TAX MANAGEMENT IN CURRENT ECONOMIC ENVIRONMENT

Corporations are looking for ways to achieve cost savings and to reduce cash leakage, particularly in these turbulent economic times. An effective tax management function can contribute to this. There is no doubt that efficient tax planning, if implemented properly, can help to reduce the tax burden and thus the costs of doing business. At the same time, one should not lose sight on another critical element of effective tax management, namely managing tax controversies. Significant resources can be consumed in dealing and resolving disputes with tax authorities when they arise.

The growing pressures from certain sections of the international community calling for tax transparency and the increasing focus of many governments and regulators on tax compliance and tax controls, coupled with the economic downturn, have resulted in many tax authorities being hungry for tax revenue, thus making managing the exposure to tax controversies and disputes more pertinent than ever.

This article looks at the recent developments that indicate the environment is more challenging than ever for tax management and discusses the responses that corporations can consider when facing these challenges.

International tax transparency

While recognising that each jurisdiction has sovereignty over its own national tax policy and the effective administration of its own tax laws, one of the objectives of the Organisation for Economic Co-operation and Development (OECD) has been the maintenance of an international level playing field for all countries by encouraging transparency and international cooperation through effective exchange of information for tax purposes. Back in 1998, the OECD published its report entitled *"Harmful Tax Competition: An Emerging Global Issue"*, in which four criteria are used to identify whether a jurisdiction is an uncooperative tax haven. These factors are (1) no or only nominal taxes, (2) lack of effective exchange of information, (3) lack of transparency and (4) no substantial activities. Two years later, the OECD published a list of Uncooperative Tax Havens in its 2000 report, *"Towards Global Tax Co-operation"*. The jurisdictions listed are those which met the above criteria and at the same time do not commit to transparency and effective exchange of tax information.

Recently this issue has come under the international spotlight again during the G20 summit held in London. Before the summit, there were calls from the French and German governments to expand the list to include jurisdictions deemed uncooperative in exchanging tax information. Following the summit, the statement that appears in the communiqué jointly issued by the G20 leaders indicates their countries will *"take action against non-cooperative jurisdictions, including tax havens"* and *"stand ready to deploy sanctions to protect our public finances and financial systems"*.

At the conclusion of the summit, a tiered list was published by the OECD grouping jurisdictions into three categories depending on their level of corporation on information exchange. They are (1) jurisdictions that have substantially implemented the internationally agreed tax standard, (2) tax havens and other financial centres that have committed to the internationally agreed tax standard but have not yet substantially implemented it, and (3) jurisdictions that have not committed to implement the internationally agreed tax standard. Some jurisdictions in the Asia-Pacific region are listed in the second category. Philippines and Malaysia (Labuan) that were originally listed in the third category have now been moved to the second category following their governments' agreement to commit to remove the impediments to the implementation of the international standard.

Although the OECD has no authority to impose any sanction or take any action against those jurisdictions which do not implement the internationally agreed tax standard, it can recommend that the leading economies take orchestrated efforts against these jurisdictions. The OECD will continue to monitor those listed in the second category in their progress towards the internationally agreed tax standard.

Similar developments are observed in the United States. Senator Levin introduced the Stop Tax Haven Abuse Bill (Bill) in March this year and Senator Doggett and 63 other senators introduced a companion bill supporting the Bill. The Bill has a list of 34 offshore secrecy jurisdictions (OSJ) and includes provisions targeting abusive use of these jurisdictions to defer/avoid US taxation. An example is the presumption that any amount (or thing of value) received by a US person from an OSJ entity or account is currently taxable income of such person in the year of receipt.

The international call for transparency in tax information is clear. Although the exchange of information is usually not automatic and there are adequate safeguards to deter "fishing expeditions", the increased transparency will no doubt facilitate tax authorities in various countries to strengthen their administration in tax collection.

Tightening the screws by the tax authorities

Locally tax authorities are in a better position than ever to shift into the full compliance and enforcement mode and there are already cases in the region showing that a number of tax authorities are tightening the screws in their tax revenue collection efforts.

The Vodafone Case — An Indian case

The issue in this Indian case is the obligation of the buyer to withhold tax on the capital gains derived from the disposal of indirect investment in Indian assets. Vodafone International (Vodafone), a Netherland-based company, paid US$11.2 billion to Hutchison Group (Hutchison) to acquire the controlling interest in CGP Investments, a Cayman Islands company, which in turn owns 67% interest in an Indian company, Hutchison Essar India Limited.

The Indian tax authorities served a notice on Vodafone asking it to demonstrate why it should not be deemed to be an assessee in default for failing to withhold tax as required in the law on payments to Hutchison. The main arguments are the transfer of the CGP shareholding from Hutchison to Vodafone constituted the transfer of Indian assets and the gains are subject to capital gains tax in India.

One of the Vodafone's defences is that the transaction is not chargeable to tax in India and thus, Vodafone did not have any obligation to withhold tax at source. In December 2008, the Bombay High Court rejected all of Vodafone's arguments in its petition. The High Court ruled that the transaction involved disposal of Indian assets and the gains prima facie are subject to capital gains tax in India. The case went to the Supreme Court of India which has referred the matter back to the tax authorities with a specific direction to the tax authorities to decide on the jurisdictional issue. At the time of writing, the final result of the case is yet to be known.

The Chongqing Case — A China case

The case was reported on the website of the Chongqing State Tax Bureau (CSTB) in November 2008. The case involves withholding tax on a capital gain derived by a Singaporean holding company from transferring its wholly owned Singaporean intermediate holding company which in turns held substantial interest in a joint venture in China to a Chinese buyer.

Although the gain was derived from the disposal of a Singaporean company and the transaction did not involve any direct transfer of equity interest in the Chinese joint venture, the CSTB concluded that the transaction, in substance, is a transfer of the equity interest in the Chinese joint venture and the capital gain derived by the Singaporean holding company is sourced in China.

The challenge on the taxing right of the capital gain was raised by the CSTB in May 2008 and the dispute was settled in October 2008. The CSTB eventually collected withholding tax of some US$145,000 on the entire capital gain derived by the Singaporean holding company.

The Board of Review Cases D94/04 and D17/08 — Hong Kong cases

The taxpayer in Case D94/04 entered into a financing scheme whereby interest expenses and other related expenses were claimed to be deductible for profits tax purposes. The scheme was challenged by the Hong Kong Inland Revenue Department (HKIRD) by applying the general anti-avoidance provisions contained in that territory's laws. The case was brought to the Board of Review by the taxpayer. The Board decided in this case that the HKIRD was empowered under the general anti-avoidance provisions to counteract the tax benefit obtained in the scheme by disallowing the deduction of interest and the related expenses. The case involves seven years of assessments and the additional taxes charged were over HK$95 million. The taxpayer appealed against the Board's decision to the High Court but subsequently withdrew the appeal.

The HKIRD then raised tax penalties on the ground that the taxpayer filed incorrect tax return without reasonable excuse. The total additional tax penalties amounted to over HK$52 million, which represented over 55% of the additional taxes involved in this case. The taxpayer appealed against these penalties to the Board of Review on the grounds that it did not file an incorrect return and, if it did, it had reasonable excuse. In Case D17/08, the Board decided that there was no ground for the taxpayer to argue that it did not file an incorrect tax return because the additional taxes raised by applying the general anti-avoidance provisions were agreed by the taxpayer and became final and conclusive. There was also no evidence that the taxpayer had any reasonable excuse.

Tax controversies

The above cases indicate that tax authorities are stepping up their efforts to protect their tax revenues. This, coupled with better information exchange through international channels, is likely to result in them being increasingly less hesitant to challenge any tax scheme or arrangement which is considered to be abusive. As illustrated in these cases, the financial consequences of being successfully challenged could be substantial.

The issues discussed in the above cases are examples of tax controversies or disputes that can arise in business transactions and restructurings. A tax controversy is a dispute or disagreement on a tax issue. This can be a result of inadequacy in the information made available to the tax authorities or disagreement in the interpretation of tax law and regulations between taxpayers and tax authorities.

Information inconsistency is a common cause for tax disputes. A tax audit is the usual means for tax authorities to collect further information to verify those provided by the taxpayers in their tax returns. Any discrepancies are likely to be challenged by the tax authorities. Unless sufficient and reasonable explanations are provided, in most situations the discrepancies will lead to additional tax and sometimes penalties.

Business restructurings usually involve cross-border reallocation of functions and risks and hence raise transfer pricing and tax treaty application issues. Cross-border transfer pricing is a risk area which often draws the attention of tax authorities. The information that tax authorities can collect from taxpayers in their tax returns and now through exchange of information internationally puts the tax authorities in an advantageous position to perform more in-depth investigation of cross-border transactions carried out by taxpayers.

Abusive use of tax treaties is also frequently challenged by tax authorities. The recent decision by the Urumqi State Tax Bureau in China to not allow treaty benefits to a company incorporated in Barbados under the Barbados-China tax treaty is an example. Based on the information collected from the exchange of information between the Chinese and Barbados tax authorities, the Chinese tax authorities concluded that the taxpayer was not a Barbados tax resident and hence not eligible to enjoy the treaty benefits available under the China-Barbados tax treaty.

Tax schemes relying on non-disclosure or less than full disclosure of information are now history. Tax authorities are better informed than ever in investigating the tax affairs of taxpayers. The increasing international cooperation will undeniably expose multinational companies to challenge from tax authorities. In the times of financial difficulties, there will be political pressures for governments to collect taxes more aggressively in order to avoid having to raise tax revenues from those law-abiding taxpayers.

Disputes could also be a result of differences in the interpretation of tax law and regulations. The Vodafone case is an example of differences in the interpretation of law. Law may remain the same, but the interpretation evolves as business environment changes. The locality of profits has been an issue of tax dispute for many decades in Hong Kong despite there being no substantial changes to the relevant Hong Kong tax legislation. Although there have been numerous court cases in this area including some recent ones, the sourcing issue is expected to continue to be at the centre of disputes for the foreseeable future.

Tax risk management

Substance is always important in any planning arrangements. Arrangements without commercial substance but for tax benefits are often targeted by tax authorities. There is an increasing attention of tax authorities on treaty shopping and abuse. Corporations should ensure their offshore intermediate entities have the necessary substance in order to fulfil the tax residency requirement and that there is sufficient commercial justification for how they structure their investments or business transactions.

Substance should be supported with proper documentation. Accuracy in documentation is critical in minimising tax disputes due to information asymmetry and is more crucial in times when governments are required to tighten their tax collection measures. Double checking the documentation to make sure all business transactions and restructurings with substantial tax effects are analysed and reflected accurately in the documentation which can be provided to the tax authorities when necessary is critical.

Communication between the tax function and operational units are necessary for the on-going monitoring of the tax risk arising from the misalignment of the business operations and the changing tax environment. Performing periodic health checks is a useful way to identify potentially problematic areas before they come on the radar of tax authorities. Conducting a “tax audit” internally will sometimes allow fresh eyes to pick up some weak points in the transactions.

Dealing with a tax audit by the tax authorities can in many instances be a time consuming and expensive process. Prevention is better then cure. Obtaining an agreement on the tax treatment of the proposed transactions with the tax authorities before implementing any arrangements involving uncertain/contentious tax issues is another way to reduce the risk of tax disputes. Most tax authorities usually provide an avenue for an advance ruling or agreement on the tax consequences based on facts of a proposed arrangement. Advance pricing agreements between taxpayer and tax authorities can be used to mitigate the risk of tax disputes in transfer pricing.

Tax laws in some jurisdictions (e.g. China) are evolving. Keeping a close eye on the developments of tax law is important to avoid misinterpretation or sometimes out-dated interpretation. Technical disputes may be caused by what may-seem-to-be unreasonable interpretations of tax law by the tax authorities. Negotiations and continuous dialogue with the tax authorities sometimes will lead to surprising results. Going to tribunals and courts should be the last resort as that is expensive and time-consuming. It is important to plan ahead on how far one is willing to take any dispute. Regardless of whether litigation is the ultimate option, planning ahead is always the best strategy to minimise the tax costs and any potential penalties.

Concluding remarks

While corporations look for ways to retain cash in the current economic slowdown, the trend of increasing transparency, development of anti-avoidance measures, and better information and audit tools available to the tax authorities could lead to significant challenges in the tax management arena. Planning ahead and continuously monitoring through effective reporting system, especially as your businesses evolve and change, could ease any uncertainties that may arise.