How Misaligned Intercompany Processes Affect Company Tax Operations

To the Editor:

When it comes to intercompany accounting — the management of financial transactions between separate legal entities that belong to the same corporate group — misaligned processes and muddled information negatively impact a multinational's tax operations and increase their tax bills.

Tax authorities' most effective way to generate tax revenue from intercompany transactions is by scrutinizing transfer pricing and extracting additional indirect taxes. For this reason, intercompany accounting has come under scrutiny by governments globally. Even though most work hard to toe the line, multinationals worry that they cannot defend their intercompany decision-making without meaningful improvements in their intercompany processes and reporting. According to a recent survey conducted by Dimensional Research, 43 percent of intercompany professionals said they were at risk of an SEC investigation. Forty-nine percent said that overdue or unsettled intercompany balances create uncertainty.

Multinational companies are under constant pressure from tax authorities to increase intercompany revenue or decrease intercompany costs for entities in their tax jurisdiction. When it comes to tax paid on intercompany transactions, tax authorities challenge the amount of profit earned by claiming the need for higher profit markups. Simultaneously, they challenge and deny the deductibility of other intercompany charges.

Although the intercompany charges themselves are a zero-sum game, increasingly, the tax costs are not, as the foreign tax authority in country A will often not agree to mirror an adjustment imposed by their colleagues in country B.

Intercompany revenue and charges require that intercompany agreements be established and backed by extensive documentation on the specific purpose of each type of transaction and related pricing. The more precise and granular intercompany charges are, and the more financial transparency can be provided with respect to the composition of underlying costs, the better chances a company will have in defending transfer pricing.

To better understand the need to improve intercompany accounting and transparency, consider recent developments in tax policy around the globe.

Drivers of Increased Intercompany Tax Scrutiny

After the 2008 financial crisis, when many large banks and companies needed to be shored up by governments, attention turned to the taxes paid by large corporations. Investigations were launched, problems were identified, and many of the new remedies that were implemented impacted intercompany financial management (IFM) and associated tax strategies:

- *Governments begin collaborating.* New anti-tax-haven rules were introduced at an unprecedented pace. It took less than six months for the Anti-Tax Avoidance Directive (ATAD 1 and 2) to be proposed and adopted by the EU. April 2015 saw the introduction of the 25 percent U.K. diverted profits tax. And in the United States, we saw the introduction of the anti-hybrid and base erosion and anti-abuse tax rules, along with the introduction of the global intangible low-taxed income rule. BEAT was introduced as part of the U.S. tax overhaul of 2017 to reduce the profits generated in the United States being claimed in lower-tax jurisdictions. BEAT specifically targets U.S. multinationals that make deductible payments — aka base erosion payments, such as interest, royalties, and certain service payments — to related foreign parties. It stands to reason that BEAT reporting requires granular transaction-level details, especially regarding the exact nature of the charge, and the profit markup.
- *Tax authorities begin making automation a requirement.* To combat fraud and innocent mistakes due to the complexity of tax regulation, more and more tax authorities, including those in developing countries, began paying greater attention to tax planning processes and demanding real-time reporting and e-compliance, especially for indirect taxes. Many have increasingly

begun implementing continuous transaction control as an efficient tool for closing the VAT gap.

- *Multinational organizations are expected to provide more tax transparency*. A recent study by the Institute on Taxation and Economic Policy found that at least 55 American corporate giants paid zero corporate income tax in 2020, despite raking in millions in profits. Many countries now expect to see what companies are paying in other parts of the world and as a percentage of total profits, and the public now has similar expectations. Reporting of cross-border arrangements is a requirement of the EU's DAC6. Multinationals based in OECD countries, including the United States, are now required to provide country-by-country reporting on their profits, headcount, and taxes paid. Further, large multinationals will soon be required to pay a minimum level of tax regardless of where they are headquartered or the jurisdictions in which they operate. The new global minimum tax of 15 percent was recently agreed upon.
- *International tax rules align with digitalization of the economy*. The allocation of taxing rights on business profits is no longer exclusively determined by reference to physical presence.

Crossing New Hurdles

With so much activity, it stands to reason that multinational corporations must be transparent about costs and be able to explain the benefit received in exchange for those costs. For that to be accomplished, intercompany processes and technologies must enable more granularity and transparency than before.

For example, multinationals are required to issue seller-side-compliant invoices for each and every intercompany (services) charge. The quantum of those invoices is largely governed by seller-side transfer pricing rules. In comparison, invoices issued to third-party customers often include descriptive language about what is sold, under what conditions, with warranty provisions and payment terms, which are typically not as relevant in an intercompany context.

Also, where enterprise resource planning (ERP) is used for tracking intercompany charges, the data structure may not enable necessary communication about details such as the cost composition and the intended purpose of an intercompany transaction. In that case, adding information into the body of the invoice tends to be a method of last resort — especially with respect to charges outside the main intercompany flows, like those related to services and indirect materials. When critical intercompany context is embedded inside the invoice, it is generally obfuscated by the reporting and analysis capabilities of an ERP.

For both compliance and operational efficiency, multinational finance teams must improve their automation game in other ways, too. In the old way of doing things, an accounting system or ERP collects transaction data in an invoice format before mailing or emailing it to the customer. Now, the ERP needs to be able to feed data directly to a tax authority for approval before the invoice is issued. For intercompany accounting, e-invoicing is complicated by the fact that one company is both the buyer and the seller. A new challenge created by this scenario is that intercompany teams are now forced to create and issue a legal invoice versus simply managing relevant intercompany transaction data within the organizations' own systems. This requires new accommodations for IFM systems, processes, and teams.

To complicate matters further, each country will operate differently, and their requirements will continue to evolve. A good example of this evolution can be found in the Revenue Agency of Italy's e-invoicing platform. Sistema di Interscambio already shares invoices between Italian entities. In 2022 it will become mandatory for all cross-border transactions to be reported via that system.

It is also worth noting that electronic documents are the tip of the iceberg as far as automated documents are concerned. Countries are exploring how electronic documents can be used in a more efficient way across the board, including import, export, and delivery documents. E-invoicing is fast becoming the new norm for tax policy globally, and intercompany transactions must keep pace.

And it's not just electronic versions of previously paper documents. In many ways, e-invoicing effectively entails pre-transaction tax reporting at a transactional level — as opposed to the traditional way of period-end, aggregated tax reporting — which is a fundamental shift in the way to think about invoicing.

Internal Struggles

According to experts, it is estimated that the trade inside multinational corporations accounts for 80 percent of world trade, yet IFM processes and automation grossly lag external transaction management. Multinational companies must rapidly modernize and coordinate their intercompany operations to ensure compliance and avoid the risk of unwelcome costs and penalties.

Consider the challenges that most intercompany teams currently face:

- staying abreast of the different specs and regulations in various jurisdictions;
- rationalizing how e-invoicing as part of customer invoicing through their ERP/accounting systems for the goods sold to customers (commercial sales) is matched with more complicated, specialized intercompany accounting that is being kept separately;
- grappling with the fact that invoicing for services is more complex than goods — for example, just setting transfer pricing for services "sold" or intellectual property "licensed" between entities within a multinational corporation does not have comparable or market-determined pricing;
- vying for IT systems and other resources typically allocated to commercial invoicing and transactions while intercompany efforts are considered lower priority; and
- keeping up with which countries pay more attention to intercompany transactions — for example, increasingly authorities' auditing teams include an intercompany specialist who looks at annual accounts between intercompany entities, investigations that could raise deeper questions about how intercompany accounting is handled.

Compounding these struggles are the divergent priorities within multinationals and the finance functions that have responsibilities related to IFM.

Each company and industry will have its own set of requirements when it comes to intercompany accounting, and the same is true for the requirements of each of the four finance team functions. The IFM requirements of a financial services company (financial regulatory pressure from central banks or insurance oversight bodies prioritizing local entity solvency) will be very different from those of a pharmaceutical company (impact of substantial centralized research and development with varying success rates) or a company operating in the aircraft industry (required meticulous traceability of origin and quality of all parts throughout the logistics chain), to name a few.

Needs of tax, financial planning and analysis (FP&A), controllership, and treasury clash with one another as well and cannot all be solved in the traditional setup of, and responsibility for, intercompany processes. What results is often a compromise between those requirements, with the outcome typically influenced by the relative strength and importance of each of the four functions.

The most obvious clashing drivers for IFMs are those between tax drivers on the one hand, and controllership and FP&A drivers on the other hand. Where tax departments have a need to require more granular and frequently updated intercompany charges in order to maximize tax deductibility, those very drivers fly in the face of fast and efficient closing processes for the controllers, and easy and consistent analysis and planning for FP&A.

A Need to Modernize Intercompany Processes

According to the Dimensional Research study, 38 percent of respondents said that the potential for tax penalties related to intercompany transactions negatively impacted their overall business outcomes and 43 percent said missed intercompany tax deduction opportunities did the same.

To reduce risk, lower the financial impact of noncompliance, and improve productivity, tax teams themselves need to evolve. They need to be included in the corporate decision-making process. They must meet rising regulatory demands for data consistency, transparency, and accuracy by shifting their focus from complex financing structures to operating processes.

Fifty-five percent of the respondents to the survey agreed that automating cost and tax allocations for intercompany accounting was the technology capability most needed by their companies. It is only with these advancements that companies can stay on top of intercompany agreements, automate tax processes, provide real-time reporting, manage e-compliance, and quickly adapt to new developments brought about by the digitalization of the economy. Only then can they prevent intercompany processes and information (or a lack thereof) from having a negative effect on their tax operations — whilst simultaneously not creating issues for the other three finance functions.

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Filing While Black: How Our Racially Biased Tax System Hurts All of Us

To the Editor:

Driving While Black — Blacks being stopped by authorities disproportionately, all too often with disastrous results — affects both the modest and the mighty (Sen. Tim Scott, R-S.C., reported being stopped seven times in a single year). Filing While Black — Black Americans targeted by racially biased tax enforcement — has the same devastating impact.[1] Unlike Driving While Black, racial profiling that makes Filing While Black risky for so many Americans will rarely be caught on camera.

But it has been.[2] However tragic, in many ways the death of Eric Garner on a Staten Island sidewalk initially appeared unremarkable.[3] Garner died in police custody, but official reports mentioned nothing about the illegal choke hold that caused his death.[4] A bystander's cell phone video of the incident would ultimately go viral, offering the world an indelible image of the dangers Black Americans face in all aspects of their public and private lives. It also highlighted the risks of Filing While Black.

Garner was suspected of committing a crime. But not just any crime. Police had arrested Garner before — in the very location he died — for evading taxes.[5] Cigarette taxes, like taxes on pollution and plastic bags, aim to discourage harmful activities (or at least to compel smokers and polluters to bear the costs associated with their behavior). In New York, selling individual, untaxed cigarettes is against the law. Garner died because officers believed Garner did precisely that.

Garner's death, caught on camera, has profoundly affected how the nation talks about law enforcement. Recent backlash — including Biden's

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[1] Steven A. Dean, "Filing While Black: The Casual Racism of the Tax Law," *Utah L. Rev.* (forthcoming 2022).

[2] *See* Al Baker, J. David Goodman, and Benjamin Mueller, "Beyond the Chokehold: The Path to Eric Garner's Death," *The New York Times*, June 13, 2015.

[3] *See id.* ("In the hours after Mr. Garner died, an initial five-page internal report prepared for senior police commanders, known as a 49, did not refer to contact with his neck.").

[4] *See id.* ("The chokehold . . . was found to be a cause of Mr. Garner's death, along with the compression of his chest by officers who helped to handcuff him.").

[5] *See id.* (noting that Eric Garner had been "arrested twice already that year near the same spot, in March and May, charged both times with circumventing state tax law").