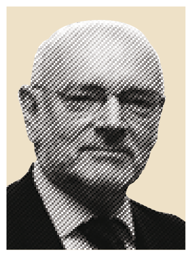
# Balancing the books

The financial crisis means that collecting tax is more than ever a priority for hard-pressed governments grappling with record deficits. But they also need to be careful to maintain business confidence.



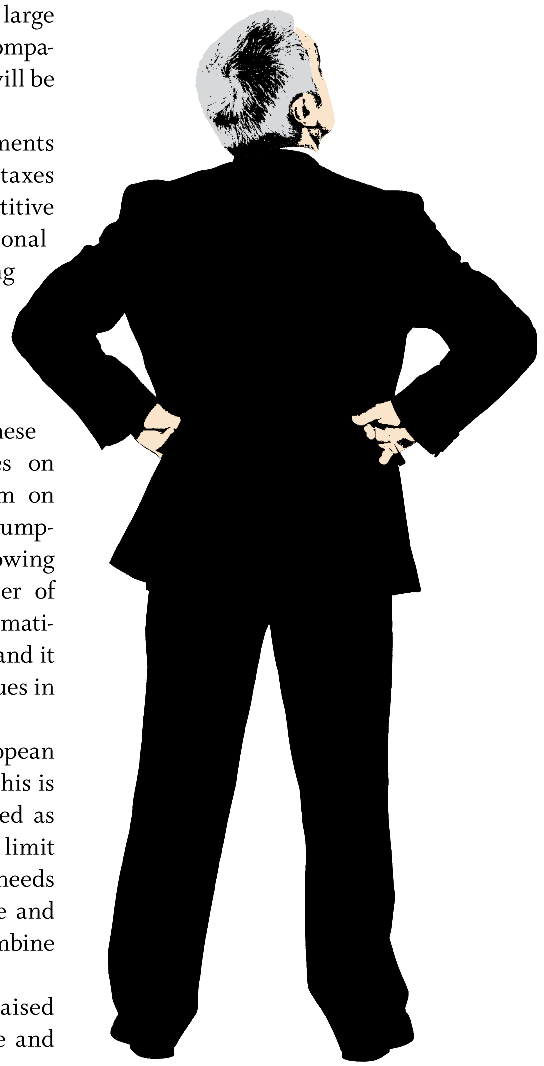
BY JEFFREY OWENS

The current financial crisis is not just one of governance but also of public finances. The level of public debt is unprecedented in peacetime, and, with public spending proving harder to reduce than expected, the focus is now on ways of collecting as much tax as possible – and that is changing the relationship between large corporations and the tax authorities. Companies may have lower tax levels, but there will be much more rigorous enforcement.

The additional challenge for governments is to balance the necessity to raise more taxes with their need to maintain a competitive business environment to attract international business. Globalisation and the increasing mobility of both capital and labour means companies can choose to operate in the most attractive regime for both tax policy and administration.

Governments are trying to reconcile these conflicting pressures by reducing taxes on income and profits and increasing them on consumption and labour. General consumption taxes have been one of the fastest-growing components of tax revenue. The number of countries using VAT has increased dramatically, from six in the 1950s to 160 today, and it now accounts for 20 per cent of tax revenues in the OECD.

VAT rates have also risen – in many European states they are higher than 20 per cent. This is not sustainable. Although VAT is accepted as the "most growth-friendly tax", there is a limit to how much it can be increased. Europe needs to learn from countries like Korea, Chile and New Zealand, where the approach is to combine a lower rate with a broader base.



European governments have also raised taxes on incomes, with Belgium, France and Germany having levels exceeding or near to 50 per cent of earnings. Fortunately, there is now a trend – in, for example, France and Italy – to reverse this tendency. The beneficiaries of this rebalancing are companies whose corporate taxes are being reduced. More than 90 per cent of OECD governments have lowered corporate tax rates since 2000, some by as much as half. Many countries are openly aiming for a rate of around 20 per cent and many others – Singapore, Hong Kong, Ireland – are already lower. In the MENA region, there is strong support for that trend.

These moves towards a more business-friendly tax system have been balanced by demands from governments for better compliance, less game-playing and less creativity from companies; they want to see a close alignment between statutory and effective tax rates. To achieve this goal, there have been considerable changes in areas such as thin capitalisation rules, control foreign cooperation legislation (CFC) and interest limitations.

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Another trend is for the authorities to focus on "base erosion and profit-shifting" (Beps), which is fast becoming the new buzzword of the G20. This represents a shift in approach so that a more effective taxation of multinational companies complements its work on high-net-worth individuals, bank secrecy and exchange of information. That should not be a surprise. Press reports that effective corporate tax rates are very low, sometimes even negative, combined with the NGO campaign against globalisation, explain why the G20's focus has shifted.

A key issue in this debate is transfer pricing. When I was at the OECD, we examined whether it was possible to simplify the rules and strip out those transactions which really are "routine", thereby freeing up time and resources to concentrate on what really matters. As a result, the OECD has changed its view on safe harbours (where estimated taxes are paid) and it explains why the Forum on Tax Administration is spending more time on the governance framework for transfer pricing audits, setting out how cases for audit should be selected, who should manage the audit and who decides when to close a case.

There is one exception – intangible assets, an area that in recent months has been heavily scrutinised. This area forms the biggest part of the tax base, as it is here that the majority of multinationals keep their most valuable assets. The OECD is now analysing a recent public consultation of business leaders. They expressed their concern about the broad definition of intangibles being proposed, the way that the parties to a transaction would be identified, how to determine the arm's length valuation of the transfer of an intangible for transfer pricing purposes, and the potential for abuse.

These concerns are unlikely to deter tax administrations from being more robust in their negotiations with multinational companies. Some 57 per cent of respondents to Ernst & Young's "tax risk and controversy" survey last year already think that tax audits are becoming "more aggressive". This probably reflects the fact that the authorities know more about international companies than ever before. Tax authorities exchange more information – more than 800 cross-border exchanges of information agreements have now been signed, compared with only 40 five years ago. The OECD's global forum has in place a robust peer review mechanism.

Some 46 countries, including all G20 members, have either signed or agreed to sign the OECD's multilateral convention on mutual administrative assistance in tax matters, which allows for all forms of assistance and information exchange. Tax authorities are also becoming more effective because they receive more data from taxpayers, who have to comply with the increasing number of disclosure and transparency requirements. The US and Australia require uncertain tax positions to be disclosed; more countries will probably follow.

Another less-publicised trend is the way many countries are gradually, yet firmly, continuing to ramp up their domestic disclosure requirements. This, they believe, will help get the information that will enable them to target their limited resources on those they feel present the highest risks. Better data means better risk management and more taxpayer segmentation.

Information reporting is also becoming international. The US Treasury is pressing more than 50 countries and jurisdictions to implement the information reporting and withholding tax provisions of the foreign account tax compliance act (Fatca). Tax authorities are making good use of these new sources of data. This is the start of a process which will lead to global reporting standards backed up by automatic exchange of information. Joint audits, largely unheard-of a few years ago are becoming a reality, with countries such as Australia, Canada, Netherlands, the UK and the US spearheading the change.

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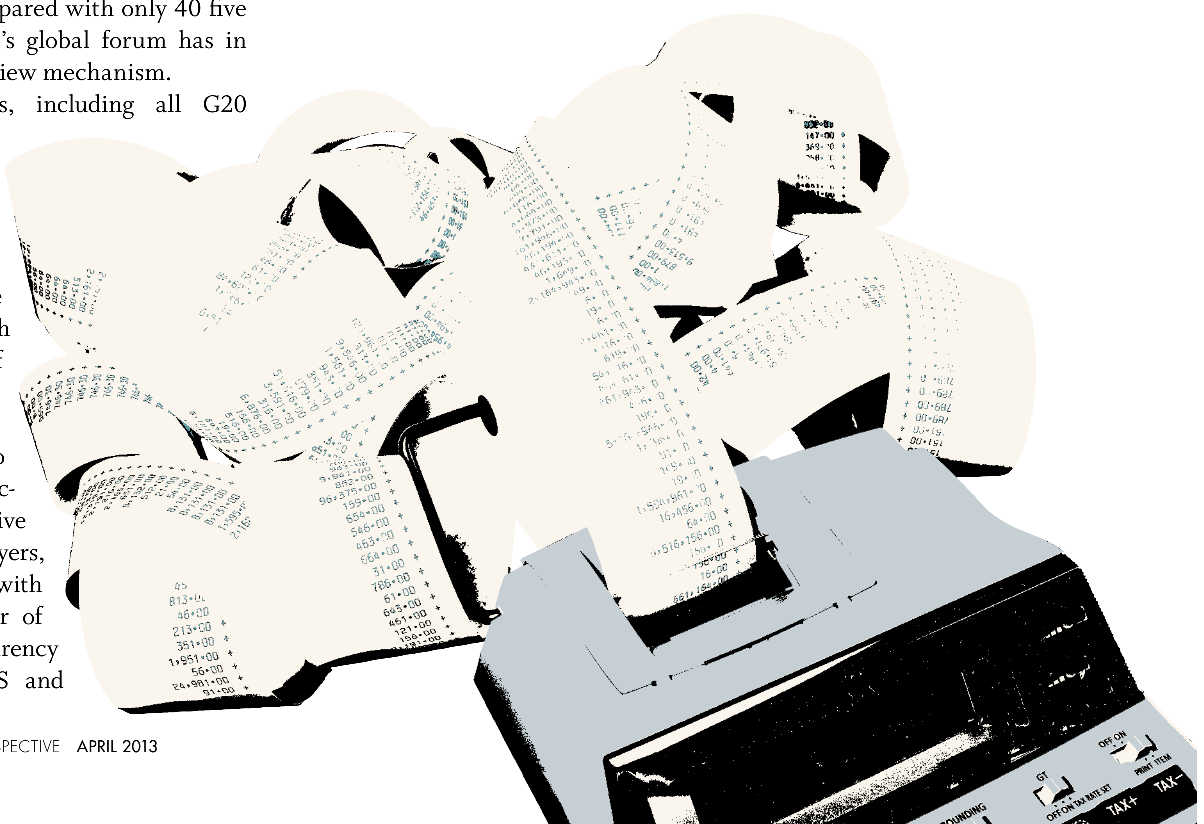
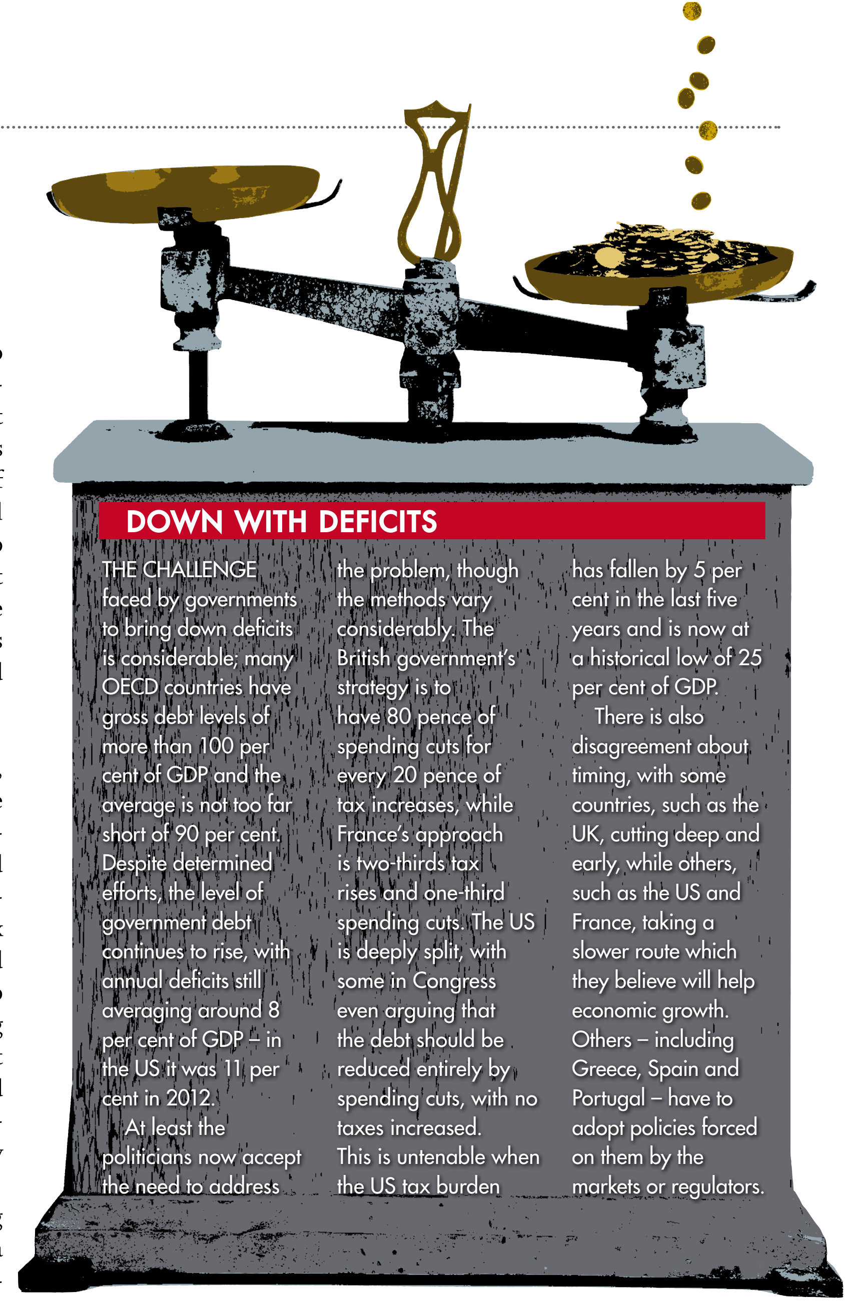


THIS STRATEGY does not, of course, mean that tax authorities are launching an assault on multinationals because they are all suspected of abusive tax planning. In practice, most multinational enterprises pay the right amount of tax at the right time and in the right place – and this is reflected in the changing relationship between most multinationals and a growing number of tax administrators. Many, but not enough, countries want what has been described as "enhanced relationships" with most multinationals: this is likely soon to be rebranded by the OECD as "collaborative compliance".

This is a new, cooperative way of building tax compliance. It is a move away from a "basic" and sometimes antagonistic relationship which operates only by reference to legal requirements, in favour of an improved relationship based on mutual trust, disclosure and transparency from the taxpayer and commercial awareness, openness and responsiveness from the tax collector.

Ultimately, there is no doubt that the roles of tax directors, chief executives and finance directors are going to change. Tax directors will have to be more engaged in the development of the company's overall strategy and develop the skills of good diplomats. Chief executives and finance directors will spend more time discussing their company's approach to taxation and how to balance their duties to their shareholders with the obligation to make a fair contribution to financing the societies in which they operate. Boards will need to pay more attention to the financial and reputation risks associated with their tax planning strategies and accept that the political debate on taxation is now more inclusive, involving all stakeholders in society.

Both taxpayers and governments will also have to accept that there will be closer cooperation between tax administrations and other law enforcement agencies in the fight against all forms of illicit activities (tax evasion, money-laundering, bribery and terrorist financing), and that this in turn will require a more joined-up approach within government and within companies. In this brave new world, there will hopefully be an increasing recognition that many of the issues faced by the global economy today can only be resolved by a constructive and open dialogue between all of the stakeholders, and that taxation does not necessarily have to be a "you win, I lose" game.



## DOWN WITH DEFICITS

THE CHALLENGE faced by governments to bring down deficits is considerable; many OECD countries have gross debt levels of more than 100 per cent of GDP and the average is not too far short of 90 per cent. Despite determined efforts, the level of government debt continues to rise, with annual deficits still averaging around 8 per cent of GDP – in the US it was 11 per cent in 2012.

At least the politicians now accept the need to address the problem, though the methods vary considerably. The British government's strategy is to have 80 pence of spending cuts for every 20 pence of tax increases, while France's approach is two-thirds tax rises and one-third spending cuts. The US is deeply split, with some in Congress even arguing that the debt should be reduced entirely by spending cuts, with no taxes increased. This is untenable when the US tax burden has fallen by 5 per cent in the last five years and is now at a historical low of 25 per cent of GDP.

There is also disagreement about timing, with some countries, such as the UK, cutting deep and early, while others, such as the US and France, taking a slower route which they believe will help economic growth. Others – including Greece, Spain and Portugal – have to adopt policies forced on them by the markets or regulators.