

Are You Ready to Respond to Changes in International Tax Legislation?

Innovative Strategies for Dealing with Change and Uncertainty

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Executive Summary

Tax compliance used to be a side show to core business operations – something that tax departments handled on an annual or quarterly basis focusing on tax avoidance. But no longer. With massive pending changes to international tax legislation, as well as a growing hyper regulatory environment within the U.S., this intricate, risk-laden part of running a business is now moving to center stage. Moreover, the regulatory burdens associated with tax compliance are costly and labor-intensive, driving up the cost of doing business internationally. These costs are compounded by the effects of an already ailing global economy.

Given this environment, it's critical that you find ways to more efficiently manage tax and compliance. You need a way to make your tax department more agile, data driven, aware of, and responsive to regulatory changes as they occur. This paper discusses some of the key areas of international tax law that will be changing and proposes actions you can take to protect your organization.

Change and Uncertainty Is the Name of the Game

The last 10 years have seen a sustained acceleration in the speed and volume of global tax rate and rule changes. Given the global economic downturn, these changes have only intensified recently because governments are short of funds to meet obligations. As sovereign deficits skyrocket, governments are focused on increasing their tax revenues by enacting thousands of global tax changes. For example, the current U.S. administration has proposed and is now implementing major international and other tax reforms aimed at reducing the deferral of foreign-based income, which will potentially increase the effective tax rates of U.S.-based multinationals.

It's expected that these changes will not only increase the cost of compliance, but also your overall effective tax rate. Triple costs are involved, including:

- Paying for tax at state and federal level
- Paying international tax
- Paying for the rising cost of compliance (including performance and process costs) that cuts into corporate profitability

What's making these changes even harder for companies to handle is that many changes in international tax legislation are yet-to-be-determined. And the resulting uncertainty is complicating the corporate compliance and planning picture considerably. How can you develop optimal tax strategies if you aren't sure what constraints you're working within?

At the same time, these tax changes are expected to create new, global risks in places where you didn't have them before – and likely won't expect them. The more regulation you have, the more compliance you need to manage; and if you're relying on manual and spreadsheet-based processes, this translates into increased opportunity for human error.

What Tax Changes Are Looming?

Let's take a closer look at key areas of international tax law where Vertex expects the most significant changes will occur.

Changes to Anti-Deferral Rules for U.S. Income

The Obama administration is actively aiming at traditional anti-deferral rules for companies with U.S. income. The goal is to amend these rules so that multinational companies can no longer shift and hide income off shore – and the U.S. government can tax this income to increase federal tax revenue. This scrutiny originated due to rising public awareness that high net-worth individuals hid income overseas to avoid U.S. income tax; in an effort to increase tax revenue, the federal government's focus has now shifted from individuals to businesses.

These newly enacted changes to anti-deferral laws will force U.S. multinationals to file tax returns that more accurately reflect their total income. This will lead to higher corporate taxes – at a time when company revenues are low. Recognizing that anti-deferral rules are interdependent and can't be amended in a piecemeal fashion, President Obama's administration is taking a holistic approach to making changes. So expect a broad-brush overhaul of anti-deferral laws that will require major changes to your tax strategy as you seek to minimize your effective tax rate.

Highlights of anticipated areas of change include:

- **The proposed elimination of "Check-the-Box" entity classification elections for certain types of offshore entities:** Today, you are free to use a "check-the-box election" to treat foreign subsidiaries as a pass-through for tax purposes. Doing so makes it easier for you to "trap" income off shore and defer U.S. taxation of these foreign earnings. Changes proposed by the Obama administration will restrict use of check-the-box rules and require that your company treat certain foreign subsidiaries as corporations for U.S. tax purposes so that income generated by them is included in the present-year income tax. However, to-date, no changes to the check-the-box regulations have been enacted, although it is believed that these will re-appear soon.

What Tax Changes Are Looming?, cont'd

- **The potential elimination of cost sharing:** The current administration is considering ways to restrict how companies share costs across divisions and geographies. For example, if you typically allocate the cost of developing intellectual property to high-tax jurisdictions as a way to increase write-offs and lower taxes in these jurisdictions, this practice may be curtailed or limited in some way.
- **Limitations on deductions to unremitted foreign income:** In the past, corporations could defer payment of U.S. federal income taxes on certain foreign profits until you repatriate them to the U.S., as well as pool foreign tax credits between different subsidiaries for maximum benefit. As an added bonus, the government allowed you to deduct select expenses that occur in the United States, yet were incurred to support the operations that generated the deferred foreign profits. Now, the Obama administration will deny a deduction for these expenses until the foreign income is repatriated back to the United States, as well as limiting the pooling of foreign tax credits. The intent is to take away an incentive for U.S. companies to invest abroad – and encourage them to invest at home to create new jobs.
- **Changes to look-through rules:** As of December 31, 2009, the look-through rules implemented by the Bush administration have expired – and it's unlikely they will be reinstated. Look-through accounts ensure that certain kinds of income, including dividends, interest, rent, and royalties, generated through intercompany transactions don't have to be recorded as sub part F income; in this way, they help reduce your effective tax rate. Assuming these rules are not reinstated, companies will need to find ways to restructure operations and impacted route cash so it doesn't become sub part F income.
- **Increased transfer pricing scrutiny:** Expect transfer pricing to be a key tax planning issue because if all else fails, it is a catch-all for tax authorities seeking to increase taxable income and state and federal revenue. While you develop transfer pricing strategies to allocate profits across entities in ways that minimize taxes, tax authorities can over-rule your strategy so that you pay more taxes than expected.
- **Foreign tax credit limitations:** Formerly, for taxes paid on overseas profits, your company can generally take a credit for these taxes against its U.S. federal income taxes. But with the new "Greenbook" regulations, everything has changed. Now, there are restrictions on multinational corporations as to what is deemed paid Foreign Tax Credit (FTC) vs. what is "actually" paid on foreign earnings, as well as the elimination

of the use of cross-crediting on high and low taxes on foreign source income. Under the new regulations, cross-crediting is no longer permitted between high & low tax foreign source income. The U.S. will now be applying what is called a "blended foreign tax pool." These changes will totally transform the current FTC system at the consolidated level, with the goal of forcing companies to bring cash back into U.S. This is another aim of the Administration; that is Foreign Tax Credit credit reform, jointly with anti-deferral and increased tax-avoidance enforcement.

All of these pending anti-deferral changes remain very fluid. But the fact remains that significant change is coming, so it is imperative that your foreign income is properly reflected for tax purposes.

Are Changes to Sarbanes-Oxley Legislation Coming?

The new administration has also hinted at Sarbanes-Oxley reforms that will occur over the next few years, as experts generally agree that SOX and its internal controls have not worked well. However, this stands to reason, as the global financial crisis expands through the banking, mortgage, international trade, and capital markets, and the corporations behind these sectors seemed to have been able to avoid, if not evade, certain internal controls arising from negligent or reckless corporate governance. Thus, the question most experts are currently asking is not only whether SOX works, but rather, whether any tax and financial reform will work without SOX reform.

Foreign Account Tax Compliance Act 2009

Effective January 1st 2010, there came into effect, new rules aimed at combating offshore tax evasion. Under FATCA (Foreign Account Tax Compliance Act), a 40% penalty applies for underpayments attributable to undisclosed foreign financial assets. There will also be a withholding tax on dividend on principal contracts amounts and other equity swaps. So if you are engaged in hiding income off shore, the penalties are worsening; you should consider taking advantage of incentives to properly report it or risk paying dearly.

Strategies and Best Practices for Handling Change and Uncertainty

No one knows for sure what the end game will look like, but one thing is certain: international tax changes and new rules have begun, and the new rules are onerous for multinationals. So the biggest mistake would be to take a wait-and-see approach. You need to prepare now.

The question on everyone's mind is, what's the best path forward? First, you can prepare for change by vigilantly "scrubbing" what you are doing from a tax data management perspective; you need to be absolutely certain that the data you collect and use for planning and compliance – the data going into your tax automation solutions – is 100% accurate and available at your fingertips.

And from a tax technology perspective, your systems must be flawless in terms of how they manage processes and data, handle tax changes, and support the development of new tax strategies. For most tax departments, this will mean finding ways to:

- Achieve complete tax data transparency and ensure accuracy
- Fix tax process inefficiencies – for example, due to reliance on manual data collection and handling via spreadsheets
- Streamline and automate compliance wherever possible
- Leverage analytics (for example, to support what-if analysis) to quickly develop new tax strategies and adapt them as tax rules change

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About Vertex Inc.

With more than 30 years of experience, Vertex Inc. is the leading provider of corporate enterprise tax solutions and process management services worldwide.

Vertex solutions help companies streamline and integrate tax provision and compliance processes, and leverage information to discover new strategic tax savings across every major line of business tax, including income, sales, consumer use, value added, communications, and payroll. To serve its customers, Vertex works in partnership with the world's leading providers of ERP software and related services.

Technology, in the form of comprehensive, automated tax solutions, is the clear path to achieving these goals. While current ERP systems may have served you well throughout the years, they are not capable of delivering a fully automated solution that can enable these kinds of capabilities. The latest tax automation solutions make you more agile and able to adapt to tax regulation and legislative changes. These tax-sensitized business intelligence solutions and tax engines are pre-populated with data, logic and reporting capabilities for all tax types across all taxing jurisdictions in the world. They place complete, accurate information at your fingertips 24x7 and a built-in, operative checklist so you don't miss anything in your compliance. Ideally, the tax technology vendor, not the in-house tax professional, continuously maintains this data and functionality so that tax professionals can focus on more strategic and operational activities.

The outlook for tax departments may become even brighter in the not-so-distant future. Vendors are currently working to deliver "end-to-end" tax solutions – offerings that encapsulate all business tax types, populated with data covering every global tax jurisdiction, and running on a single operating platform. This next-generation of tax engine technology is being developed today by leading tax solution providers and will make international tax compliance even faster and easier, particularly, given the continuing and increasing wave of regulatory measures and its mounting burden.

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