International Tax: Choppy Waters Ahead, Life Vests Advised

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The international tax system is continuing to experience a period of significant change, as taxing authorities across the globe are continuing to adopt and implement new rules and procedures to respond to the new economy and perceptions that taxpayers are arbitraging differences among jurisdictions.

We have seen increased enforcement, widespread changes in substantive laws and an increased focus on how to tax companies engaging in digital transactions, and we expect to see more of the same over 2020 and the next few years. While many of the new rules are intended to prevent deductions from being claimed in more than one jurisdiction and income from escaping taxation entirely, they may inadvertently result in taxpayers being subject to double taxation or whipsaw, particularly as the new rules are being adopted and implemented simultaneously and without coordination. Taxpayers will need to be vigilant, thorough and proactive to minimize their risks.

Increased Enforcement Efforts

Around the world, taxpayers are faced with new disclosure obligations, enhanced information sharing and increasingly aggressive enforcement strategies. The EU has introduced a new mandatory disclosure regime, known as DAC6, requiring intermediaries (including tax advisers, accountants, lawyers and banks) who establish or advise on certain kinds of "cross-border arrangements" to provide extensive information about those arrangements to local tax authorities.

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While the first reports are not due until August 2020, the period covered looks back all the way to June 2018. Once reports start to be made, taxpayers can expect enhanced information sharing between tax authorities and wide-ranging follow up information requests.

We expect DAC6 to result in a significant increase in audits and assertions of tax underpayments by taxing authorities. In the United States, businesses using partnership structures can expect audit activity to increase in 2020, as the IRS begins examining the first wave of returns filed under the new partnership audit rules in effect for partnership tax returns filed for tax years beginning with 2018. Additionally, several jurisdictions, particularly in Europe, are increasingly resorting to criminal investigations, prosecution, and/or "dawn raids" of companies perceived as not paying their fair share of taxes. Many companies are establishing dawn-raid crisis management plans, even if they have no reason to believe they have underpaid their taxes.

Significant Changes to Tax Systems

Recent years have witnessed an unusual increase in significant changes to tax systems, and we expect this trend to continue in the near future.

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The United States enacted major tax reform legislation at the end of 2017, and the US Department of the Treasury is still writing regulations and issuing guidance implementing significant aspects of the law. Mexico enacted similar reforms, effective in 2020, including a new interest expense limitation and a rule limiting deductions for payments to non-Mexican related parties. Brazil recently announced major tax reform to be enacted in four phases over several months, which is expected to include a VAT-like regime and reduced individual and corporate tax rates.

In addition, the EU anti-avoidance directive took effect in 2019 and includes extensive anti-hybrid rules modelled after the Organization for Economic Co-operation and Development's (OECD) "BEPS" recommendations. The EU has also established a "blacklist" of non-co-operative jurisdictions for tax purposes and regularly publishes updates of the commitments taken by tax haven jurisdictions to implement tax governance principles, such as transparency and fair taxation. New economic substance rules have been introduced by several jurisdictions (e.g., Bermuda, Cayman Islands) that were under EU scrutiny for facilitating offshore structures or arrangements without real economic activity.

Multinational companies should be prepared for similar reforms across the globe in the coming months and years and should evaluate their intercompany transactions and structures accordingly.

Emergence of a Minimum Tax System?

The EU and the United States have enacted or proposed various measures intended to ensure that multinational companies pay a minimum rate of tax on global income. The 2017 US tax reform included two new minimum tax regimes: the Base Erosion and Anti-Abuse Tax (BEAT), dealing with deductible payments from US companies to non-US affiliates; and the Global Intangible Low-Taxed Income (GILTI), aimed at current US taxation of foreign subsidiaries' offshore earnings.

The EU's anti-avoidance directive also includes changes to Controlled Foreign Corporation (CFC) rules and a harmonization of the rules across the EU. In May 2019, the OECD published a new work program that proposes rules similar to the US BEAT and GILTI (so-called "Pillar 2" proposals). Multinational companies should assess the impact of these minimum tax regimes and evaluate the ongoing usefulness of their current tax-minimization strategies.

Reshaping the Global Tax System for the Digital Economy

Various jurisdictions have introduced or enacted unilateral rules targeting digital transactions and structures, and many of these rules are set to take effect in 2020.

France and Italy have taken an expansive audit position regarding the nexus created by digital transactions, asserting that local affiliates or service providers constitute "permanent establishments" and therefore subject foreign companies to local tax. The UK government has announced a UK digital services tax (DST) that may take effect as early as April 2020. While the details and scope of the UK DST may change, it is currently proposed to apply at a rate of 2% on revenues derived by certain businesses from social media platforms, search engines, or online marketplaces. To fall within scope, the taxpayer does not have to be UK tax resident, but the relevant revenue must be linked to the participation of UK users.

In July 2019, France adopted a DST levied at a rate of 3% on the turnover derived on or after January 1, 2019, from certain digital services provided in France including online intermediation and advertising services. A similar tax is expected to come into force in Italy effective as of January 1, 2020. The US Treasury is also considering adopting regulations relating to the sourcing of income from digital and cloud transactions that could result in increased US taxation of non-US technology companies with US customers.

Finally, the May 2019 OECD program includes new proposed nexus and profit allocation rules to ensure that multinational companies (including digital companies) pay tax wherever they have significant profit-making consumer facing activities. Companies offering digital services should be prepared for drastic changes to their worldwide tax exposure and filing obligations as these measures take effect in the coming years.