels of investment you and other multinationals make in different territories.

Stimulating growth and cutting deficits

Many governments spending and tax policies are now constrained by the need for deficit reduction to maintain the confidence of financial markets. In the East, while tax policies have not had to be formulated particularly to address the impact arising from the 2008 financial crisis in the West, governments have nevertheless been prompted to address the sustainability of the overall economic growth and improvement of social conditions.

Some have argued for a financial transactions tax (FTT) as a means of raising revenues, and it is on this basis that it is more likely to be adopted even though there has been a desire to penalise the financial sector for its part in the financial crisis. The G-20 has discussed a global FTT but little progress seems likely. Several countries have had a form of FTT for some time. Brazil's IOF is one example which has been getting tougher over the last year or so. Nelio Weiss, PwC Brazil tax policy partner, comments "Many cross border foreign exchange loans which will effectively mature within five years (or in fact do so) attract a 6% rate rather than a zero rate. The period has changed several times since it was first set at 90 days. It has subsequently been increased to 360 days, 720 days and then 1080 before the latest change."

The European Commission put forward a draft directive on an FTT but the UK and several other Member States objected. With Germany and France apparently keen to keep the momentum going, an FTT across certain states could be a possible compromise and, in late June 2012, EU Finance Ministers concluded that a request for adoption of the enhanced cooperation procedure be put forward under which a minimum of nine Member States could decide on a harmonised approach. In the meantime, France has adopted a stamp duty on various financial transactions, along the lines of the UK's existing duty and this could be a possible alternative for broader consideration. One of the principal criticisms is that the burden of a FTT or stamp duty will ultimately be shifted to the underlying consumer. On the other hand, we've seen the introduction of a bank tax in the UK and various European countries (the Netherlands being the latest to come up with proposals) with specific regulation under the Dodd-Frank Act in the US.

The plight of many of Europe's governments is well documented. Greece and Italy have been forced to adopt austerity measures but they have by no means been the only ones. Apart from the idea of a blanket FTT, the range of measures has varied but Spain's new government appears to have taken an unusual tack in its urgent budgetary, tax and financial measures to correct the country's public deficit by targeting personal income tax.

PwC's tax policy partner in Spain, Jose Felix Galvez, says

> *"Marginal tax rates of over 50% in most autonomous communities in Spain, and even 56% in one autonomous community, have not been seen in Spain for more than 20 years."*

In North America, the Canadian government is working at eliminating its deficit by controlling/reducing spending, by reforming some of its social programmes (such as pension programmes) to ensure they can be sustained in the long term and by focusing on tax avoidance schemes, closing perceived tax loopholes. Interestingly, until a consensus can be reached on tax reform, the US has been attempting to attract marginal investment and spur economic growth by providing accelerated recovery of domestic capital investments. Absent a quick economic recovery, it is likely such incentives will continue to be proposed.

In South America, many countries continue to address the growth of key manufacturing and other industries with a plethora of different taxes. This has clearly contributed to the high perceived administrative tax burdens in many of those countries.

Mexico's Decree for the Promotion of the Manufacturing Industry, Maquila and Exportation Services Program, IMMEX programme is one

Government deficits in many countries will not be redressed for some years to come. We're likely to be living with austerity budgets for some time. The need to attract inward investment and grow domestic business means that Governments are likely to continue to use tax as a competitive weapon. At the same time, there will be greater pressure than historically to avoid taxpayers using reliefs in circumstances where they are not primarily intended. This will affect the nature of your planning in future. You can shop around though to find countries that are keen to encourage particular industry sectors or investment in key regions.

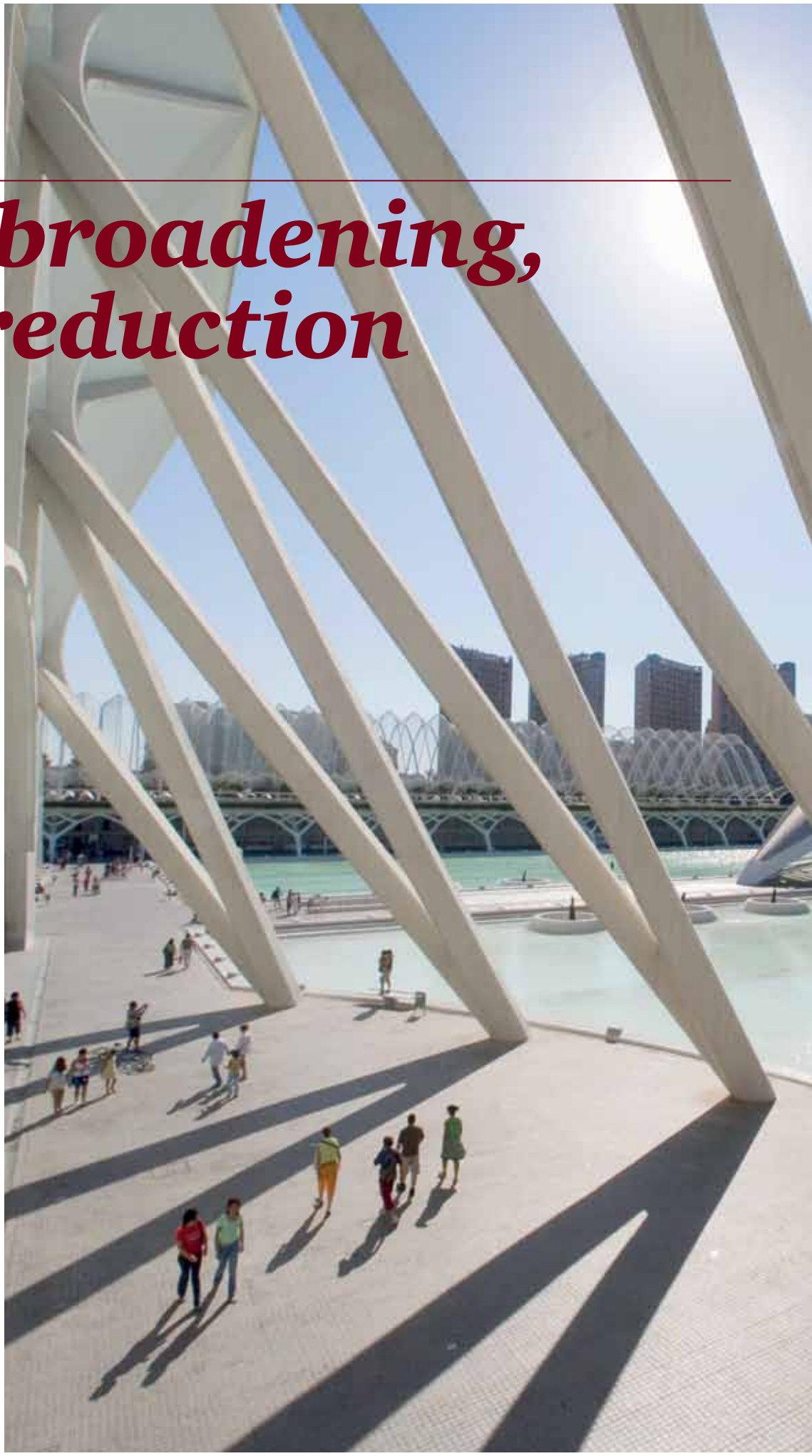
example of an incentive which has resulted in continual changes to the tax system. But at the same time, one of PwC Mexico's tax policy partners Karina Perez Delgadillo points out that in cutting deficits,

"the Mexican authorities are expected to increase formal audits to assess permanent establishment (PE) risks and transfer pricing deviations and to review customs procedures."

In the East, the Chinese government is continuing to implement tax policies to stimulate economic growth. It will heighten the VAT and Business Tax taxation thresholds and extend preferential tax treatments for small and thin-profit enterprises, it has said. It will also implement tax incentive policies to encourage development of cultural industries and to support regional economic developments in a harmonised manner, to encourage innovation and science conversion, to develop strategic industries, to support corporate restructure of large state owned enterprise, etc. Japan too is targeting regional development, to stimulate inbound investments by foreign multinational companies (MNCs) and to encourage Japanese MNCs to locate regional and other operations in Japan, a new investment incentive was created for "Designated International Strategic Areas" (located in designated metropolitan areas). Qualifying corporations doing business in a Designated International Strategic Area are granted tax credits or income exclusions.

Russia is one country outside the West that also faced a swelling state pension fund deficit. Several tax policy proposals were being considered by the Russian government, in the run up to the presidential election. These include measures to stimulate entrepreneurial activity beyond the natural mineral resources sectors (oil and gas, metals, chemicals).

Base broadening, rate reduction



The UK's phased reduction in the main corporation tax rate, described above, is more than matched by the 5% reduction made by Japan with a long-term policy announced of further reductions. The Canadian government's low tax plan for jobs and growth has nearly reached its target of a combined federal and provincial rate of 25%. In Germany the financial crisis has put paid to rate reduction aims with new taxes also being introduced (mainly on the basis of being green taxes, as discussed later). The combined US federal and state corporate tax rate is now the highest in the Organisation for Economic Co-operation and Development (OECD), and future reform efforts are likely to focus on reducing the federal statutory tax rate.

At the same time as rate cuts in many territories over recent years, their respective tax bases have generally been broadened in a number of ways in order to make up for the lost tax revenue.

Pam Olson, Head of PwC US Washington National Tax Services practice notes,

"Base broadening in light of any federal tax rate cut is likely to be focused on repealing or limiting tax provisions that result in taxable income being less than income reported on financial statements (which may be referred to in political discourse as 'eliminating tax loopholes')."

While we have seen technical adjustments by way of additional taxable revenues or the narrowing of definable deductions, particularly in the areas of interest payable, territories have also been favouring the approach of clamping down on what is seen as avoidance. These are discussed further below, but it is worth noting here the approach of the Mexican tax authorities which have sought more actively to disallow certain deductions on the grounds that taxpayers do not demonstrate that the respective expenses are strictly indispensable or to apply a presumptive determination of a taxpayer's taxable profit. Canada is a good example of the focus too on seeking to restrict the efficiency of debt push-downs, the March 2012 Budget introducing amendments targeting subsidiaries acquiring foreign companies, whether or not from an internal group restructuring or refinancing.

The ability of EU Member States to take action in this area would in future be limited by any agreement on a Common Corporate Tax Base (CCTB). It is not yet clear that enough countries will agree to a standardisation of the tax base or, indeed, the wider Common Consolidated Corporate Tax Base (CCCTB) proposals currently put forward by the European Commission and widely endorsed by a resolution of the European Parliament. The consolidation route would involve calculating the tax basis over multiple countries and apportioning the taxable profit before applying participating countries' tax rates. Bob van der Made, PwC's senior adviser on EU Public Affairs, says

"If the proposal is adopted by the Member States in Council – either by all of them or by at least nine Member States under a special procedure – multinational companies would need to rethink their EU tax strategy".

Some of the arguments for a broader tax base but reduced rates apply equally to indirect taxes.

Headline tax rates can be a powerful component in a decision about whether to invest in a particular territory or where to locate particular parts of the business. Broadening of the tax base and elimination of relieving provisions will have a significant effect on the nature of tax planning in future though. Increasingly it seems likely that you will want to consider more structural solutions such as value chain transformation.

Shift from direct tax to indirect tax

Value added tax (VAT) systems (including goods and services tax) have now been implemented in more than 150 countries, as we noted in the second edition of our recent publication *Shifting the Balance*.[1] Seven more are considering doing so by 2013, with particularly the countries of the Gulf Cooperation Council (GCC) having indicated their intention to move towards a uniform VAT system, with India and China also reforming their systems. The EU has also developed recommendations for a simpler and easier to administer VAT system within what are now the 27 Member States. Among other things, in its resulting White Paper, a reduction in the large number of exemptions and preferential treatment currently enjoyed by some Member States – a more broadly harmonised base – is likely.

The Canadian federal government has taken the lead to moving Canada to more fully harmonise provincial sales tax systems with the federal goods and services tax (GST). Harmonisation is seen as being particularly beneficial to Canada's manufacturing sector because it removes the provincial sales tax drag on exports that still exists in the non-harmonised provinces.

Nick Pantaleo, Canada's tax policy partner commented that "This initiative, along with its initiative to lower corporate income tax rates, might suggest that the federal government would favour increasing the shift from direct to indirect tax. But the federal government recently lowered the federal GST from 7% to 5% and it seems unlikely it would reverse this decision, at least in the short term, in the current economic climate for fear that it would harm Canada's economic recovery."

China's current situation is quite unique in that revenues from indirect taxes (>60%) have been far greater than those from direct tax (<40%) for quite some time already. Some view such a ratio as an indication of over-reliance on indirect taxes that could be unhealthy or even detrimental to a tax system, economy or even social stability in the long run. But there's no information from official sources indicating that the Chinese government is dedicated to adjusting the revenue weighting between direct tax and indirect tax in the foreseeable future. A critical factor is the unique revenue sharing mechanism between the Central government and local levels because different types of direct and indirect taxes would be allocated to different levels of governments for their expenditures. One change that is expected to take place during this Five Year Plan is the gradual expansion of VAT to cover service industries that are currently subject to Business Tax. Once the evaluation of a Shanghai Pilot Program is declared successful, the transformation should be expanded nationwide. Such transformation, resulting in mitigation of multiple taxation for service industries, may suppress the indirect tax revenues collection which may then help balance the mix a bit.

Other territories having expressed a specific intention to reap more from indirect taxes in the near future include The Netherlands (to the benefit of a reduction in the direct tax on employment income) and Japan (merely proposing that the VAT rate be changed from 5% in two steps to 10% by 2015).

At this point, there is no political impetus in the US to introduce a VAT system. This is the case whether for broader tax policy purposes or, like many other countries, to pay for corporate tax reform. The US is the only one of the G-20 and major OECD states without either a VAT or GST regime.

[1] Shifting the balance: From direct to indirect taxes, 2011

You could benefit substantially from tracking countries' intentions to introduce new indirect taxes. As indirect taxes become more prominent in countries' budgets, governments will also take steps to increase the effectiveness and efficiency of collection and minimise avoidance. The time taken to comply with indirect taxes is often much greater than that for direct taxes and you will probably want to make sure that the shift in direction is not matched by a significant increase in the resource you have to devote to compliance. For most companies though, there is no getting around the fact that the majority of their Tax departments and the greater part of their tax strategies will have historically related to direct taxes and that is likely to change.

Environmental tax

As 2011 drew to a close, all eyes were on Durban as governments gathered there for the annual United Nations climate change summit. One of the key outcomes from the summit was the launch of a roadmap towards agreeing an ambitious global deal in 2015, to be in force by 2020. This was as good an outcome as could have been hoped for, given the economic climate. With such a deal still years away, we can expect to see continued development of sub-national, national and even multinational policies, as governments look to new approaches to address climate change.

Attention then turned to The Rio+20 UN conference on sustainable development in June 2012. Taxation was recognised as a tool to improve income growth and distribution. The appropriate role of government in relation to the promotion and regulation of the private sector would vary, it was noted, from country to country depending on national circumstances.

Territories seem to be adopting mixed approaches to environmental issues through taxation. Germany has introduced new taxes (on the use

of nuclear material in a reactor and an air traffic tax). The Chinese government is considering introducing an environment protection tax and adjusting other environmental tax policies to target taxpayers who emit certain polluting waste. Australia has seen the introduction of a carbon tax. In the UK, a carbon price floor for electricity generation is to be introduced from 1 April 2013, starting at around GBP16 per tonne of CO_2 up to GBP30 per tonne in 2020, though plans to introduce a new form of air passenger duty have gone back to the drawing board. The 'greening' of existing taxes with incentives to target particular behaviours has not been considered particularly successful in the UK but Japan has adopted an experimental incentive by way of special depreciation for acquisition of certain machinery and equipment. In Canada, there are some discrepancies between provincial and federal tax policies. At the federal level, Canada is unlikely to adopt new environmental taxes in the short term, the current government resisting calls to implement carbon taxes. Certain provinces, most notably, British Columbia, have enacted such taxes.

The past few months have seen some interesting developments in international green policy. In South Africa's 2012 Budget review, the Government confirmed that it will introduce the country's much anticipated carbon tax from 2013. In other parts of the world, a series of national climate strategies have been unveiled, as governments set out their plans to transition to low carbon economies and look to secure their energy futures. Meanwhile, a global trend has gained momentum which has seen cuts to renewable energy subsidy schemes spread across Europe, and other regions throughout the world. Our Global Green Policy Insights newsletter for April 2012 noted, for example, impacts on the Czech Republic, Greece, Germany, Spain and the UK. But in the US measures to incentivise clean energy technology innovation and deployment featured heavily in the Administration's proposed Budget for 2013.

The level of knowledge of environmental taxes and the amount of time spent planning for them has, in most organisations, been comparatively low. This will need to change. Similarly, organisations will need to become more effective in sharing views on environmental taxes. So, you need to decide whether you want your organisation's views to be represented at this and other similar conferences which will be establishing long term business regulation in the environmental arena.

More inter-state collaboration to counter tax avoidance

There is something of a process shift by tax authorities from cooperation with other tax authorities to coordination with such authorities. The US and certain other OECD (Organisation for Economic Co-operation and Development) countries are using 'joint audits' to review cross-border transactions. The Internal Revenue Service (IRS) has completed joint audits with Australia, and more recently with the UK culminating in a bilateral Advance Pricing Agreement (APA). The IRS particularly has adopted the joint audit as a core approach with the expectation that it will become more prevalent and is, we understand, in the process of carrying out a joint audit with Canada.

Of the JITSIC (Joint Information Tax Shelter Information Centre) countries, that leaves only Japan whose preference seems uncertain. There are though active interchanges of information between all JITSIC members (including US, UK, China, Canada, Australia, etc.). This includes information gathered during audits in any of the countries where the transactions impact the tax consequences in one of the other participating countries.

Supranational non-fiscal taxation policy bodies are also increasingly involved in areas of tax avoidance. Officials of a wide number of countries are actively participating in various OECD and UN tax committees and making contributions through sharing of views and experiences. In particular, the OECD has published a report on hybrid mismatch arrangements at the same time as the EU is consulting on double non-taxation. The OECD also has working parties focus on such things as high wealth individuals, transfer pricing guidelines/ policies, permanent establishments, beneficial ownership, etc. Many tax authorities also take part in the Forum on Tax Administration (FTA) or more regional variants.

Agreements on exchange of information on tax matters between jurisdictions have grown considerably since the infamous OECD blacklist. Some double tax treaties covered this sufficiently already. But in some cases treaties have been modified in order to enhance cooperation between the treaty partners. Some treaties were also completely replaced by new ones which provide for closer cooperation (and note the expanding Latin American tax treaty network). Furthermore, a number of countries have concluded new agreements that are restricted to information exchange (and do not tackle double taxation in general) - Tax Information Exchange Agreements (TIEAs) - with traditional tax havens.

One country that has been particularly active is the Netherlands. As Sytso Boonstra, PwC Netherlands tax policy partner notes

> *"From 2009, the Netherlands started to negotiate TIEAs with 43 tax havens. Currently, the Netherlands has concluded TIEAs with 28 jurisdictions."*

More of these conventions on information exchange are likely to be concluded in the future though peer reviews have suggested that some are currently inadequate. Canada has offered an incentive for non-treaty countries to enter into TIEAs by giving the benefit of 'exempt surplus' to foreign affiliates of Canadian companies carrying on active businesses in such countries.

Up to now, information has most often been requested only on a case by case basis. But the Australian Tax Office (ATO) is actively looking to use a significant number of information exchange agreements entered into over the last two years. Mexico has entered into arrangements with many of its tax treaty partners (Canada, Japan, New Zealand, the Czech Republic, Poland, Spain and the US) to automatically provide information about all payments made by tax residents of the treaty partner to tax residents of Mexico, and vice versa. For example, Spain sent Mexico a list of 60,000 payments that were made in 2007 by Spanish companies to individuals and companies claiming to be tax residents of Mexico. Usually, these payments were subject to low or no tax withholding in Spain. The reports contain information that helps the Mexican tax authorities identify and find the recipient in Mexico, allowing the Mexican tax authorities to verify whether that income was properly reported in Mexico.

Patricia Gonzalex says "Despite having this information, the Mexican tax authorities have been slow to act upon it. That is changing, however. For example, the authorities have initiated a targeted programme to identify and audit expatriates working in Mexico who are paid from Spain with no Spanish tax withheld, in order to identify parties that have not reported all of their compensation in Mexico. We believe that the Mexican tax authorities will eventually expand this initiative to include income received from other countries, as well as other types of income."

More territories are signing up to the Convention on Mutual Administrative Assistance in Tax Matters. India became the first country outside the membership of the OECD and the Council of Europe to become a Party to the Convention and Colombia is the latest non-member participant. China has also signed a Letter of Intent and is actively seeking formally to enrol as a full member of the Convention.

You should be aware of information 'traded' between territories in which you operate. The nature of that sharing may impact your relationship with the relevant tax administrations and whether you want to pre-empt consideration of specific issues. Indeed, you need to assume that in future information provided to one tax authority is likely to be shared with another tax authority. Your response will require greater co-operation within your organisation at all levels of the tax departments of individual companies. It will no longer be sufficient just to be aware of an issue with a tax authority in a particular territory, you will need to fully understand the arguments and data put forward in mitigation.

Tougher defence of domestic taxing rights

There are a number of areas in which taxing rights of individual territories have posed particular difficulties, and many of these are the subject of OECD working parties, as noted above. In the meantime, some territories have determined their approach to these issues.

The US is expected to continue to strive in its tax treaties for effective protection through enhanced limitation of benefit (LOB) articles against 'treaty shopping'. The US has entered into a new treaty with Germany on the basis that where income is derived by a hybrid person which is fiscally transparent in one state but is non-transparent in the other, the source state may only be obliged to reduce source taxation if the resident state treats the income as income of a resident person. This seems to have become part of Germany's tax treaty policy, also being included in its new treaties with Bulgaria and Mexico.

The pressure from governments for tax authorities to generate increased tax revenues is likely to continue to increase. You should expect more challenges than has been the case to date. If you are likely to be affected by the ongoing discussions about beneficial ownership or permanent establishment thresholds etc, you may want to play a more active part in groups lobbying for particular points of view. There are opportunities to become directly involved with, for example, the OECD's initiatives. You need to recognise though the greater likelihood that in future you will have to reach agreements with more territories in these kinds of areas and accept that some may involve significant amounts of tax having to be paid.

Following the OECD's consultation on beneficial ownership in relation to certain tax treaty requirements, there has been an ongoing focus in this area. The terms 'beneficial owner' and 'beneficial ownership' are not new to Canadian tax law, having a domestic meaning under common-law and being employed in the Canadian taxing statute. The Canadian Revenue Authority (CRA) has always had an interest in determining the beneficial owner of property for the purposes of the Income Tax Act and Canada's income tax treaties.

Nick Pantaleo, Canada's tax policy partner notes "Recently the CRA has established an aggressive tax planning initiative whereby it is devoting more time and audit resources to identifying transactions designed to shift income offshore or enhance or obtain the benefits available under one of Canada's treaties. In the latter case one of the CRA's audit tools is to question/determine who is the beneficial owner of the income (property) received from a Canadian entity. These challenges have now found their way into the courts, with two cases having been decided in favour of the taxpayer (Prevost and Velcro)."

China is another territory with a beneficial ownership test and the SAT issued a circular to embed anti-avoidance into that test in 2009; although the SAT is considering providing some relief from such a policy and easing compliance administration, the anti-avoidance motive to some extent, may be toned down in the new supplementary policies. The Russian tax authorities apparently applied the beneficial owner concept to what the authorities considered back-to-back structures where the intermediary was not the beneficial owner, with a view to applying withholding income tax.

Discussions on updated guidance to the OECD's Model Tax Convention Article on permanent establishments (PEs) are also coming to a head. Some territories have started to take account of the 2010 updated Authorised OECD Approach (AOA). Article 7 of Germany's draft treaty with Liechtenstein (signed in November 2011) uses the revised wording and drafts signed earlier with several countries provide for it happening. The Mexican tax authorities have consistently been of the view that any type of service (e.g., consultancy) rendered by foreign taxpayers for more than six months constitutes a PE and should be taxed accordingly. So, the inclusion of an example of a service PE provision in the 2010 update to the OECD Model Tax Convention was greatly welcomed by the Mexican tax authorities, who have included provisions of a similar nature in the vast majority of recently negotiated tax treaties, including those with Colombia, Hungary, Panama, South Africa and Uruguay.

The greater debate though is probably over indirect equity transfers. The recent decision of The Supreme Court of India in favour of Vodafone in a case involving a transfer of shares between two foreign companies has been eclipsed by the Indian Government's controversial amendments retrospectively to tax transfers indirectly involving Indian assets (limited by an administrative instruction to cases which have not been assessed before 1 April 2012 or which have been subjected to a reassessment notice before that date). Coincidentally, China is considering whether it should allow some more lenient treatments in certain situations because of the burden on business and the potential impact on investment. The Chinese tax authorities have paid more and more attention to the indirect equity transfer of Chinese entities via offshore vehicles and would tend to invoke the GAAR (see more below) to impose China corporate income tax (CIT) on the transfer gains.

Economic substance and GAARs

In an interesting note about the spread of thinking on anti-avoidance issues, the Russian tax authorities have recently brought claims based on the substance over form approach and used several international taxation concepts. These claims included enforcement of domestic thin capitalisation rules with respect to a loan formally outside the scope of the rules arguing that the lender was a conduit company inserted with the main purpose of obviating the rules.

Andrey Kolchin, tax policy partner in PwC Russia indicated

"We believe the above indicates that the Russian tax authorities are becoming more focused and sophisticated in their approach to cross border financing structures and use an array of anti avoidance tools developed in international tax administration practice."

Codification of the US economic substance doctrine has not had a significant impact on corporate transactions, but has resulted in taxpayers performing more analysis and documentation to ensure that any transaction satisfies the heightened requirements – in order to be respected, a transaction must have a non-tax business purpose and change in a meaningful way the taxpayer's economic position.

A number of countries are looking closely at the possible adoption of a general anti-avoidance rule (GAAR).

The UK is in the process of consultation on a general anti-abuse rule, a limited form of GAAR. A 2004 case decided that the tax law involved no separate principles which applied akin to a 'substance over form' doctrine, or the 'abuse of law' principle found in some continental European tax codes. While HMRC defeated several examples of planning after 2004 which they regarded as offensive, some others succeeded. The Aaronson report concluded that it was feasible to supplement the existing common law and targeted rules with something far more wide-ranging and more like a substance over form rule, while not making UK tax law so uncertain that business would be deterred by it. It was recommended that the government consider a GAAR targeted solely at 'abusive arrangements'.

It will be increasingly important to ensure that a greater level of substance is not just included in planning but that its implementation is consistently robust over time. This will increase the cost and administrative inconvenience of some of the things you do. It could include significant impacts on the senior people in the organisation, including where they are based, so this is something which needs to be recognised at the highest levels.

Initially the GAAR, if it is introduced, should apply mainly to direct taxes and not to VAT (which has its own EU-based abuse of law regime).

There is a rising concern in Canada in relation to the shifting of income and gains from one province (or territory) to another to take advantage of corporate group tax losses and lower provincial or territorial tax rates. While it is expected that provincial GAARs will be employed to curtail this type of tax avoidance, to date this has proved difficult. The Canada Revenue Agency (CRA) continues to apply GAAR though to counter many types of tax avoidance plans that it considers abusive including capital gains strips, surplus strips, loss creations, loss transfers outside an affiliated group and other tax base erosion plans.

The broader debate about the efficiency of GAARs is continuing. China's tax authorities tend to invoke the Chinese GAAR to tackle indirect equity transfers and India is planning to introduce a GAAR to tackle a range of perceived abuses on top of its retrospective action on such transfers (as noted above). But, having suffered a range of setbacks before the courts on the Australian general anti-avoidance rule a review is now being conducted of its effectiveness and scope. This takes place though against a tougher stance on protection of the Australian tax base with some significant changes being proposed around transfer pricing (in relation to which, see more below) and other cross-border areas, some of which are retrospective in application.

The development of country-specific GAARs around the world, all differently worded and backed-up by jurisprudence involving interpretations of disparate review tribunals, potentially gives rise to greater uncertainty for business. We've established a global GAAR team to try to influence and advise on this area and have published a paper that considers the approaches considered by 17 different countries, so please contact us if you're concerned about the impact on your organisation.

Tougher transfer pricing rules

There are undoubtedly tougher requirements on groups to prevent transfer pricing (TP) adjustments being made though the drivers behind them differ. There is certainly pressure for tax authorities to increase tax revenues and transfer pricing is perhaps a soft target: Mexico is one that has stated it is placing more emphasis on TP in 2012 purely due to the lack of other major tax reforms and reduced tax revenues from other areas. That said, there have been wide-ranging calls for a focus on alleged behaviour of MNCs deliberately to manipulate prices to avoid tax by directing profits to lower taxed territories. The OECD's project to look at aspects of TP and intangibles is well underway.

The focus of particular tax authorities varies, apparently according to risk and the return on its investigation effort. The Chinese tax authorities are increasingly scrutinising taxpayers' outbound payment of royalties and service fees, on the basis that Chinese subsidiaries may not necessarily benefit from the services in point; there is a focus too on certain selected industries, such as automotive, retail and consumer sectors. Canada is focusing on interest rates and guarantee fees. Mexican audits target restructurings and migration issues, capital transactions and charges for headquarters services; in some instances they are requesting evidence that the services for which amounts are paid to related parties were actually received and provide some economic benefits.

There has been more attention directed toward weaknesses in annual TP documentation including a focus on sample selection issues, statistical analyses, applicable grouping of transactions, segmentation of operations, years used for samples or years used for determining profitability of the tested parties. Complete information on all inter-company relations and transactions is normally required to be provided at the beginning of each tax audit in Germany. The past year has seen the request for TP documentation become standardised in the initial Information Document Request provided in corporate tax audits in Canada, and has seen such requests being made even at a local tax office level (rather than only at the level of the regional bureaux). The Chinese tax authorities are pushing back a number of TP documents after the requirement of TP documentation since 2009. Due to the poor quality of the TP documentation, the tax authorities are asking some companies to re-do them: they might even select some cases and conduct on-site audits in order to establish some 'best practice' of TP documentation as standards for all taxpayers.

The levels at which TP enquiries are carried out varies. In Germany, if tax officials become aware of extraordinary transactions which involve foreign parties they tend to alert the tax investigation department earlier than they used to because the members of this unit have larger investigation powers (e.g., with regard to search and seizure). Although there is a specific transfer pricing audit division within Canada's tax authority, there is an increasing focus on raising TP issues in audits being conducted by examiners outside of this division, i.e., in regular corporate tax audits.

Demand for bilateral advance pricing arrangements (APAs) continues to increase while the number of unilateral APAs is declining. Canada has had an APA programme since the early 1990s, which has since grown significantly and it has recently started to make it more challenging to be accepted in the programme if the issues are too complex (e.g., business restructuring) and/or would require Canada to negotiate with foreign governments with which it believes would be too difficult to conclude a bilateral APA. On the other hand, the IRS in the US has joined its APA programme personnel with the Tax Treaty Office staff that handle MAP transfer pricing cases. This combined office should be able to work through a large backlog of APA requests and place it in a stronger position to address the continuing surge.

The biggest challenge in TP, though, remains whether the OECD model convention achieves the levels of revenue that some countries, particularly developing countries, feel is appropriate. This dissatisfaction has led some countries to shy away from the arm's length principle (ALP) altogether and develop their own systems - like Brazil with its fixed margin scheme or a so-called 'formulary apportionment' approach. Some have turned to the United Nations to consider whether ALP could be addressed in a way that better works for them. For developing countries this might, for example, allow focus of limited resources on areas of greatest concern at a point in time, and reduce levels of data seeking and number-crunching required for each individual case.

There are some countries though that are coming more into line with OECD methodologies.

Sachihiko Fujimoto, PwC Japan tax policy partner, notes that

"...recent changes to Japan's practices involve, for example, the acceptance of an arm's length "range" concept, where previously the practice was focused on identifying a single arm's length "price" and the shift away from using secret comparable data."

It is important to note also the increasingly wide knock-on effects of TP adjustments. This can be problematic when it extends to indirect tax as this is not usually covered in double tax treaties and the lack of available platform for Competent Authorities (CA) to resolve double taxation scenarios. Mexico is one country that has noted particular problems with customs duties and value added taxes, etc.

We will see an increasing demand for transparency of data and there will be a corresponding rise in the resources that will need to be allocated to dealing with it. You'll also potentially notice an increase in the resulting cash settlements. You would do well to review your pricing strategy and documentation and consider whether some central co-ordination hub would help in the inevitable event of transfer pricing audits taking place in particular territories. Have you fully explored the potential of bilateral APAs in territories between which you conduct significant transactions?

Pressure on offshore activities by taxpayers

The US has been at the forefront of the pursuit of provisions preventing companies taking their profit-making apparatus outside the US. Others have followed in its footsteps. New 'earnings stripping' rules that would limit the deductibility of foreign related party interest expense are being introduced in Japan with strong similarities to the US model. The UK's corporate tax reforms are adopting a more territorial approach with an effective participation regime for most dividends and, where there is a substantial shareholding, capital gains being allied to an exemption for profits of foreign branches.

George Forster, PwC US tax policy co-leader says

"While US multinational corporations have a strong interest in the US adopting a participation exemption regime - and draft legislation providing such a system has been released for comment by interested parties - there are also countervailing forces concerned that such a system could encourage US companies to shift domestic activities and income abroad."

China is another territory where tax resident enterprises should pay CIT on their worldwide income. The SAT is very conscious therefore of reviewing holding structures and financial structures, as well as transactional exposures and compliance to ensure no leakage or delay in payment of tax to China. The SAT has a pretty comprehensive plan to address all these Chinese outbound investors' tax matters step by step in a reasonable timeframe. Conversely, there is an obvious trend that more and more Chinese domestic invested enterprises are making investments or undertaking businesses overseas. Since the Chinese government encourages Chinese enterprises' outbound investments and overseas business activities, the SAT is gearing up support for these enterprises to ensure their eligibility to enjoy tax treaty benefits in the destination jurisdictions, resolve unfair tax treatments overseas, and even eliminate double taxation scenarios through CA negotiations.

Unless businesses are prepared to make more radical changes in the future, including being more geographically mobile and adapting their financing or value chains, they will almost certainly pay more tax. For example, you could be adversely affected if you are not able to react sufficiently flexibly to changes in controlled foreign company (CFC) regimes, which are under the spotlight in many territories, or other measures, particularly those restricting finance expense.

Transparency and reporting of information

The US also leads the world with its attempts to increase tax disclosure and transparency. Examples include reporting mandates enacted in the Foreign Account Tax Compliance Act (FATCA), expanded reporting requirements for Foreign Bank Account Reporting (FBAR), regulation of executive pay (Dodd-Frank), required disclosure of 'uncertain tax positions' with the filed corporate tax return, and reporting more information on ownership of entities. Recently, the IRS has shown a willingness to assess penalties and use other enforcement measures to address taxpayer failures to comply fully with information reporting requirements, especially if the information is relevant to addressing policy concerns. These trends of requiring taxpayers to provide more detailed information on activities and ownership and of stricter enforcement by the IRS are likely to continue.

The FATCA rules have caused consternation as well as raising practical and legal concern. For example, in Mexico, the implementation of FACTA rules would imply a breach of bank secrecy rules, bank-client deposit agreements and an infringement of the North American Free Trade Agreement (NAFTA). Currently, banking associations Asociación Mexicana de Bancos and Asociación Mexicana de Instituciones Financieras have issued letters to the US Treasury to bring these legal implications to their attention. A joint statement issued by the US and UK, France, Germany, Italy, Spain announced that through cooperation with US auditing efforts the subject of FATCA would be sought through exchange of information agreements. More recently the US has signed similar but slightly different statements with Japan and Switzerland. Mexico had sought a similar agreement, so it will be interesting to see how far the US is prepared to negotiate.

There are a growing number of specific reporting requirements in individual territories. These may be related to specific types of income, as with the Japanese government's focus on foreign source income by wealthy Japanese nationals, or particular processes, like China's requirements for taxpayers seeking benefits under a double tax treaty or those with equity movements which might be caught by its GAAR, as noted earlier.

It is worth briefly noting that most territories report that treaty information requests have dramatically increased in number and scope.

Pressure for greater transparency will continue and will affect the thinking of governments and regulators. The impact of this on the way in which your tax departments operate must not be underestimated, especially by those in territories where reporting is somewhat limited. You need to have systems in place to be able to respond to reasonable reporting requests from tax authorities. On the other hand, you should consider responding strongly where proposed rules appear unreasonable. Tax administrations are often very willing to discuss views on implementation where policy makers may not have fully thought through objectives. It may be advisable sometimes though to join with other taxpayers in a concerted lobbying initiative to increase your firepower and protect your relationship.

Risk-based approach to compliance and tax audits

The UK has been at the forefront of adopting a risk-based approach to audits by the tax authorities. Part of that has also included increased reliance on a large corporate's own governance where this warrants it. The direct interaction between a single customer relationship manager (CRM) and the taxpayer across taxes, issues and initiatives, together with a more real-time hands-on approach has built up greater knowledge of the taxpayer's commercial affairs as well as identifying and in some cases resolving potential challenges at an earlier stage.

Australia has introduced a 'reportable tax positions' schedule to the corporate income tax return for large businesses, which will disclose certain issues and areas that might previously only have arisen on audit, in a similar manner to the US Schedule UTP (for uncertain tax provisions – linked in to the wider reporting agenda below). The ATO has also introduced a comprehensive risk rating system for large business called the Risk Differentiation Framework (RDF) which drives the matching of ATO resources and approach to the risk.

Michael Bersten, tax policy partner at PwC Australia notes

"The ATO has made a concerted effort over a decade to raise its profile with Chairmen and CEOs. These recent developments which reinforce the corporate governance and risk management emphasis at large corporate are really making Boards and the C-suite take notice. The ATO is also reaching out to build direct relationships in an attempt to manage risk transparently and to encourage stronger tax governance with a reduced risk appetite ."

In the US, the IRS has introduced and is now expanding its Compliance Assurance Process (CAP), which is designed to increase transparency and complete audits on a real-time basis. Further, to reduce time and effort expended by IRS agents on frequently occurring examination issues, the IRS has increased its issuance of 'safe harbor' guidance intended to provide taxpayers with an ability to obtain certainty on often contentious audit issues in return for conforming to the guidance. For example, recent rules regarding success-based fees provide taxpayers with an election to deduct the majority of such costs and capitalise the remainder in lieu of an extensive analysis into the purpose for each incurred expense.

Other territories are following suit with adaptations to suit their own circumstances and style, establishing a true trend rather than a model to be followed precisely. It is taking time for the entire Chinese tax authorities' network to adapt the risk assessment approach and model into their operations. Some local-level tax bureaus are working on releasing a list of their selected Large Business Enterprises (LBEs) in their jurisdictions and issuing implementation rules of their own in line with the SAT's 2009 Guidelines. Canada is currently rolling out its new risk based approach to selecting large business files for audit and is sending out questionnaires to large businesses. It's planning to interview senior corporate executives and in some cases board members, in order to determine the extent of management oversight of the tax aspects/decision making in respect of complex transactions undertaken in their businesses.

A detailed review of all documents sitting behind major transactions, such as a restructuring project, particularly focused on planning where motive and purpose tests are involved, can head off potential increases in your risk profile.

There are things that you can do to address the risk perception of your organisation by the tax authorities. The nature of your existing relationship, particularly any real-time interaction, is a vital starting point. You need to understand the tax authority's risk review process. You can then benchmark your organisation against others in a similar position. The tax authorities' reliance on a risk-based approach, when combined with greater transparency, means you'll need to be prepared to face greater challenges in the future and be willing to defend your position, sometimes in public. You need to make sure you are aware of the risks involved with particular transactions and properly evaluate whether there are benefits in trying to reduce those risks through particular initiatives with tax authorities. It is worth noting that these new approaches are still in their infancy and there is, as yet, little evidence as to the impacts on a cost/benefit type basis.

Online processes

With seven years of data now available from the *Paying Taxes* surveys, it is clear that reducing the administrative burden on taxpayers has been a long term goal for many tax authorities. Over the past seven years more than 60% of economies made paying taxes easier with 244 reforms. Easing the compliance burden can benefit both government and business. The most common feature of tax reform though seems to be the ongoing introduction of electronic systems - 66 of our 183 economies surveyed last year now have online filing and payment systems.

China is one territory where it is seen as a gradual process. E-filing has been introduced for some types of tax returns in many cities and become more and more popular but, under the Five Year Plan (mentioned above), the SAT indicates the focus is standardisation of systems and achieving tax e-payment options nationwide. There are no drastic changes to be expected but continuous improvements in this area in the China tax system. Of course, reliance on paper invoices as key source documents of taxable transitions has not been on any agenda of reform.

PwC *Paying Taxes* survey

7

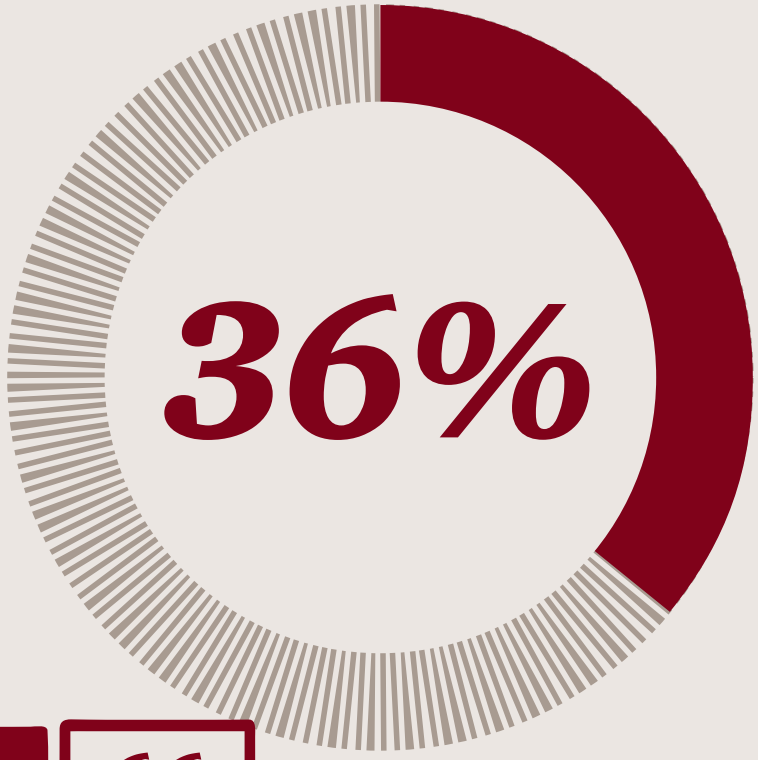
7 years of *Paying Taxes* data is available for analysis

60%

More than **60%** of economies made paying taxes easier

244

Economies made paying taxes easier with **244** reforms.



66 of our 183 economies **(36%)** surveyed last year now have online filing and payment systems

There are territories in which commentators think e-filing has not been a great success. The German legislator has been trying to promote electronic data exchange between taxpayers and the tax authorities (e.g., electronic accounts information) as well as between taxpayers (electronic invoicing). But, as PwC Germany's tax policy partner Juergen Luedicke, points out

"the requirements which have been established for the use of electronic communication are so high that their introduction has hardly facilitated anything. While 'reducing complexity' and 'improving efficiency' are terms which are frequently used by politicians and officials, in many cases this rather seems to be empty talk."

Germany has not been the only one to find the use and issuance of digital invoices for tax purposes a problem. Mexico's attempt to limit tax evasion in the form of false invoices has given rise to a number of administrative problems, particularly for the financial sector, as the new rules have restricted certain administrative facilities for banks, stock brokerage firms, etc., such as the use of statements of account as a tax receipt. Both sides have felt the pinch, not only the party issuing the invoice but also the party intending to make use of the invoice to support the deduction of the payment.

From 2012 taxable persons in Luxembourg that are subject to the Standard Chart of Accounts (SCA) and keep their accounts electronically, are in principle under an obligation to use the FAIA (standard file) to make data electronically available when requested by the VAT authorities. "It will be interesting to see how this plays out in practice." says Dido Shadie, PwC Luxembourg's tax policy partner.

A novel attempt to address some of the difficulties Mexican taxpayers have faced comes with introduction of what is being called an 'electronic customs office'. In 2012, all paperwork will be uploaded onto new web service (VUCEM) designed to reduce time and cost for both importers and exporters.

In this regard, Brazil has introduced a wide-ranging regime. Its SPED system requires most companies to send all their bookkeeping and digital information electronically to the tax authorities. The required information can include calculations with respect to transfer pricing, certain tax credits, social security contributions, and income tax, among others. PwC Brazil tax policy partner, Nelio Weiss, says "The government now has a large mass of information which is being shared with state and local tax authorities". It is perhaps too early to assess its impact on Brazil's poor ranking on the *Paying Taxes* scale, with more time being spent on compliance than in any of the other 182 countries surveyed.

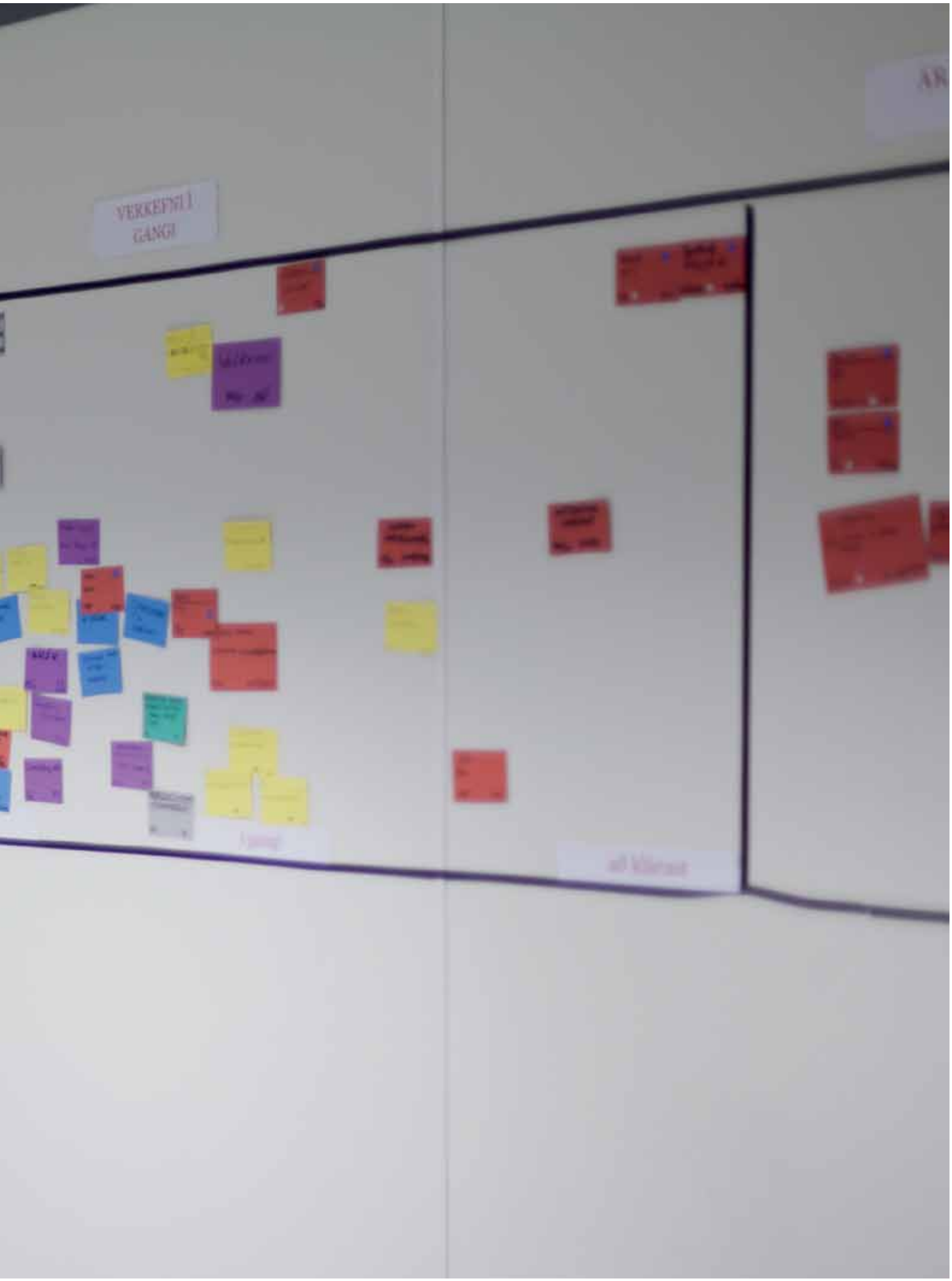
Although experience of different e-filing and extended online reporting systems to date has varied, the direction of travel is clear. Tax authorities in the developing world will expect to be able to extract data directly from multinationals information systems. This reinforces the need to ensure that inputs to those systems are correct rather than the historical model of placing reliance on outputs which can be adjusted. The nature of compliance is changing and you'll need to bear this in mind when developing systems and processes in future.

Growing external pressures to resolve disputes

External factors may increasingly drive taxpayers to seek early settlement of disputes with tax authorities in the coming years. Historically, information regarding tax audits and disputes has been considered a private matter between the company and the tax authority in many countries. Going forward, however, such information is likely to become more susceptible to public disclosure and attention. How might this information become public? Disputes rising to the level of litigation where court filings are involved generally become public information in many jurisdictions. Public disclosure of significant tax controversies may be required in a company's public financial statements or otherwise demanded by non-governmental organisations (NGOs). In some countries, a leak may occur to the media. Whatever the mechanism, the disclosure can ultimately lead to far reaching dissemination and form the foundation for broader public debate of the issue.

High profile disputes such as the Vodafone case in India and the Glaxo cases in the United States and Canada are telling examples of this trend.

Companies, seeking to be seen as compliant taxpayers and good corporate citizens, may seek to avoid potentially negative publicity affecting stakeholder perceptions. Early dispute settlements may help avoid the limelight and may contribute to a growing trend to resolve controversies. Unfortunately, this may also collide with external public scrutiny affecting tax authorities. As fiscal deficits rise, tax authorities will be more intensely reviewed by government politicians to capture the largest amount of revenue possible and set a precedent for other taxpayers. This political interference could place pressure on tax authorities to aggressively pursue large tax assessments and prolong the settlement process, with certain cases proceeding to judicial litigation.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PwC's Tax Policy and Administration Network works closely with PwC's other global networks, including Tax Controversy and Dispute Resolution (TCDR), in helping you reach solutions that also take into account current trends and forward-thinking expertise. Our relationships and knowledge involving supranational bodies, policy makers, and tax administrations can help you gain valuable perspectives when considering the challenges set out in this paper. Please do not hesitate to contact the following members of either of those specific networks:

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