2017 Tax Risk and Controversy Survey Series

Out of the dark: how efforts to stop BEPS are driving tax risk

EY

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This report is the second in a series discussing the EY global 2017 Tax Risk and Controversy Survey. It provides a deeper look at the risks businesses reported in responding to BEPS. To receive other reports in the series, please visit **ey.com/taxriskseries** or connect with your local EY Tax contact.

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"Businesses are still trying to understand all of the implications of BEPS. A lot of implementation work remains, but in many cases we don't know precisely what the outcome will be. Some businesses are taking a wait-and-see approach."

– Peter Griffin
EY Global and Americas Transfer Pricing Leader

Out of the dark: how efforts to stop BEPS are driving tax risk

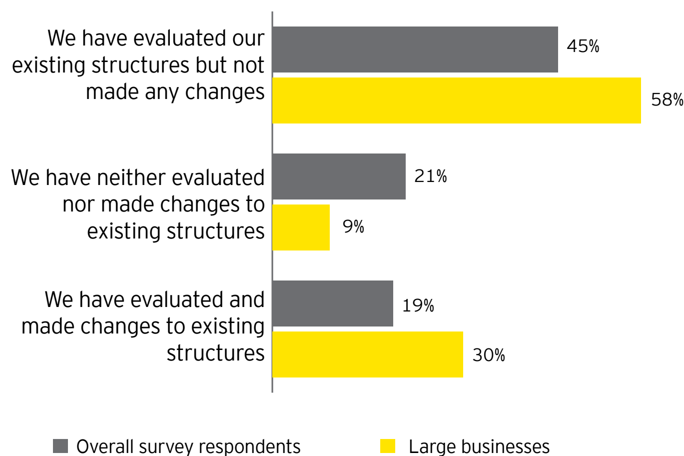
The global efforts of the G20 and the Organisation for Economic Co-operation and Development (OECD) to combat perceived base erosion and profit shifting (BEPS) have fundamentally changed the international tax landscape and created a host of new risks for businesses. The changes to long-standing definitions, rules and practices, along with the explosion of transparency and disclosure measures, have had profound implications for businesses' tax compliance and reporting functions, audits and controversies, and reputational risk.

While the OECD's October 2015 release of the final BEPS reports may have moved the project from the theoretical stage to the real world, for many businesses the BEPS era doesn't quite feel like reality yet. There has been some clarity in certain areas — notably with the new country-by-country reporting (CbCR) obligations introduced under Action 13 of the BEPS Action Plan — but many businesses still have a sense of uncertainty around how the implementation phase will unfold. With the OECD still doing follow-up work on some Action items — such as the treaty entitlement of non-collective investment funds and the attribution of profits to permanent establishments (PEs) — and countries moving at different speeds in their implementation efforts, some businesses are unable to move forward in their own implementation until further clarity is given and legislative language and/or regulations become available.

"Businesses are still trying to understand all of the implications of BEPS," says Peter Griffin, EY Global and Americas Transfer Pricing Leader at Ernst & Young LLP, who is based in Minneapolis, MN. "A lot of implementation work remains, but in many cases we don't know precisely what the outcome will be. Some businesses are taking a wait-and-see approach."

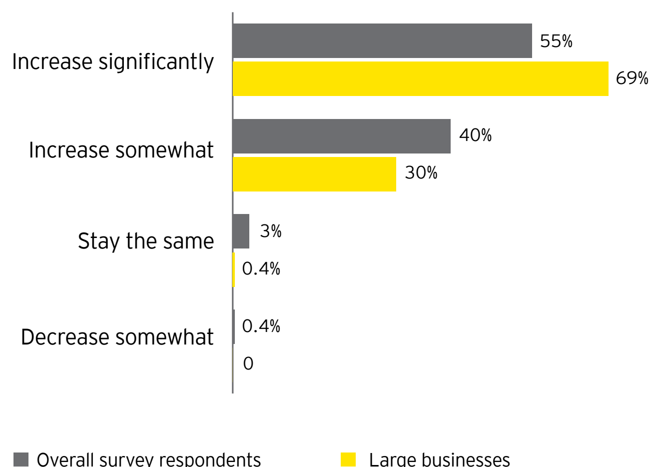
The lingering uncertainty around BEPS implementation is reflected in the results of the EY 2017 Tax Risk and Controversy Survey. According to the 901 tax and finance executives in 69 jurisdictions who participated in the survey, businesses are, in general, still in the early stages of weighing how the BEPS reforms will affect their business operations and tax strategy. Nearly two-thirds of all survey respondents (64%) said they have evaluated their existing structures in advance of the BEPS recommendations being implemented, but only 19% said they have made changes to their structures. The numbers are higher among large businesses (i.e., global businesses with more than US$3 billion in annual revenues), where 88% said they have evaluated existing structures and 30% said they have made changes.

Have you carried out any of the following activities in anticipation of BEPS Actions being implemented?



The survey results further show that businesses expect their reporting burdens will continue to grow in the years ahead. Despite the unprecedented number of disclosure and reporting measures that have been introduced in the wake of the BEPS project, 55% of all respondents said they think global disclosure, reporting and transparency requirements will increase significantly in the next two years. Forty percent said they think requirements will increase somewhat, and just 3% believe they will remain the same. Among large businesses, 69% said they think requirements will increase significantly, and 30% believe they will increase somewhat.

In the next two years, do you think disclosure, reporting and transparency requirements globally will:



As noted in the first report of the EY 2017 Tax Risk and Controversy series,[1] the task of managing tax risk and controversies is more difficult than ever — and has arguably become murkier than some may have envisioned when the BEPS recommendations were published in October 2015. Businesses are under pressure from multiple stakeholders to demonstrate compliance in a rapidly evolving legislative and regulatory environment, as well as reveal how they approach tax and corporate social responsibility. In our first report, we noted that while sunlight is popularly regarded as the best disinfectant by advocates for more transparency, it's also true that too much exposure to the sun can be harmful to the body. It is important in the current environment that businesses know how to turn to the light without getting burned.

Many tax authorities continue to be driven by a desire for more revenue, greater efficiency and improved compliance in an environment of shrinking resources — and they show no signs of slowing down their efforts to obtain more information from businesses so they can get a clearer picture of how their profits are taxed globally, where they locate their intangible assets and whether their business model is backed by sufficient amounts of substance. In this more encompassing compliance environment, businesses need to have systems in place to monitor ongoing BEPS developments and to have the right people, processes and technology in place to respond.

[1] The first report, *Tax steps into the light*, is available at ey.com/taxriskseries.

Greater transparency and scrutiny

"Tax administrations are using data analytics to better understand taxpayers, collect taxes faster and improve how they audit taxpayers. Data analytics is enabling tax authorities to narrow the scope of taxpayer inquiries more quickly, as well as shorten response times."

– Carolyn Bailey
EY Digital Tax Administration Leader

The BEPS project has ushered in a new era of transparency and given tax administrations more – and better – access to information that, in some cases, did not previously exist. As a result of measures such as the three-tiered approach to transfer pricing documentation (i.e., master file, local file and CbC report) introduced under Action 13 and the compulsory spontaneous exchange of tax rulings introduced under Action 5, tax authorities now have a wider range of data they can use to assess transfer pricing risk and other BEPS-related concerns.

At the same time, to cope with the unprecedented volume and pace of data collection and analysis, many tax authorities are building sophisticated data-gathering platforms that enable matching and sharing of taxpayer data. They are then using data analytics to mine this data to help increase tax collections, target compliance initiatives and improve overall efficiency. The move toward tax digitalization is allowing tax authorities to collect tax data in real time or near real time and is, in some cases, allowing taxpayer information to be cross-referenced and shared among governments and agencies.

"The digital revolution is changing the world of tax," says Houston-based EY Digital Tax Administration Leader Carolyn Bailey of Ernst & Young LLP. "Tax administrations are using data analytics to better understand taxpayers, collect taxes faster and improve how they audit taxpayers. Data analytics is enabling tax authorities to narrow the scope of taxpayer inquiries more quickly, as well as shorten response times. This is putting an enormous amount of pressure on businesses to improve their data management and analytic capabilities and create files that are 'audit ready' when they are submitted to the tax authorities."

Not surprisingly, our survey respondents are experiencing the effects of this era of increased transparency and scrutiny. Fifty-eight percent of survey respondents said they have experienced an increased focus by tax authorities on cross-border issues and/or transactions in the last two years. Fifty-five percent said they have experienced an increase in disclosure and transparency requirements, and 41% said they have seen an increase in the number or aggressiveness of tax audits. Eighteen percent said they have experienced an increase in the application of general anti-avoidance rules or specific anti-avoidance rules.

Asked specifically if they have experienced an increased focus by tax authorities on issues related to the tax treatment of intangibles, 32% of all respondents said yes. Among large businesses, this number jumped to 45%. Businesses in health (57%) and life sciences (48%) responded "yes" to this question at significantly higher rates when compared to the overall survey population.

Have you experienced any of the following events in the last two years?

58%
An increased focus by tax authorities on cross-border issues and/or transactions

55%
An increase in disclosure and transparency requirements

41%
An increase in the number or aggressiveness of tax audits

18%
An increase in the application of general anti-avoidance rules or specific anti-avoidance rules

8%
The use of "name and shame" techniques by tax authorities

Multiple responses allowed

"The emergence of tax risk linked to permanent establishments has implications for the entire enterprise."

– Ai-Leen Tan
EY Global ITS PE Knowledge Leader

Increased permanent establishment risk

The question of whether a business performs a sufficient amount of activity or activities in a host country, such that the business can be deemed to have a taxable presence (i.e., a PE) in that country, has been a key concern for many tax authorities in the last few decades. Action 7 was intended to address what the OECD considered as strategies used to artificially avoid having a taxable presence in a country under tax treaties. The final Action 7 report significantly limited the business activities that an enterprise can undertake without a host country being able to assert a PE.

Given the far-reaching implications of the changes to the PE definition, it's not surprising that PE-related issues ranked, on a weighted basis, as the third highest tax risk for businesses in our survey, after transfer pricing of goods and services (the highest risk) and indirect taxes (the second highest). This is consistent with the findings in the EY 2016 Global Transfer Pricing Survey of transfer pricing professionals,[2] in which PE risks was selected as the fourth highest expected source of controversy in the next two years (at 44%, up from 26% in the 2013 survey). In that survey, transfer pricing of goods and services was cited as the most important expected source of controversy going forward (75%), followed by transfer pricing of intangible property (49%) and transfer pricing of intragroup financial arrangements (48%).

"The emergence of tax risk linked to permanent establishments has implications for the entire enterprise," says Zurich-based Ai-Leen Tan, EY Global ITS PE Knowledge Leader at Ernst & Young AG. "It can affect supply chains, worker mobility and business travel, even decisions on how to draft personnel advertisements and how to market your products."

"Virtual presence and server access can, in a growing number of jurisdictions, now be included in the definition of operations and be an area of dispute that gives rise to tax controversy," Tan added. "More and more companies that do cross-border business are looking at ways to better identify, monitor and manage PE risk through the use of data analytics and tax technology tools, to be better prepared for the potential tax controversy in various jurisdictions that may arise."

Top 10 activities or issues that represent the highest tax risks for companies

1. Transfer pricing of goods and service
2. Indirect taxes — including VAT, GST and customs
3. Permanent establishment risk
4. Limitation of deductibility of financing expenses
5. Withholding taxes
6. Group charges/allocation of head office expenses
7. Transfer pricing of intangibles
8. Global workforce-related issues, including employment tax risk and social security risk
9. Use of losses
10. Transfer pricing of financial transactions

[2] www.ey.com/tpseries

BEPS readiness

Businesses have had to invest an extraordinary amount of time, money and resources to prepare for BEPS implementation. Many have evaluated their organizations from top to bottom, including their employees and where they work, business and operational models, their supply chain network and information technology (IT) systems. To keep up with the dizzying pace of legislative and administrative developments — and be aware of any inconsistencies in countries' laws and regulations — many businesses have put in place protocols to monitor BEPS implementation efforts in the jurisdictions in which they operate.

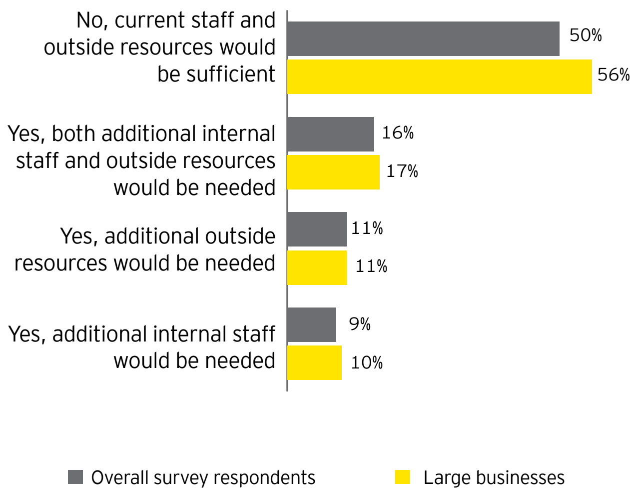
For many businesses, preparing for CbCR is presenting significant challenges, not only because it is a new filing requirement but because many countries had already adopted legislation or regulations requiring CbCR for financial years beginning on or after 1 January 2016. In most cases, preparing for CbCR has required collaboration among representatives from multiple business units, such as the tax function, finance and IT departments, who have to review the business's data collection process to determine whether the business can deliver globally consistent data, assess the existing IT and reporting infrastructure to identify potential gaps in the systems and develop a plan for sustainable reporting.

As may be expected, large businesses are more likely to have the necessary tools in place for complying with the CbCR obligations. Seventy-two percent of them said they have reporting systems that will gather and comply with CbCR guidelines, with around 20% saying they do not. Among the overall survey population, 53% said they have the necessary reporting systems and nearly 31% said they do not. Among sectors, businesses in health reported the highest level of readiness (67%).

"It's important to remember that complying with anti-BEPS rules is a middle market issue, too," says Alex Postma, EY Global Leader for International Tax Services at Ernst & Young Erissa Affiliate LLC. "Any company that does business across borders should be paying attention and improving their readiness to comply with existing and future requirements."

Interestingly, just 36% of survey respondents (and 38% of large businesses) said they would have to add additional resources to be able to gather and provide the required information for CbCR. This suggests that many businesses are investing in sustainable automated reporting systems or are outsourcing their CbC collection, rather than applying labor-consuming methods of dealing with CbCR.

Do you believe your company would have to add additional resources in order to be able to gather and provide the required country-by-country information?



"Any company that does business across borders should be paying attention and improving their readiness to comply with existing and future requirements."

– Alex Postma
EY Global Leader for International Tax Services

Engagement with policymakers

The OECD and national governments have carried out extensive consultations during the development of the BEPS recommendations and in the implementation and follow-up phase. Our survey respondents were asked if they have engaged, or are engaging, with either the OECD or national governments on BEPS developments.

Five percent of all survey respondents said they have engaged or are engaging with the OECD, while 11% said they have engaged or are engaging with one or more national governments. The numbers were slightly higher among large businesses: 8% said they have engaged or are engaging with the OECD, and 20% said they have engaged or are engaging with one or more national governments.

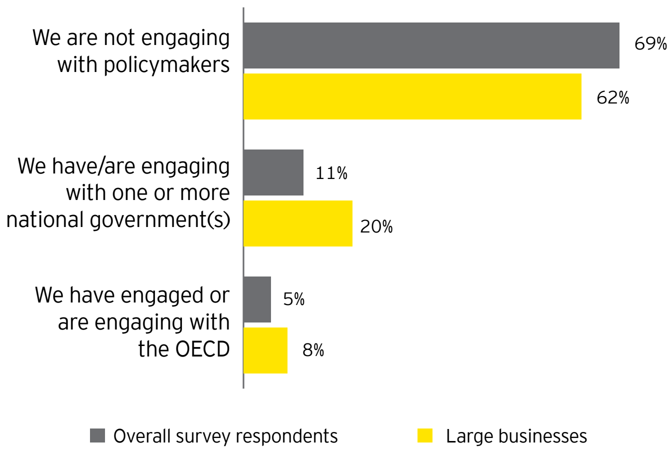
Among sectors, businesses in life sciences, power and utilities, technology and telecommunications reported the highest levels of engagement with policymakers. Thirteen percent of businesses in life sciences said they have engaged or are engaging with the OECD, while businesses in power and utilities and telecommunications (both 25%) and technology (20%) said they have engaged or are engaging with one or more national governments.

Marlies de Ruiter, EY Global ITS Tax Policy Leader at Ernst & Young Belastingadviseurs LLP and former Head of the Tax Treaty, Transfer Pricing and Financial Transactions Division at the Centre for Tax Policy and Administration of the OECD, says the survey results reflect that the number of businesses engaging directly with the OECD and other such international organizations tends to be relatively low. "In general, most businesses engage with the OECD through intermediaries, such as the U.S. Council for International Business, the Business and Industry Advisory Committee and BusinessEurope," she said.

By contrast, the number of businesses engaging directly with national governments tends to be higher, although there may be significant differences among governments when it comes to ease of engagement, de Ruiter said. "Some governments may be more inviting than others," she explained. "In countries that are more aggressive toward business, engagement may be more difficult. There may also be differences in the way that local businesses and international businesses operating in the same country engage with that country's government."

Businesses should take every opportunity available to engage with governments or international organizations in developing tax policy, says de Ruiter. "Policymakers solicit taxpayer feedback for a reason. Providing input can be invaluable in terms of helping them better understand the concerns and business practicalities of specific industry sectors," she said.

Is your company engaging with either the OECD or national governments on developments related to base erosion and profit shifting?



"Policymakers solicit taxpayer feedback for a reason. Providing input can be invaluable in terms of helping them better understand the concerns and business practicalities of specific industry sectors."

– Marlies de Ruiter
EY Global ITS Tax Policy Leader

What lies ahead

With governments continuing to implement the final BEPS recommendations, the results demonstrate that businesses still have their work cut out for them. Forty-two percent of all respondents foresee "availability and quality of data for CbC, master and local file reporting" as their greatest BEPS implementation challenge (for large businesses, this number jumps to 57%). Twenty-seven percent of all respondents foresee potential controversy in some countries' implementation of BEPS Actions as their greatest challenge (for large businesses, this number increases to 40%).

Tracking and managing many countries' implementation of BEPS Actions was chosen by 25% of all respondents (and by 32% of large businesses), followed by obtaining the right people with the right skills so that the new policies and rules are consistently adhered to, at 24% (and by 29% of large businesses), and providing structural alignment of business units and tax departments globally with the BEPS Action items, at 23% (and by 30% of large businesses).

Where do you foresee your company's greatest challenges in relation to the implementation of the BEPS Action items?

Multiple responses allowed

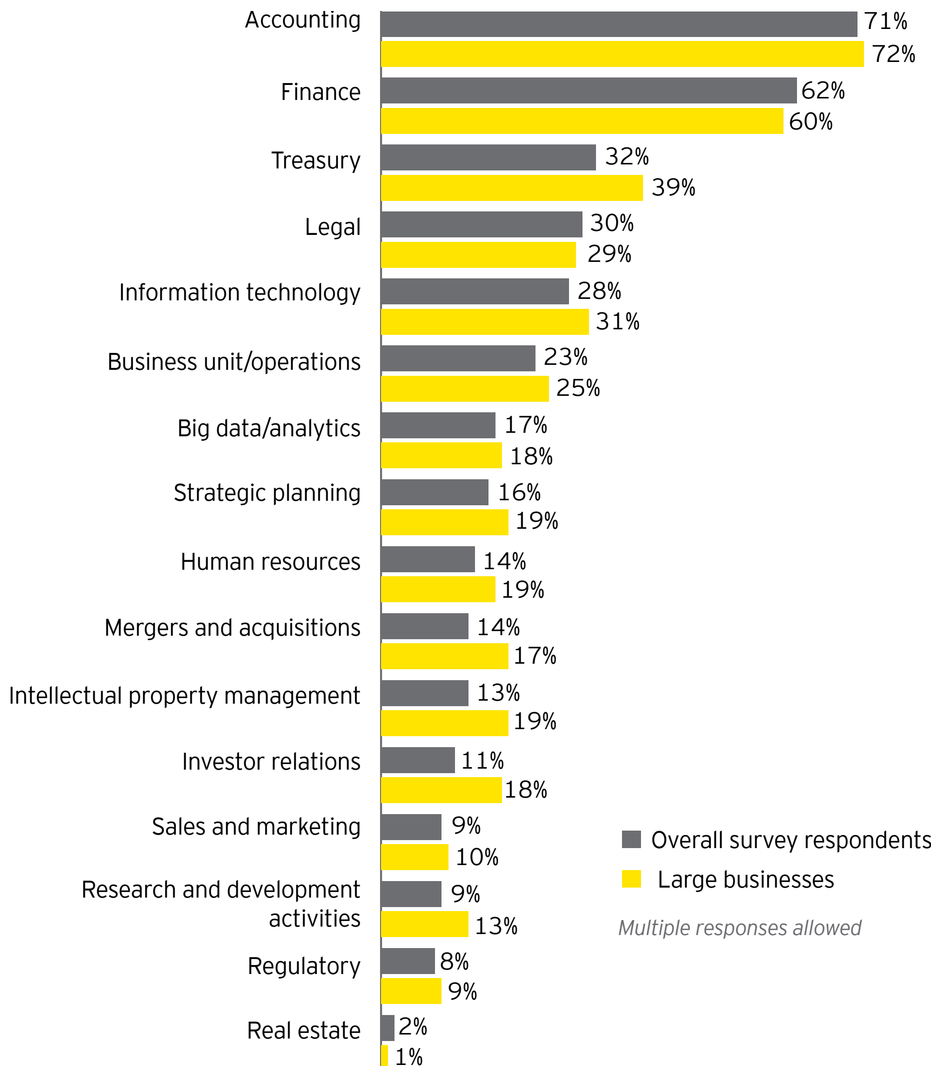
BEPS is broader than tax

It cannot be emphasized enough that the BEPS reforms extend beyond businesses' tax departments. Indeed, the BEPS recommendations being implemented by governments around the world are affecting not only tax compliance, but also the manner in which organizations conduct their business. Businesses that are reviewing their business models and developing strategic plans for any necessary restructuring or realignment needed in the countries in which they operate should consider a broad range of factors, including:

- Tax impact
- Market and competitive dynamics
- Intellectual property strategy
- Legal entity structure
- Relationships with tax policymakers and administrators
- Planning for acquisitions and dispositions

Asked which nontax functions will be impacted most significantly by BEPS implementation over the next two years, the top five selected by survey respondents were accounting (71%), finance (62%), treasury (32%), legal (30%) and IT (28%). The results were similar for large businesses, with accounting topping the list at 72%, followed by finance (60%), treasury (39%), IT (31%) and legal (29%).

Over the next two years, which of the following nontax functions will be impacted most significantly by the implementation of the BEPS action items?



Multiple responses allowed

Action steps

In view of the depth and breadth of the BEPS recommendations and their disparate impact on different industries, there is no one-size-fits-all approach to dealing with BEPS. However, having protocols in place to continuously monitor tax law changes in the countries of operation is essential no matter the size, scope or scale of your business. Having clear and consistently applied tax and transfer pricing policies will also be helpful in reducing risk and controversy. If controversy cannot be avoided, having a solid dispute management system in place is critical so that questions from tax authorities are answered in a manner consistent with global company tax policy.

What follows are more concrete steps that may be appropriate for businesses to take.

1 | Develop a strong controversy management approach that aligns with the level of your business model risk

The new transfer pricing approach taken by the OECD may result in a misalignment between profits, people functions and assets or risks. These misalignments will pique tax authority interest if they involve countries with lower tax rates. Such circumstances are directly targeted by the BEPS initiative. Taxpayers in this situation will therefore have more expensive and complex compliance and a greater likelihood of adjustments than before. Such taxpayers should consider taking some of the following steps in managing controversy:

- Assume full value chain transparency and transparency over system profits
- Do not rely on long-standing administrative approaches and norms; take a fresh look at the current practice in key countries

- Undertake a multi-sided transfer pricing analysis of the global value chain; addressing risk across all key countries is a much more sophisticated and complex exercise than multiple traditional one-sided analyses
- Make greater use of advance pricing agreements (APAs), especially bilateral and multilateral APAs; such an approach will be hard-won and expensive in many cases, but this is an inevitable consequence of BEPS
- Make sure your APAs are consistent with your policies in all jurisdictions where you operate, not just the countries that are part of the APA

That said, the BEPS initiative reaffirmed that countries have a sovereign right to set their own tax rates; thus, business models that are sensitive to tax rates across countries can be transparent and sustainable when profits are aligned with economic activity in lower tax rate countries.

Both companies with higher- and lower-risk business models, where the focus is primarily on compliance, may want to consider putting in place a clear controversy reporting and management system, whereby answers to queries from tax authorities are centrally coordinated and tested against global tax policies and practices.

2 | Proactively manage the impact of increased transparency

As tax authorities use new tools and laws — from data analytics and robotic process automation to strict regulatory enforcement — controversy is likely to increase. Tax departments will therefore have to be faster, smarter and nimbler. Businesses should proactively analyze their global tax footprint by, for example, reviewing their draft three-tier transfer pricing reporting (CbC report, master and local file) to find any red flags and consider potential remedial action, such as reexamining their underlying operating models, revisiting transfer pricing policies and/or strengthening transfer pricing documentation.

Tax departments will have to be multifaceted in order to address a host of technical, commercial, technological, political and social considerations. Technical skills will still be very important, but so will commercial insights in order to better align tax with operations. Technology and data analytics will be deployed to monitor and provide real-time report variances and results. All of this means the 21st century tax function of a global business will have to be very flexible in order to meet a wide variety of strategic demands.

Action steps (continued)

3 | Engage with the competent authorities

While improving dispute resolution mechanisms was a critical component of the work under Action 14, mutual agreement procedures (MAP) and arbitration remain largely government-to-government procedures, with little involvement of taxpayers and their advisors in the process itself. Nevertheless, taxpayers and their advisors can help and support the competent authorities in navigating the dispute and successfully resolving the case.

Taxpayers can have a positive impact on the process by, for example, understanding the objectives, ways of working and key positions of the relevant competent authorities; engaging early before positions become polarized; providing the clearest, highest quality information and ensuring the same information is provided to each country; and providing the competent authorities with the relevant information they need to advance the case (this can prevent delays arising from incomplete information).

4 | Don't take a "wait-and-see" approach to PEs

The recommended changes to the PE definition under Action 7 have created some uncertainty and complexity for taxpayers. At the 7 June 2017 signing of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), 20 jurisdictions did not reserve the right for the entirety of the MLI's three main PE articles not to apply to their tax treaties, which in effect means they want to apply those articles.[3] Tax authorities will be paying more attention than ever to PEs, and with their new tools, will likely be scrutinizing the detailed facts of particular cases. Moreover, some tax authorities may be tempted to apply the new concepts under existing domestic law, even if their tax treaties have not yet been amended.

Businesses need to take steps now to adapt to the new PE environment. They should closely monitor PE developments in the countries where they do business. They should also not simply rely on the contractual setup; they must ensure their staff are "living" the business's tax model.

Having undisclosed PEs can produce harsh consequences, such as imposition of penalties and a shifting of the burden of proof from the tax authority to the taxpayer. Given that it may take some time for businesses to amend their transactional model, they should start thinking through the consequences of the new rules and developing strategies for aligning their business models with the new rules.

[3] The MLI contains three main PE articles (Article 12 covering commissionnaire arrangements and similar strategies; Article 13 covering the specific activity exemptions; and Article 14 covering splitting-up of contracts) and a fourth (Article 15) defining when a person is closely related to an enterprise for the purposes of Articles 12, 13 and 14. For an overview of countries' positions on the MLI's PE articles, as well as other MLI provisions, see EY Global Tax Alert, ***Signing by 68 jurisdictions of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS highlights impacts for business to consider***, dated 14 June 2017.

Conclusion

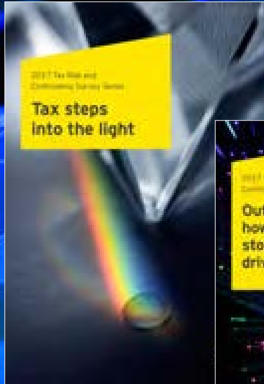
It's not hyperbole to say that the G20/OECD BEPS project represents the most comprehensive change to international taxation in the last 100 years. The final BEPS recommendations do not amount to a mere rewriting of technical tax rules, nor do they affect only businesses' tax strategies. Having risen to the top of the political agenda of the world's largest economies, the goal of the BEPS project was not just to change the international corporate tax framework but to change the behavior of businesses themselves. The BEPS reforms that are being carried out by governments around the world are reshaping business models, industries and key companies within different sectors, as well as prompting businesses to rethink how tax decisions will affect their reputation, brand and communications with internal and external stakeholders.

For businesses, the October 2015 release of the final BEPS recommendations didn't just mark the start of the implementation phase but the beginning of a challenging, unpredictable journey. The varying speeds at which countries have acted to implement the BEPS Action items — and their different, sometimes inconsistent interpretations of what the recommendations mean — have created new risks for businesses and shone a spotlight on corporate taxation like never before. With proper controls in place to monitor and implement BEPS developments, and careful planning so that business models and structures are aligned with the new global tax mindset, businesses can successfully navigate the BEPS journey and dim the glare of that spotlight.

Survey methodology

The survey was conducted between January 2017 and February 2017. The survey was distributed via email and conducted using an online tool in English, Spanish, Chinese and Japanese; 90% of respondents chose to complete the survey in English. Routine reminders were sent out to respondents who had not completed the survey. Once an adequate number of responses had been recorded, the survey was closed. Any survey with two-thirds or more of the questions answered was considered complete for analysis purposes. The respondents included 901 tax and finance executives representing more than 17 industry sectors in 69 countries. Figures contained in the report may not add to 100% due to rounding, non-reporting of "don't know" responses and no responses. Questions with fewer than five respondents are not reported in the interest of data confidentiality.

Tax Risk and Controversy Survey Series



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