Global governments are getting hungrier

Transfer pricing, information sharing and the possibility of reform top international tax issues

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Virtually all transactions that cross international borders have tax implications - and as more and more clients engage in business around the world, international tax issues are becoming increasingly important to practitioners of every size.

Transfer pricing, information sharing and the possibility of tax reform are the areas of international tax that most concern practitioners, according to Bruce Reynolds, managing editor of international tax at Bloomberg BNA.

It is no surprise, he indicated, that concerns over both transfer pricing and information sharing are related to the worldwide economic slowdown. "A lot of countries are looking for tax revenue, and one of the things they're focusing on is transfer pricing," said Reynolds.

The term "transfer pricing" started out as the price used in a commonly owned group of entities and has grown to mean appropriately recording the right amount of income when there are cross-border transactions between members of a controlled group, Reynolds explained. Section 482 of the Tax Code authorized the Internal Revenue Service to adjust the income, deductions, credits or allowances of commonly controlled taxpayers to prevent evasion of taxes or clearly reflect their income.

The regulations under Section 482 say that prices charged by one affiliate to another in an inter-company transaction involving the transfer of goods, services or intangibles should show results that are consistent with results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.

"It's been growing in importance for some time, because as countries have begun to exchange information and work together with financial structures used to move income from one country to another, transfer pricing is becoming one of the few ways to determine how much income goes from one country to another," said Reynolds.

A subset of the transfer pricing issue is the divergence between the Organization for Economic Cooperation and Development, consisting primarily of developed countries, and the developing world.

"The OECD method assumes you should get paid for what you do and the risks you take on in doing it," said Reynolds. "So if you're taking on more activities and risk, you should make more money. It looks at what is going on in each country, and is based on having reliable information in corporate financial reports, which don't exist in many developing countries."

"Less-developed countries are trying to find a pricing method that doesn't require comparable information," he said. "At the same time, the philosophy in the less-developed world is that they are being taken advantage of. They believe that the method under OECD guidelines doesn't leave enough money in those countries, so they're developing methodologies that don't need information on comparable businesses. A lot are turning toward effectively mandated profit margins. For example, if you make a 15 percent profit, that's fine. If you don't, they'll adjust the figures so you do. They're basically saying they want to grab 15 percent."

NOWHERE TO HIDE

Information sharing gained its share of the spotlight after Swiss bank UBS gave the IRS a disk of several thousand accounts, Reynolds observed. "That started a major push here, and it got other countries thinking that they shouldn't be so relaxed about people hiding information. Some of this has been generated by the U.S. with its FATCA [Foreign Account Tax Compliance Act] legislation. And some has been generated by foreign countries thinking that the economy is so bad, they need money from sources that they haven't tapped before, so it's a better idea to share information than to keep raising tax rates."

"People are saying that the era when you could hide income from your tax authority is coming to an end," he continued. "It will probably be a few years before that's fully true, but if you're advising anyone with foreign assets, they should be cautioned to fully report them, because it will become dangerous to hide them."

"The IRS wants to know if you have assets anywhere in the world," agreed Miguel Farra, principal at Morrison, Brown, Argiz & Farra LLC. "Form 8938 is brand-new. Even if you're required to file the FBAR form [Treasury Form 90-22.1, Report of Foreign Bank and Financial Accounts] you still might have to report on Form 8938. And the other side of FATCA - reporting by foreign financial institutions - comes into play in 2013."

Under FATCA, a bank or a hedge fund has to report information about accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. "It's a costly reporting requirement," said Farra. "A number of foreign financial institutions are not geared up for this. In some cases, they are telling their U.S. customers to close their accounts."

"It all starts with government," said Brian Tully, head of Thomson Reuters' ONESOURCE transfer pricing group. "Because of the global recession and increasing budget deficits, almost all countries have a need for more revenue.

One way to get that revenue is to scale back transfer pricing, which is the ability to transfer money and goods out of one country into another. It can be used to lower the tax rate by moving money, goods or intangibles out of a high-tax jurisdiction to a lower-tax jurisdiction. Countries have found if they tighten up their transfer pricing policies, they can make from $500 million to $2 billion in revenue each year. So it's becoming increasingly popular as a revenue source on a worldwide basis. Countries are adding more auditors to their revenue agencies all over the world - the IRS is adding 900 auditors to focus on this."

"In fact," Tully noted, "transfer pricing is one of the last remaining areas in which people can do tax planning. That's why there is so much interest in it. But corporations are wary, because if they do transfer pricing the wrong way, they can be double- or triple-taxed. For example, say that a company moves money from India to Thailand to Japan to the U.S. If it's done correctly and within the rules, it might pay 21 percent tax. But if it does it incorrectly, it could be taxed on the full rate in each country and pay over 100 percent in tax. On top of that, 75 percent of Fortune 500 companies say they are getting audited more aggressively. That's how governments see this as at least a partial answer to their revenue problems."

As governments run short of money, transfer pricing becomes a fight for what governments believe is rightfully theirs, agreed Doug Eckert, leader in the international tax practice at Brown Smith Wallace LLC. "There's always a tension, globally, on where profits should be allocated. Governments want to maximize the amount allocated to their jurisdiction, while businesses want to minimize their exposure and allocate income to the low-tax jurisdiction. That will continue to be an issue."

Eckert noted the current interest in tax reform in the international sphere. "They've been talking about tax reform for a long time, specifically a move toward a territorial system," he observed. "With the November elections on the horizon, there's some doubt whether anything will happen before then."

Two different reform proposals - the Obama administration's proposal and that from House Ways and Means Chairman David Camp, R-Mich. - are not that far apart, according to Sang Kim, co-managing partner of the Silicon Valley office of DLA Piper.

"If you look at the proposals in a sense of compromise, they are not that far apart," he said. "The Camp proposal suggests a more territorial view of the world, while the administration would continue the worldwide approach, but if you look at tax rates alone, they're not so far apart. The Camp proposal provides for repatriation of foreign earnings to the U.S. with very limited tax."

A move toward a territorial system is primarily aimed at reducing U.S. tax imposed on an active business in a foreign country, explained Reynolds: "So what we're talking about is the tax on a foreign branch or foreign subsidiary getting some sort of exemption. As more development goes on, it's not as simple as it sounds."

Whether corporate tax reform replaces the worldwide system of taxation with a territorial system in the U.S. within the next year is an open question, according to Reynolds. "I could go either way on whether or not it will happen," he said. "But I wouldn't be surprised if something happens to make it less tax-costly to have an active business in a foreign country."