FOCUS

Developing economies

Opportunities, risks and tax

The growth paradox

Controversy trends

Kim Jacinto-Henares
Commissioner of Internal Revenue at the Bureau of Internal Revenue of the Philippines

EY
Building a better working world
Unlocking developing economies’ DNA

Although developing countries are often grouped together, each country has its own distinct business DNA. Businesses that want to thrive in developing markets need to understand and address both the substantial growth opportunities as well as the risks for each market.
Developing economies

A developing story

Developing countries have long been synonymous with opportunity. With time has come a more nuanced appreciation of the opportunities that developing countries represent. While some are slowing down, others — such as Vietnam and Indonesia, as well as some Latin American and many of the countries of Sub-Saharan Africa — are speeding up. The fortunes of individual countries will continue to change, but as a group, today and for the foreseeable future, developing countries are an important component of the world economy.

Population figures that promise both a huge consumer base and a deep reservoir of talent; a rate of growth that currently outstrips that of many more developed economies; and infrastructure needs that range from IT to health-care systems to mass transport are just some of the opportunities. Yet developing countries also pose significant risks that businesses need to consider. The same lack of infrastructure which presents opportunities for multinational companies also demonstrates the obstacles that can exist for those investing in these economies. Issues associated with overregulation, as well as the uncertain application of these regulations and the need to deal with corruption in some developing economies present additional challenges.

These opportunities include population estimates that project a huge consumer base and deep reservoir of talent; a rate of growth that currently outstrips that of many more developed economies; and infrastructure needs that range from IT to health-care systems to mass transport.

Along with these broader business and regulatory risks, the tax environment is another of the risks facing those choosing to operate in developing economies. For example, tax systems differ widely from one developing country to another and between regions within a single country, complicating compliance. Rapid growth means that developing countries are under pressure to raise revenues. That has led to a proliferation of new tax laws and to tougher enforcement.

In most developing countries, but especially where tax regimes are less sophisticated, inconsistent interpretation of tax policy and a lack of resources in tax administrations increase uncertainty and unpredictability. Similarly, different rules for cross-border transactions, or limited knowledge of existing rules, increase the risk of double taxation and mean that compliance can become more burdensome, time consuming and costly. Nonetheless, tax issues should not be the primary driver of business decisions. Companies need to start from a point of understanding that they cannot go everywhere all at once. Instead, they should select the most suitable markets for their industry and then optimize their choice in terms of the most relevant factors for them — whether that is consumer base, skilled labor force or investment incentives — weighed against the tax risks (present and future) and costs of compliance. Understanding how to manage some of the unique issues associated with developing economies in the context of their global organizations, policies and procedures is also vital.

Once a company has decided to enter or expand their presence in a developing market a number of important questions need to be addressed. How much time and resource is the company able to devote to tax matters in developing countries where the risk of tax controversy may be high, and will the expansion into new markets change this position? Is the appropriate governance structure in place, and will existing control mechanisms and policies be sufficient given the change in business environment? Will the existing balance between centralized and decentralized responsibilities of risk management and control be adequate given the change in circumstances?

Our goal in discussing some of these factors in this issue of Tax Insights is to help you to make more informed decisions based on a careful analysis of risks and benefits that developing economies can present.

Stephan Kuhn
Tax Insights Editor-in-Chief
Opportunities – doing business in developing countries

The growth spurt in developing countries in the last decade has been dramatic. In Asia alone, the middle class currently numbers 525 million people, greater than the total population of the European Union. Over the long term, the increase in spending power of the growing middle class has the potential to make a significant contribution to global economic growth and offer opportunities for companies that serve them with relevant products and services.

Population 2013

<table>
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<th>Region</th>
<th>Population 2013</th>
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<td>EU</td>
<td>506.7m</td>
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<td>China</td>
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<td>India</td>
<td>1.3b</td>
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<tr>
<td>Africa</td>
<td>1.1b</td>
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<tr>
<td>US</td>
<td>316.1m</td>
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<tr>
<td>Brazil</td>
<td>200.4m</td>
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</tbody>
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Middle class by 2030

80% of world’s middle class will reside in developing countries ...

and account for 70% of total consumption expenditure

Development of world population 2009–50

- Americas: 26.5% in 2009, 26.5% in 2050
- Europe: -5.6% in 2009, -5.6% in 2050
- Africa: 97.9% in 2009, 97.9% in 2050
- Asia/Oceania: 26.9% in 2009, 26.9% in 2050

Sources: World Bank, UN
“Regaining momentum in our economic growth is the key for the current generation of Chilean adults to reach income levels similar to developed economies.”

Felipe Larrain
Former Minister of Finance, Chile
“It’s a crucial time for tax policy in developing countries.”

Richard Stern
Lead Tax Officer at the World Bank Group
Challenges – doing business in developing countries

How do large multinationals move forward to exploit the new opportunities arising in developing countries while mitigating the risks involved? The World Economic Forum’s Executive Opinion Survey asked 14,000 business executives in 148 economies to rank what they perceive to be the most problematic factors affecting business in their country.

Evaluating business obstacles

Many factors are relevant when assessing the perceived risks of operating in a developing economy. In the above graphic, the closer a point is situated to the center, the greater are the challenges perceived in that particular area. The executives surveyed by the World Economic Forum, for example, expressed more concern about access to financing than about an inadequately educated workforce or tax rates in China. In Brazil, labor regulations, infrastructure, and tax rates topped business leaders’ concerns. Executives were more concerned about the lack of infrastructure than tax rates or restrictive labor regulations in Nigeria. The biggest issues in India included access to financing and tax rates, while in Russia executives were least concerned by policy instability. Corruption was perceived as relatively problematic in three of the five jurisdictions according to the survey.
FOCUS

Developing economies

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The EY Emerging Markets Center is our organization-wide Center of Excellence connecting you to the world’s fastest-growing economies. It is part of EY’s Global Economic Programs team that produces predictive and analytical insights to help companies and governments make economically sound strategy and policy decisions.

Emerging Markets Committee
The Center supports the EY Emerging Markets Committee, which comprises senior managing partners from emerging economies across the globe. Its purpose is to expand expertise and talent in the emerging markets and empower our local teams who work closely with clients and those with an interest to expand into these markets. In Tax Insights, Rajiv Memani, Chairman of the Emerging Markets Committee, talks about the risks and opportunities of doing business in developing countries.

emergingmarkets.ey.com

Rapid-growth markets attractiveness surveys
EY’s attractiveness surveys examine the attractiveness of a particular region or country as an investment destination. The surveys are designed to help businesses make investment decisions and governments to remove barriers to future growth.

Coming soon:
- EY’s 2015 Africa Attractiveness Survey
- EY’s 2015 India Attractiveness Survey

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EMEIA Tax Leader
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In the spotlight
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Developing economies

By Jim Hunter

Developing countries are defined by their potential for growth. Although that potential has been obvious for several decades, the resilience shown by these economies in recent years has given it new impetus. Moreover, yesterday’s frontier markets are closing ranks with maturing markets like India and China, making way for the next tier of developing economies.

Investing in a developing country provides an opportunity to both improve the economy and expand growth. According to the United Nations (UN), foreign direct investment (FDI) flows to developing countries reached a new high of US$759 billion in 2013, topping that of developed countries. While companies entering these markets face clear challenges, those that have taken the plunge include consumer firms, carmakers, banks, telecoms and supermarkets.

This transformation is being driven by factors that include social reforms, the advancement of online and mobile technologies, and demographics. The developing world contains not only most of the globe’s population, but also the majority of its youth. Although the developing world is still trying to stem its brain drain, countries like India, where 65% of the population is 35 or younger, should nevertheless provide a critical source of talent as the economy climbs the value chain. A growing middle class is another key trend in these countries. By 2030, the UN projects that 80% of the world’s middle class – 3.9 billion people – will reside in today’s developing countries and account for 70% of total consumer spending.

The change in consumption patterns is most dramatic in China. But by 2022, Brazil, Russia, Mexico, Turkey and India will each have more than 10 million households earning the equivalent of US$35,000 per year. This growth, and the increasing urbanization that goes with it, will fuel higher demand for health and education services; communications, culture and recreation; and infrastructure such as green technologies and public transport.

Naturally, that spells opportunity for businesses worldwide.

No one-size-fits-all

It is hard to overstate the breadth and diversity of developing countries. Brazil and Russia, once ascendant, are now stumbling. China and India still dominate. In fact, China is clearly transitioning from a manufacturing-based economy to a services-based one. As it does so, wages for Chinese workers are rising. That is helping to grow the middle class, but it is also chasing low-cost manufacturing out of the country. As businesses seek alternatives, two separate developing country regions are ready to step into the gap: the economic communities of Southeast Asia and Africa.

The Association of Southeast Asian Nations (ASEAN) comprises 10 developed and emerging countries whose combined population of 600 million has long captured the imagination of investors. Vietnam, for example, is becoming a manufacturing hub for everything from textiles to electronics. Indonesia has a population nearly the size of the US and is the largest producer of crude palm oil. Myanmar, strategically located between China and India, is now emerging from years of economic isolation. It has arable land, oil and gas, precious stones, a cheap and young workforce and a government supportive of a market economy.

Africa represents a different but equally fascinating proposition. Nigeria, one of three regional hubs along with Kenya and South Africa, attracts a significant amount of investment owing to its large population and oil reserves. Ghana is smaller but stable, democratic and has abundant natural resources. Rwanda, although geographically small, is ranked among the highest in the region in the World Bank’s ease of doing business index.

EY’s latest Attractiveness Survey reveals that the African continent is now the second most desirable regional investment destination in the world, tied with Asia. Sixty percent of survey respondents with a presence in Africa believe that the continent’s attractiveness improved in 2013. Africa’s resources continue to draw FDI (primarily from the EU and the US), but so do its agriculture and infrastructure.

Increasingly, capturing opportunities in developing countries means tracking the flow of investment to, from and between them. For many years, FDI flowed primarily from developed to developing countries. In 2013, for the first time, FDI between developing countries actually surpassed trade from developed to developing countries, accounting for a quarter of total world exports. China’s exports to other developing countries represent 20% of trade between developing countries, but Vietnam, India, Turkey, Chile and other countries also play a significant role.

Multinational enterprises headquartered in developing economies are becoming increasingly important to global trade. In 2014, the Fortune Global 500 list included 95 companies based in China, up from just 73 in 2012. As these companies expand into established markets like Europe and the US, they are fundamentally altering the nature of global commerce.

Getting down to business

The dynamism of developing economies is remarkable. India went from having fewer than 6 million mobile phones (in a country of 1 billion people) in 2000 to more than 962 million of them by October 2014. Kenya pioneered mobile money: cashless transactions between mobile phone subscribers that can be used to pay for goods and services or transfer funds. The value of these transactions now exceeds 40% of the country’s gross domestic product. In Bogotá, Colombia, a low-cost bus rapid transit system that shuttles two million passengers a day became a worldwide model.

Nonetheless, doing business in developing countries is very different from what many companies are accustomed to. One of the downsides of rapid industrialization and growth in China has been air pollution, which not only has public health implications, but also disrupts transportation and some industries as well. In Pune, India, a fast-growing IT and pharmaceutical hub, there is not enough electricity to meet demands, resulting in supply restrictions. Africa’s infrastructure is still so underdeveloped that it is a major challenge to move goods and people to where they are needed.

And despite its appeal, ease of business varies across ASEAN, making it hard for its member states to attract the FDI they need to expand their economies. Consequently, ASEAN has been working toward a single market to bring about a better flow of goods, services, finance and people since 2007. The initial plan
was to achieve an integrated economic region by 2015. But progress has been slow, hampered by language issues, pre-entry requirements and differences in laws and regulations.

One fact that should not be overlooked is the critical role that governments play in building a stable society. While contributing to growth, they also put in place the structures that ensure a predictable planning environment for companies and in turn a better return on investment. Structural reforms achieved following Mexico’s presidential election in 2012 (11 in the first 20 months of the new administration) show how a government can instill confidence. Similar postelection reforms are playing out in India as well.

The tax landscape
Across the developing world, taxation represents a hodge-podge of measures aimed at compliance, expanding the tax base, reorienting business incentives and various degrees of reform. Countries are shifting away from so-called “tax holidays” toward incentivizing certain types of industries, geographies and investments, such as research and development into green technology. Take China, for example, where the east coast is densely populated. The government’s 2000 “go west” strategy is aimed at encouraging investment in hinterland regions such as Sichuan.

Respondents to EY’s 2014 Tax Risk and Controversy Survey identified China, India and Brazil (in that order) as the three emerging markets that pose the highest risks related to tax. Respondents also felt that emerging markets pose more tax risk today than they did two years ago. They include reputational, legislative and enforcement risk, in particular transfer pricing, indirect tax and permanent establishment risk.

One such challenge is posed by local business culture, where fraud policies do not meet the standards of global compliance frameworks. This issue has had a high profile in Asia, but not exclusively. Tax authorities are also perceived to be more aggressive in many developing countries, a perception reinforced by a number of high-profile tax disputes in India, China and elsewhere. Finally, rapid growth entails considerable policy, legislative and regulatory change as developing countries try to strengthen their tax systems. However, government ability to implement needed policy changes is often outpaced by business expansion needs. While companies seek to know what the tax regulations are and what is appropriate in terms of the law and tax planning, agility and perseverance is necessary as frameworks shift in developing countries.

Perhaps adding to the uncertainty at present in the developing world is the Organisation for Economic Co-operation and Development (OECD) Action Plan on Base Erosion and Profit Shifting (BEPS), arguably the most important current development in international taxation. Key issues across all governments include addressing cross-border frictions such as transfer pricing – especially with regard to the expanding digital economy – and enhancing transparency. Because developing countries figure so largely as a focus of present and future growth, they need to be fully involved in the discussions on reforming the international tax system, particularly the BEPS project. The G20 group of major economies last year questioned whether developing countries weren’t being left behind in the deliberations. As a result, the OECD released its Strategy for Deepening Developing Country Engagement in the BEPS Project. As this plays out, it is also clear that indirect taxes (GST, VAT) will continue to play an increasingly important role in broadening the tax base, which is particularly true in developing economies as they move toward consumer-based markets.

Lessons learned
Companies that only “dip their toes” into a developing market or simply seek to apply a nuanced appreciation that was learned elsewhere are likely to fail both from a business and tax perspective. Examples of both successes and failures are readily available.

One key consideration is choosing the right target. In a continent as diverse as Africa, where to start is a strategic decision based on the sector of interest, be it raw materials like oil and gas, or new consumers, among other factors. Being increasingly transparent with authorities and potentially local market partners is also likely to be strategically important.

Carefully addressing the impact of new operations in developing economies on existing risk management structures, controls and policies is important. New risks may present as a result, including reputational risks. The current balance between central and local management of risks may no longer be suitable.

Capitalizing on the rapidly growing middle class in developing countries will require new capabilities too. EY’s 2012 survey, Innovating for the Next Three Billion, found that getting close to customers and understanding the problem that needs to be solved is crucial. Generally, businesses cannot simply take products from the developed world and hope to sell them in the developing world.

Today, companies need to think globally and locally at the same time. They will have to engage deeply in local markets to see how innovations can be applied. Learning how to do business, putting in place the local and extended partnerships needed to build and maintain an enterprise, and engaging with the tax and regulatory landscape takes perseverance as well as passion.

Place your bets
Opportunities and tax
Developing markets are no longer simply reshaping the world economy. They are now part of its core. This rapid evolution not only offers opportunities for companies operating in developing markets, but also entails a variety of risks, notably with regard to tax.
“In emerging markets there is more volatility than in the US or Europe, but there are signs of improvement.”

Ian Brimicombe
Head of Tax at AstraZeneca

Stability and change
Discussions about developing economies run the risk of excessive generalization. The state of development and the key to business success can be quite distinct in each one. Within larger countries, even regional differences are substantial. As Rajiv Memani, EY’s Chairman of the Global Emerging Markets Committee, puts it, “You cannot look at an entire basket of emerging markets collectively. You need to look at the individual country.” Nevertheless, they have some key elements in common.

First, there are far more potential consumers in developing markets than in wealthier countries. According to the United Nations’ population statistics, 1.26 billion people live in developed countries, roughly 17% of the world population. That is less than China alone and not far ahead of India.

Average incomes in developing economies may still be low, but EY estimates that three billion people will move from poverty into the middle class between 2009 and 2030, the vast majority in the developing world.

Some companies are already feeling the impact. Blythe notes that emerging markets “really are a market force that is coming to maturity.”

But a variety of challenges remain. Perhaps the most obvious relate to the differences between and within these developing markets. Each needs a tailored strategy, something that Memani says “a lot of even global companies still struggle to do.”

Governance is another perennial issue. One element is state capacity: countries with fewer economic resources have less to devote to the tasks of government.

Another issue is policy predictability. Again, this varies widely by country, but it can also be a substantial regional problem. Andres Valle, EY Region Tax Managing Partner in Latin America, notes that in that part of the world, “You can see countries making changes in fiscal policy every four years depending on the new president.”

Memani senses that even though sharp policy shifts are still occurring, predictability is on the rise. Ian Brimicombe, Head of Tax at AstraZeneca, agrees. In emerging markets, he still sees “more volatility than in the US or Europe, but there are signs of improvement.”

Finally, the rule of law remains a substantial governance challenge. For example, a brief glance at a global map showing the results of Transparency International’s latest Corruption Perceptions Index shows the continuing perceived divide between developing and developed markets. Intellectual property is also harder to defend in developing countries than in developed ones. A longer-term issue for those operating in developing economies is finding the right talent. Although not an issue unique to developing economies, a recent EY survey found that it is widespread even in those developing countries with large populations and good school systems.

Memani says, “Talent is an issue because these emerging markets have developed pretty rapidly in the last 10 to 15 years. Opportunities have outrun the talent.” The specific issues vary. In China, firms are looking for more locally trained managers, while engineers are in short supply in Brazil.

Although many of the issues surrounding developing economies have been present for years, another apparent macroeconomic shift in the world economy has more recently affected corporate risk-reward calculations.

Developing economies nearing maturity are seeing their rapid GDP growth of the >
Developing economies

Sources: CIA, Worldbank, WTO, WEF, Nigeria National Bureau of Statistics, Transparency International

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<tr>
<th>Area</th>
<th>Population</th>
<th>Population density</th>
<th>Gross domestic product</th>
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<td>Balance of trade (surplus)</td>
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<td>Unemployment rate</td>
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Capital city: Abuja

Main languages: English is the official language. Other languages include Hausa, Yoruba, Igbo and Fulani.


Corporate income tax
Companies incorporated in Nigeria are taxed on their profits worldwide, but nonresident firms are only subject to tax on the profits of their Nigerian operations. There is an initial three-year tax holiday for companies involved in gas utilization downstream operations, as well as for those using gas for industrial projects. This break can be extended for another two years.

Indirect taxes
Nigeria has a 5% value-added tax (VAT) on certain goods and services, including imported products and professional services.

Other taxes
There is a general, 10% withholding tax on dividends for residents of Nigeria, along with recipients in non-treaty countries. But dividends distributed from the profits of companies with so-called pioneer status (deemed vital to Nigeria’s economy) along with after-tax profit from petroleum are not subject to the tax.

Administration
Nigeria ranked 179 in the area of paying taxes in the World Bank’s Doing Business 2015 report. It takes companies 908 hours, on average, each year to prepare, file and pay their taxes in Nigeria.

Infrastructure
Nigeria has an infrastructure network of airports, highways and ports that covers much of the nation. The country’s infrastructure received a rating of 134 out of 144 countries in the World Economic Forum’s Global Competitiveness Report 2014–2015. Nigeria scored higher in terms of the availability of the latest technologies.

Education
Half of women and nearly three-quarters of men in Nigeria are literate. Some 44% of eligible people attend secondary school. In 2013, two major projects were launched to improve the quality of education and provide young people with better skills and training in Nigeria.

Legal system
Nigeria’s current constitution was adopted on 5 May 1999. The country’s legal system is based on common law and traditional law, along with Islamic law in its northern region. Its president heads the country’s executive branch. The Senate and the House of Representatives make up the legislative branch, while the Supreme Court is the highest court in the country.

International organization membership
African, Caribbean and Pacific Group of States (ACP), G-15, African Development Bank (AfDB), United Nations (UN), World Intellectual Property Organization (WIPO), World Trade Organization (WTO)

Transparency International’s Corruption Perceptions Index: 27 out of 100 (100 is very clean)

For more information:
Worldwide Corporate Tax Guide 2015
Developing economies

recent past slow. The Economist Intelligence Unit (EIU) forecasts that India’s and China’s GDP will rise by around 6% per year over the next five years.

For countries that are more reliant on commodities, price declines in recent months have put even more pressure on growth.

This is not a signal to abandon commodity-based developing markets. Some, like Brazil, have “strong companies, diversified offers in terms of commodities and different kinds of manufacturing companies,” notes Valle. “When commodity prices go back up they will be better equipped in the international market.” It is, however, a reminder of the typically higher volatility of these markets.

Evolving tax risks
Tax complexity has always been an issue for companies operating in developing economies. Differences can be stark across countries. “Latin American countries,” Valle says, “don’t have similar tax systems. Some have complicated systems with a strong focus on indirect taxes; others are based on income tax.” Then there is Brazil where 60% of the price of a typical consumer product is made up of over 50 different indirect taxes.

Complexities frequently go beyond the national level, especially in larger states with regional governance structures such as Brazil, China and India, where tax requirements are enacted by sub-national jurisdictions. Brimicombe adds that the expectations and operating procedures of these different authorities are important to understand as they “will not be the same as in the US or Europe.”

Such understanding has become essential as tax risk in many developing economies grows. Some 78% of executives working for companies with annual revenues over US$5 billion that are headquartered in developed countries said in 2014 that operating in developing economies significantly increases their level of tax and controversy risk. In 2007, that figure was just 3%. These executives identified Brazil, China and India as the countries with the most potential for tax controversy risk.

This increased risk has parallels in developed economies, and the leading drivers are similar worldwide. The first is constrained budgets. Most developing economies are in a phase of fiscal consolidation, dealing with deficits and facing tremendous pressure to raise revenue.

Many developing governments are spending in order to ensure that the benefits of growth are more widely spread. This includes substantial infrastructure investment and what the World Bank calls “an exponential growth in social safety nets, especially cash-based programs.”

Whatever the causes, budget deficits are common. The Finance Ministry of the PRC published data showing the 2014 budget deficit was 1.78% of GDP. Meanwhile, the EIU has estimated that the deficit of Brazil for the same period will be 6.3%. Valle says, “We have social demands in most, if not all, South American countries in terms of education, health care, security and infrastructure. It is very clear that governments need more resources.” The decline of commodity prices will only aggravate the situation.

Enforcement
Predictably, tax enforcement officials in these jurisdictions have increased their activities. Brimicombe says, “No question that there is increasing tension and that there will be higher degrees of scrutiny.” He adds, however, that this trend is not unique to emerging markets.

Matthew Andrew, EY’s Asia-Pacific Operational Model Effectiveness (OME) Leader, adds that in Asia, “Across all taxes and in many jurisdictions there is greater uncertainty from a more unilateral, robust approach.”

India in particular has developed a reputation for a tough approach to tax collection in recent years, with the government even using retrospective legislation when it did not win court cases. Help may be at hand: concern about foreign investment recently led Indian Finance Minister Arun Jaitley to announce a less robust enforcement approach, but it takes time for such changes to become established.

Sometimes, fluctuating views on how tax should be determined accompany a tough stance on tax collection. Brimicombe explains that authorities in some jurisdictions “will be more at liberty to change the rules than those in more developed markets.”

Making matters worse, the appeal process in many developing countries is weak or absent, Blythe adds. The exception is India, which has strong courts.
Aside from governance issues, authorities in developing markets often have different perspectives about where profits are earned – an issue of increasing relevance as the Organisation for Economic Co-operation and Development (OECD) proceeds with its Base Erosion and Profit Shifting (BEPS) agenda. Brimicombe explains, “Emerging markets have a different perspective. They often argue that if labor is cheap in a jurisdiction, then that jurisdiction should be rewarded for the lower location cost with a higher profit allocation. You will have to work through these tensions with local governments.”

Nor is the BEPS process likely to bring consistency across these markets in the near term. In Latin America, notes Valle, “most countries are welcoming BEPS.” In contrast, most Asian jurisdictions have not commented, Andrew says, creating “a lot of uncertainty” about future implementation.

Finally, administrative weakness can still be an issue. Brimicombe says that tax administrations in some developing economies may need to understand a given supply chain model. “There is an obligation to help them build their understanding,” he says. This problem is, however, diminishing.

Improved capacity by the authorities can be a mixed blessing for companies. Valle says that in Latin America, improved technology and data-gathering requirements for companies is empowering tax officials to be more determined than in the past.

Dealing with the tax risks
Three clear elements should be part of any strategy to deal with the evolving tax risk environment in developing economies.

1. Understand relevant local conditions in depth: Successful companies rarely have a single developing economies strategy but instead adopt a collection of tailored strategies shaped by national and local conditions. Tax is no exception. Ultimately, there is no substitute for learning about the local tax conditions of where a company operates. Brimicombe notes that AstraZeneca sent senior tax colleagues to China “to meet and network with local business personnel and advisors in order to understand how to establish AstraZeneca as a good corporate tax citizen and get an understanding of the practical application of the law. I would advocate getting a real understanding in emerging markets and, if possible, to engage with tax authorities.” This takes effort, he adds, but allows the in-house tax team to give better advice to the company on how to plan local business opportunities and mitigate tax risk.

2. Work with local officials to create as much certainty as possible: Even as tax authorities in these markets are frequently becoming more robust, they are also often increasingly willing to engage with companies. The results can be formal agreement on potentially contentious matters such as transfer pricing. Having an ongoing dialogue with local tax officials is generally beneficial. Brimicombe notes that dialogue can provide an “understanding of their expectations and an opportunity for them to understand your business and tax approach so you don’t get any surprises down the road.” Blythe agrees, saying, “If you are going to invest millions of dollars, go to the government up front. Set the parameters that will allow you to make a profit and allow them to achieve the social development they are looking for. Be transparent.”

3. Integrate tax and business policy: As in the rest of the world, tax planning divorced from business reality will not succeed in emerging markets. Andrew explains that “the days of tax-driven structures are long gone. On the other hand, Blythe says, “tax shouldn’t drive business decisions; good business decisions should consider tax.” This involves more than risk mitigation and includes legitimate ways to lower tax costs in many developing economies.

Keeping the risks in perspective
Blythe’s last point is important to remember amid the increase in tax risk in developing economies. Although rates vary widely by jurisdiction and exceptions are numerous, Blythe finds “generally tax rates are attractive” in developing economies. Accessing these low tax rates may take work but, as Brimicombe notes, “emerging markets are alive to the fact they can offer tax incentives.” Companies that bring investment, and especially employment, are welcome in many jurisdictions and special R&D and manufacturing zones are common. “There are some basic tax arrangements that you can enter into, with the full sanction of government that may align with your business,” he adds. As developing economies continue to mature, tax will be more challenging, but if well managed it need not be more expensive.
Developing economies

Developing trends in merchandise trade

World merchandise exports have more than tripled over the last two decades, with a quarter of that trade comprising exports among developing countries. By 2020, three developing countries — Brazil, China and India — are predicted by the World Trade Organization (WTO) to account for more world output than Canada, France, Germany, Italy, the UK and the US combined. By 2025, developing economies are likely to account for 600 million households with incomes of over US$20,000 and an overall annual consumption of US$30 trillion. With such prospects, developing economies clearly represent markets with major growth opportunities.
Developing economies

**Developing economies’ exports**

Developing economies sent 52% of their total merchandise exports to other developing economies in 2013.

Source: WTO

**World trade distribution**

As of 2013, the value between developing economies trade had reached US$5 trillion, an amount close to that of trade between developed economies.

Source: UN

**Exports/Imports**

Exports from developed economies grew more slowly than the world average at 1.5%, while shipments from developing countries grew faster than average at 3.3%. On the import side, developed economies recorded a small decline of –0.2%, while developing economies and Commonwealth of Independent States increased by 4.4%.


**Exports from developing countries, 2013**

<table>
<thead>
<tr>
<th>Country of destination</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>South Africa</td>
<td>1%</td>
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<tr>
<td>Russia</td>
<td>1%</td>
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<tr>
<td>Brazil</td>
<td>2%</td>
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<tr>
<td>Least developed countries</td>
<td>2%</td>
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<tr>
<td>India</td>
<td>4%</td>
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<tr>
<td>China</td>
<td>10%</td>
</tr>
<tr>
<td>Others</td>
<td>32%</td>
</tr>
</tbody>
</table>

**Merchandise exports from developing countries, 2013**

- 2% To Commonwealth of Independent States
- 3% To unspecified destinations
- 43% To developed economies
- 52% To developing economies

**Imports**

- Asia: 4.6%
- South and Central America: 0.7%
- Africa: -3.4%

**Exports**

- Asia: 4.4%
- South and Central America: 2.5%
- Africa: 4.0%

2013 compared to 2012

**Developing economies**
Indirect taxes, but a direct business impact

They may not get as much media coverage as corporation tax and personal income tax, or generate as much political controversy, yet indirect taxes are an important source of revenue for developing economies and one of the biggest tax-related headaches for companies.

by Nick Huber

Indirect taxes include customs duties, excise taxes and taxes on consumption, such as value-added tax (VAT) and goods and services tax (GST). Managing these taxes – to reduce costs and avoid errors that lead to penalties and business disruption – is crucial to maintaining profitability.

This is especially true for businesses operating in developing economies, where keeping pace with rapid business developments, changing supply chains and unfamiliar and dynamic local laws creates complexity and risk that need to be appropriately managed.

Companies that successfully manage indirect tax systems in more developed markets can find themselves in unfamiliar territory in these developing economies. That unfamiliarity can lead to expensive mistakes that can have a significant impact on profitability.

The following key indirect tax trends identified in developing economies will therefore test companies’ tax departments in 2015 and beyond.

An increasingly important role

“Some governments in Asia earn a staggering amount of their total tax revenue from indirect tax,” says Robert Smith, Leader of EY’s Indirect Tax Practice for Asia-Pacific.

China, he says, gets about 60% of its total revenues from indirect taxes – about twice the average rate of countries that are members of the Organization for Economic Co-Operation and Development.

Indirect taxes represent an important revenue source for the jurisdictions already applying them, and more comprehensive indirect taxes have become prevalent in a growing number of jurisdictions. The spread in VAT/GST regimes is an example.

According to the OECD’s “Consumption Tax Trends 2014,” 164 countries levied a VAT as of 1 January 2014: 46 in Africa, 1 in North America, 18 in Central America and the Caribbean, 12 in South America, 28 in Asia, 51 in Europe and 8 in Oceania. The list has already expanded further this year. On 1 January 2015, VAT was introduced in the Bahamas. Egypt, Puerto Rico and Suriname are expected to follow suit.

The Indian government has been working on replacing the current indirect tax regime with a comprehensive GST.

India has one of the most complicated indirect tax systems. Its federal government, for example, charges three rates of customs duty on imported goods, says Harishanker Subramaniam, National Leader, Indirect Taxes at EY in India.

State governments also charge VAT on the sale of goods. Dealing with different tax authorities in the same country can increase a company’s tax costs.

The main aim of the GST is to modernize India’s indirect tax system. The GST would reduce the amount of tax cascading (taxes applied at different stages of the supply chain that accumulate) for businesses.

Subramaniam believes it could “significantly improve the competitiveness of the Indian industry products and services.”

Malaysia introduced a consumption tax on 1 April 2015, replacing its previous sales tax (10% on certain goods manufactured in Malaysia or imported...
into Malaysia) and service tax (6% on prescribed services only). The GST will help the government broaden its tax base and aims to make the tax system more efficient. “The GST will supersede the deficiencies of the current sales tax and service tax, for example, the inefficient reliefs provided via specific limited exemptions and administrative challenges,” says Bernard Yap of EY in Malaysia, who specializes in indirect tax and financial services.

Details of the GST took a long time to be finalized, which has made it hard to prepare for. “Businesses have to prepare in an atmosphere of uncertainty. Those that didn’t are now making last-minute changes,” Yap says.

VAT regimes are also being expanded by some jurisdictions. China is expanding its VAT pilot and introducing VAT for a range of industry sectors such as financial services, real estate, hospitality and restaurants in the next 12 to 18 months. “In China, some industries are only being given three to six months, which makes it extremely difficult to prepare,” Smith says.

Despite the implementation horizon of changes sometimes being short, it is essential that the task of preparing a multinational for a new, or expanded, indirect tax system is not underestimated. The amount of change and complexity involved in moving to a VAT accounting system for the first time means that the introduction of VAT is not just a tax change. It’s a significant business transformation affecting the whole company and its supply chain. Reduced taxation may be offset by increased compliance costs and increased investment needs for recruitment, staff training and upgrades to IT systems.

Changes to indirect taxes need to be successfully implemented from the first day of operation, given they are often applied on each transaction, and reporting obligations tend to have a shorter horizon than corporate taxes.

“How do you get VAT liability right on each transaction?” asks Chris Needham, Global VAT/GST Director at General Electric, a conglomerate whose services range from aircraft engines and power generation to consumer financing. In his personal view, “...it’s not as simple as putting VAT on each transaction. Who’s the supplier? What’s the product category?

There are different VAT rules for different goods and services.”

Rising risks
Companies are spending more time than ever managing tax risk and controversy, according to EY’s 2014 Tax Risk and Controversy Survey. Despite the importance of indirect tax, many companies’ finance and tax leaders are confused about where the responsibility lies, the survey of 830 tax and finance executives in 25 jurisdictions also found.

Seventy-one percent of respondents from the finance or accounting department said their department managed indirect taxes, but 65% of people in a tax role said the tax department was in charge. “The more our clients go global, the harder it is to manage indirect tax because there are so many different global rules,” says Sergio Fontenelle, Leader of EY’s Indirect Tax Practice in Brazil.

Brazil’s VAT system is very different from those of other countries, which can have implications for exported goods and services, he says.

“Any company exporting from Brazil will have excess credit indefinitely. And that money will become a cost because the company won’t get it back from the government. When European and especially US companies come to Brazil, they simply can’t understand why their money will not be refunded by the government.”

Brazil’s rapidly changing tax laws are another challenge.

“Companies in Brazil [often have to] hire lots of people in tax departments,” Fontenelle says. “In Brazil, corporate tax departments can be significantly larger than those in other countries.”

Tougher enforcement
Tax audits are changing. More data is shared, and ever more tax administrations are instituting electronic auditing of businesses’ financial records and systems.

Technology is also helping change the approach of tax authorities by increasing the frequency and effectiveness of indirect tax audits. Tax audits are increasingly done electronically and in real time. Tax authorities in 59 countries extract data electronically to audits of indirect tax, EY research has found.

Malaysia and Brazil’s tax authorities run electronic audits using risk parameters based on taxpayer and industry profiles.

The electronic filing of indirect tax returns and invoicing is becoming more common. Bolivia and Indonesia recently made electronic invoicing for larger transactions mandatory, for example.

The move online can cut costs for companies, but it can also increase costs if companies need to upgrade their IT. It’s also a different way of interacting with tax authorities.

“Companies [in Brazil] work very transparently — [information on] everything you sell and buy has to be sent to the tax authorities each month,” Fontenelle says. >
Developing economies

“Some companies weren’t ready for this change and neither were their IT systems.”

In India, customs officials use risk-management software to spot discrepancies in cross-border transactions, says Subramaniam.

More tax disputes are settled in court and fines are getting tougher, he says. “While in most cases such challenges get resolved in favor of taxpayers, the time taken for these resolutions can be significant, typically taking from between 5 to 15 years to resolve,” he adds.

A changing trade landscape

Global trade is changing, and developing economies are playing a key role. By 2020, Brazil, China and India are predicted by the World Trade Organization (WTO) to post more world output than Canada, France, Germany, Italy, the UK and the US combined.

For multinationals, this has both business and tax implications.

As world trade increases, so do the number of restrictions imposed. WTO data shows that G-20 countries have adopted 1,244 trade-restricting measures since October 2008, but only 282 have been lifted.

“There is an increasing focus on compliance for global trade,” Smith says. “Customers are investigating a lot. For example, sanitary and licensing requirements are on the increase, and companies complain about this because it adds to their compliance costs.”

As more and more companies are faced with the practicalities of cross-border business, they encounter unfamiliar indirect taxes that are inextricably linked to trade flows and transactions.

Rising excise taxes are adding to companies’ tax costs, and therefore indirectly to the costs of goods and services. This is particularly true of environmental taxes, when they are levied on transportation, fuel and energy – all important elements of global trade. South Africa’s government, for example, is expected to introduce legislation for a new carbon tax in 2015.

A lot of large companies often don’t fully understand all of the excise duties and other indirect taxes they pay in Asia, according to Smith. “They’re lucky if they have an Asia-Pacific indirect tax director.”

There are some positive signs, however. The number of free trade agreements (FTAs) negotiated and signed is growing. The WTO currently reports 604 active and pending reciprocal regional trade agreements among its members.

Free trade, or special economic zones, are also being used by developing economies to foster trade and investment. While the operation and benefits of these zones vary, three key areas of benefit can exist:

1. Tax exemptions or reductions, which can aid profitability
2. Exemptions from duties and VAT payments on imports, which can aid cash flow
3. Simplified administrative procedures, which reduce compliance costs

These trends in indirect taxes have a direct impact on those businesses operating in, or trading with, developing economies. More than ever, it pays to proactively manage indirect taxes. Setting a clear indirect tax strategy will help businesses keep up to date with the rapidly changing tax environment.

A view from business

Chris Needham, Global VAT/GST Director at General Electric, a conglomerate with services ranging from aircraft engines to power generation and consumer financing, is an expert on the complexities of indirect tax systems in developing economies.

He agreed to speak to Tax Insights in a private capacity.

“In developing economies, the differences in indirect tax rules can be more marked than in developed economic regions such as the European Union, where there is more harmonization,” he says.

“There are lots of differences in developing countries’ indirect tax rules and they haven’t always kept pace with different ways of transacting, such as the internet or digital downloads.”

The structure of large companies can also complicate indirect tax calculations.

“A global corporation may have many accounting systems accumulated over decades from acquisitions,” Needham says.

Some older accounting systems may not be well integrated and unable to easily share information. That makes it harder to extract the right data from transactions for indirect tax returns.

“Generally the more accounting systems you have, the more expensive they are to consolidate and maintain,” Needham says.

Having multiple accounting systems means that each needs to be configured with current indirect tax rules in developing economies. One way to simplify the maintenance burden is to have a single instance of all the rules and rates embedded in software known as a “tax engine.” This can then be interfaced with the other accounting platforms yielding one version for use around the globe.

“A country’s rules for different types of indirect tax transactions need to be verified within the software, however,” Needham says. As with all IT systems, the data going in and coming out need to be checked for accuracy. This task is harder if the tax rules aren’t online or easily accessible or if they’re unclear.
India

Sources: CIA, World Bank, The Economic Times, UN, Transparency International, EY, WTO, WEF.

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<th>Area</th>
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Capital city: New Delhi
Main languages: Hindi, along with English, Bengali, Telugu and others

Attractiveness of economy to business: India ranked 142 out of 189 countries on the World Bank’s Doing Business 2015 report, receiving a high mark for protecting minority investors, yet low marks for enforcing contracts and dealing with construction permits.

Top export markets:
- European Union 16.7%
- United States 12.5%
- United Arab Emirates 10.1%

Foreign direct investment:
India recorded FDI (net inflows) of US$ 28 billion in 2013, a 17% increase over the previous year. India has FDI caps in certain sectors, including defense, insurance, petroleum and gas, aviation and media.

Corporate income tax:
Resident companies must pay tax on income generated around the world, while nonresident corporations are subject to tax for income accrued in India. The corporate tax rate for resident companies can go up to 33.99%, while the tax rate for nonresident corporations ranges from 41.2% to 43.26%.

Indirect taxes:
Depending on the state, value-added taxes range from 4% to 15% on goods. There is also a central sales tax – a minimum 2% – on the sale of goods. Other indirect taxes include a service tax and customs and excise duty.

Other taxes:
Interest, royalties and technical services fees are all subject to tax in India. The rate of tax for interest is 10% when paid to domestic companies, and starts at 20% when paid to foreign corporations. The tax on royalties from patents, etc. starts at 25%, as does the tax on technical services fees.

Administration:
India ranked 156 in the area of paying taxes in the World Bank’s Doing Business 2015 report. It takes companies 243 hours, on average, each year to prepare, file and pay their taxes in India.

International organization membership:

Transparency International’s Corruption Perceptions Index: 38 out of 100 (100 is very clean)

Infrastructural:
The country’s infrastructure ranked 87 out of 144 countries in the World Economic Forum’s Global Competitiveness Report 2014–2015, with its electricity supply quality scoring 3.4 on a scale from 1–7 (best), and the quality of its roads scoring 3.8.

Education:
In India, 75% of males and 51% of females are literate. The gross enrollment ratio for secondary school is 69%. In 2012, India launched a project to improve access to, and the quality of, secondary education.

Legal system:
India’s constitution was adopted on 26 November 1949, and has since been amended on many occasions. The legal system is based on common law. The president, who is the head of state, and the prime minister, who is the head of the government, lead the executive branch. The legislative branch is composed of the Council of States and the People’s Assembly. The Supreme Court is the highest court.

The manufacturing sector accounts for 59% of exports
30% minimum corporate income tax rate

For more information: Worldwide Corporate Tax Guide 2015
Developing economies

Emerging markets plot a new tax road map

The boom in cross-border investment is driving developing countries to modernize their tax regimes and multinational companies to redouble their efforts to manage associated risks in emerging markets. The challenges are many, and the benefits of success substantial.

by Rob Thomas

n a windowless room in Angola’s capital city, Luanda, the clicking of a 50-year old ceiling fan provides a metronome-like backdrop to the intense concentration of three Angolan tax officials as they wrestle with complex new transfer pricing concepts.

The officials are 24, 27 and 33 years of age and representative of Africa’s youthful population. Under the banner of the OECD’s “Tax inspectors without borders” program, designed to help emerging markets quickly build their tax capacity, they are studying the very latest transfer pricing concepts with a tax official from France’s tax authority. Using case studies involving existing multinational companies who have recently established a presence in Angola, they are estimating not only how much more such transfer pricing changes may bring to local coffers, but what cutting-edge techniques they might reasonably expect companies to employ in order to reduce their tax bills to the legal minimum.

As simple as this tax capacity-building exercise may seem, it is certainly not a new phenomenon. Bodies such as the International Monetary Fund (IMF), United Nations (UN) and World Bank Group long ago seized upon the need to assist developing economies, as did nongovernmental organizations (NGOs) and charities. But it is only now that such cooperation and collaboration is attracting the full attention of other groups, including the OECD, who realize that a bright global future requires all stakeholders, developed or developing, to be properly engaged. Designed in just the last few years, the tax inspectors program is representative of a number of new ways in which developing economies are trying to make it easier for business to establish itself, while also making sure that business pays “a fair share of tax”.

That fair share is not always paid, say some NGOs and charities. A recent Oxfam report, for example, estimates the tax gap for developing countries to be US$104 billion each year, while an estimated US$138 billion is given away by their governments each year in statutory corporate income tax exemptions.

The rapid increase in cross-border investment is having a big impact on tax, says Richard Stern, Lead Tax Officer at the World Bank Group. “There’s recognition that domestic tax bases have been eroded by bad tax policy and bad application of tax policy,” says Stern. “For example, mistargeting tax incentives can lead
to poor results in many countries. Take the granting of VAT exemptions, for example. Say a developing country wants a big anchor investment in the extractive or manufacturing industry. Local businesses in the country are liable for VAT. If a big global company is given a VAT exemption for mining activity, it’s not economically viable for the company to buy goods and services from local companies because they have to pay VAT. This hinders the local economy and comes back to bite the countries later on.”

**Where frictions meet**

“I need a billion new babies to put into diapers,” said an executive from a Fortune 500 consumer products company recently. “And I’m not going to find them in America. They’ll be in Africa.” But, as exciting a picture as developing economies paint for companies in search of new consumers or new sources of raw materials, operating there can be a leading source of tax and controversy risk. Because of rapid growth in inbound investment, such countries tend to experience large volumes of tax policy and tax administration change as they develop the laws and processes needed to secure what they feel are the right levels of tax.

A lack of highly skilled tax policymakers leads many developing economies to rely on existing legislation and processes that some taxpayers may view as unsophisticated, complex and culturally different. And as emerging market countries become more confident, they are increasingly challenging commonly applied international standards. The resulting mix can be combustible for companies who may not have the resources, insights and understanding of how things work in a developing economy. “It doesn’t matter how low the tax rate is in a country or how generous the tax incentives might be,” says Rob Hanson, Global Tax Controversy Leader for EY. “If you’re getting a billion-dollar penalty on the enforcement side for doing something that the country finds wrong, then that’s a billion dollars of lost revenue.”

**The corporate impact**

Many companies may not have dedicated resources with strong local tax knowledge or deep cultural experience. Couple that with the fact that the tax policy, tax legislation and tax administration processes can change rapidly as the country develops at high speed, the risk of major disputes – even to the point of expulsion from the country – increases dramatically.

The pitfalls are numerous: there may be few or even no tax treaties in place, inconsistencies in tax legislation, ambiguous interpretation and, in many cases, a lack of clear judicial and administrative guidelines about how to resolve a tax dispute. Language differences and the lack of a long-standing relationship between taxpayer and tax administration may also compound the difficulties. And with parts of the cross-border tax architecture effectively being replaced and upgraded, how developing economies implement such changes will be key to global growth in coming years.

Alongside tax policy change, tax administrators in developing economies are renowned among business as moving extremely quickly to enforce new laws, sometimes in ways seemingly at odds with the actual intention of such law or with internationally accepted practices. The result is a long, often contentious, expensive road to achieve certainty. Unfortunately, the examples of potholes on this road are many:

- Argentina removed the registered exporter status of a number of agricultural companies as the result of a major tax dispute.
- A large copper mine in Mongolia was disrupted after the company that owns the rights to the mine said it would challenge tax claims made by the country’s authorities.
- Four-fifths (79%) of companies in Asia-Pacific and 77% of those in Brazil, Russia, India and China surveyed in EY’s 2014 Tax Risk and Controversy Survey said audits of VAT and other indirect taxes were getting stricter. Sometimes, it’s not just about technical interpretation of the laws, though. “It’s ultimately about the revenue authorities in different countries wanting to tax as much as possible,” says the tax director of a European multinational company who wished to remain anonymous. “In that respect, double taxation is the result. I would say the greatest risk is that everyone is looking for money, so they’re getting more aggressive and trying to figure out how you owe each jurisdiction more.”

**Common characteristics of emerging economies**

Developing economies tend to share a number of characteristics. In each case, corporate leaders can learn much about a country by studying it through these various lenses:

- The existence of tax and resource “nationalism”: One of the attractions of investing in developing economies can be their abundance in natural resources and fast-growing consumer markets. Taxes vary by country, but there is a trend for higher taxes on the most lucrative industries. This doesn’t just affect resources companies, though; some developing economies will tax all inbound companies more highly that domestic enterprises. For example, when all surcharges are taken into account, India taxes foreign companies at 43.26%, a full 9 percentage points higher than the domestic company rate of 33.99%.
- A traditional reliance on indirect taxes: Some developing economies are more reliant on indirect tax for revenue than many developed economies because corporate profits are

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**Key action points**

- Engage in discussions on tax policy changes worldwide and their impact on your company and the markets in which your organization operates.
- Review your tax and accounting software for its ability to accommodate changes to domestic and international tax rules, particularly BEPS.
- Engage in the consultative processes around changes to domestic and international tax rules, such the OECD’s BEPS Action Plan.
- Focus your resources on the tax changes that will have the biggest effect on your operations and profits.
Developing economies generally smaller. China, for example, gets about 60% of its total revenues from indirect taxes – about twice the average rate of OECD member countries. China is expanding its VAT pilot to include businesses in a range of industry sectors, including financial services, real estate and hospitality.

- A new focus on direct taxation: Many of the countries attracting high levels of foreign direct investment realize that income taxes are becoming more relevant. But this is not without its risks; not only do countries have to try and catch up with decades of sophistication in both tax policy and administration, but they must do this at a time when the tax architecture is going through the largest set of changes since the 1920s.

- Using tax policy to drive desired economic activity: Developing economies, keen to move their economies from being predominantly centered on low-cost manufacturing toward being desirable locations for high-tech manufacturing and providers of business outsourcing services, are using their tax systems to attract certain types of business activity. For example, China is offering tax incentives to companies judged to be a “technologically advanced service company” or having a “high- and new-technology enterprise” status. It is available in 21 cities until the end of 2018, according to EY’s 2015 Worldwide R&D incentives reference guide.

- A new focus on how tax incentives are used: Today, among both developed and developed economies there is greater scrutiny into the role that tax incentives play in an economy. Many developing economies are questioning whether all incentives continue to be appropriate. As Stern of the World Bank Group notes, “The erosion of domestic tax bases through profit tax holidays is one example. Most young companies are not earning profits when they start off, but when they do make profits they can shift profits in and out of the economy. They shift profits into the country when there is a profit exemption and book costs somewhere else.”

- A growing understanding that the tax system is only as good as its administration: Developing economies are increasingly understanding that a tax system is made up not only of policies and laws, but their effective administration. Long, high-cost disputes and litigation are a deterrent for companies to invest into a new market.

The drive to modernize

Governments in developing economies realize that they have to meet each of the above challenges if they are to be successful in their quest for long-term growth. They are not on their own when it comes to modernization. Capacity building is probably the key issue for developing economy tax officials, and visiting sessions (known as “missions”), technical assistance, training and collaboration programs have long been part of IMF, World Bank Group and UN activities.

These bodies have been joined by the OECD, whose November 2014 Strategy for Deepening Developing Country Engagement saw more than ten developing countries invited to join the Base Erosion and Profit Shifting (BEPS) project. The OECD will also create five regionally organized networks of tax policy and administration officials to coordinate an ongoing and more structured dialogue with a broader group of developing countries on BEPS issues, as well as to develop “toolkits” that developing economies need to support the practical implementation of the BEPS measures.

For their part, developing economies are trying to modernize their own tax systems. In Africa, the African Tax Administration Forum (ATAF) was formed in 2008 to try and improve the consistency of tax administration across the continent. Today, ATAF boasts 36 member countries, with the ATAF secretariat working with tax administrations both inside and outside Africa to provide a broad range of technical workshops, alongside day-to-day knowledge sharing and research.

Such approaches are also mirrored in other regions. In Asia-Pacific, the Study Group on Asian Tax Administration and Research (SGATAR) is made up of representatives from 16 Asian jurisdictions. In Latin America, the Centro Interamericano de Administraciones Tributarias (CIAT) performs much the same role, allowing national tax administrators to collaborate and share leading practices.

These initiatives seeking to build capacity and expertise among tax authorities in developing economies become even more powerful when they harness the resources and insights from a broad range of stakeholders. Take the Academy of Public Finance as an example.

The Institute for Austrian and International Tax Law at Vienna University of Economics and Business (WU) and the African Tax Institute at University of Pretoria, in cooperation with EY, the International Tax and Investments Center and the International Finance Corporation of the World Bank worked together to establish the Academy. Initially aimed at Africa and Eurasia, the goal of the Academy is to improve the capacity of tax administrations to implement tax legislation effectively and to provide a pre-investment quality of tax policy, legislation and administration through a platform of sustained engagement between all stakeholders.

“Whereas many other training programs that are offered to government officials tend to be purely instructive, and do not include a private sector business dimension, there is a lot of value in providing a programme that is intended to be an interface between government, business and academia, encompassing policy dialogue, research and training,” explained Dr. Jeffrey Owens, Senior Tax Policy Advisor at EY, and Professor Riel Franzen in a March 2014 report by the Academy of Public Finance.

Takeaways

Multinational companies face a battle to stay on top of the large number of changes in developing economies’ tax regimes. More growing pains are likely as emerging markets transform their taxation approach to more closely match global economic realities and changing business models. The transformation from “developing” to “developed” market is not a quick one, at least where tax policy, legislation, tax administration processes and culture are concerned.

Corporate leaders need to know that while the ride may not be entirely smooth, it can certainly be improved by getting the right governance, policies, resources, processes and systems in place to manage emerging markets risk. But as important as those things are, they are eclipsed by the ability to tap into local knowledge and cultural experience. The most welcome visitors will always be those who show a willingness to learn, understand and share a little of their own knowledge.
Mexico

**Infrastructure**
Mexico has launched a US$590 billion infrastructure plan, targeted at the energy sector (new gas pipelines and power plants), as well as the transportation sector (a new airport, a high-speed rail project and an expanded fiber optic cable network). Mexico's infrastructure was ranked 65 out of 144 countries in the World Economic Forum’s Global Competitiveness Report 2014–2015.

**Education**
Mexico has a literacy rate of 93.5%. The percentage of adults aged 25–64 who have a high school degree is 36%. Mexico has introduced a series of reforms in recent years in a bid to improve the quality of its education system.

**Legal system**
Mexico’s current constitution was approved on 5 February 1917, with many subsequent amendments. The legal system is based on civil law. The president heads the executive branch, while the Senate and Chamber of Deputies make up the legislative branch. The highest courts are the Supreme Court of Justice and the Electoral Tribunal of the Federal Judiciary.

**Corporate income tax**
Resident corporations are subject to tax on all worldwide income, while nonresident companies must pay tax on income derived from doing business in Mexico. Only the federal government taxes corporations.

**Indirect taxes**
Mexico has a 16% value-added tax (VAT) on goods and services, excluding exports. There is also a 5% residence tax on the salary of each employee.

**Other taxes**
There is a 10% income tax on dividends paid out to shareholders (both residents and nonresidents). If the earnings were already subject to corporate income tax and the company has enough in its “net tax profit” account, then no corporate income tax is paid on the dividends.

**Administration**
Mexico ranked 105 in the area of paying taxes in the World Bank’s Doing Business 2015 report. It takes companies 334 hours, on average, each year to prepare, file and pay their taxes in Mexico.

**International organization membership**
Asia-Pacific Economic Cooperation (APEC), G-15, Inter-American Development Bank (IADB), Organisation for Economic Co-operation and Development (OECD), United Nations (UN), World Trade Organization (WTO)

**Transparency International’s Corruption Perceptions Index:**
35 out of 100 (100 is very clean)

For more information:
Worldwide Corporate Tax Guide 2015
Developing economies

Meet
Jakarta’s
middle
class

Indonesia
Imports by market

China 16%
Singapore 13.7%
Japan 10.3%
European Union 7.4%
Malaysia 7.1%

Across the developing world, an estimated 150 million people are expected to enter the middle class each year through 2030. EY Tax Insights had the opportunity to visit a typical middle-class family in Indonesia. Prasetyo Yulianto, a senior associate at EY, lives with his wife, Indah Dwi, daughter, Nayshila Cinta Ramddhani, and son, Rafli Syafikri, in a two-room house in a quiet suburb outside the busy metropolis of Jakarta. They shop for vegetables, beef and rice at the local market. They own their own cell phones, flat-screen TV and washing machine, and use a scooter and the bus to get around. They like to dine out, see the latest Hollywood films at the cinema, and go on vacation in eastern Java. In the following pages, Yulianto, 40, provides a glimpse into everyday life for Indonesia’s growing middle class, an increasingly attractive market for businesses around the world.

by Catherine McLean
The family owns its own scooter, a model from Japanese motorcycle manufacturer Yamaha that was assembled in Indonesia. While Yulianto takes the bus to work, his wife uses the scooter to take the kids to school and pick them up, as well as for shopping trips to the market. Yamaha, Suzuki and other scooters are popular with members of Indonesia’s middle class, who often buy them on credit. Car ownership remains relatively rare, estimated at just 7%. Yulianto dreams of one day owning a “family car” made by Toyota.

Developing economies

**Japan**

Most important export markets

- United States 18.8%
- China (mainland) 18.1%
- European Union 10%
- Republic of Korea 7.9%
- Taiwan 5.8%

**Tax profile**

Indonesia has a flat corporate tax rate of 25% for domestic companies, along with foreign companies with a permanent establishment. The rate is higher than that of some other countries in Southeast Asia, but lower than in the Philippines (30%).

Sources: WTO, World Bank; Credits: Keystone, Laif, Donang Wahyu
Like many Indonesians, Yulianto’s family regularly buys tofu and tempeh, products that are manufactured locally. Tempeh and tofu are staples of the Indonesian diet, and the country currently imports two million tons of soybeans each year, including from the United States. Traditionally, Indonesians bought their food at a small shop called a warung, located in local markets. But the Indonesian middle class is increasingly turning to mini-markets to do their shopping. Large supermarkets, some of which are operated by well-known foreign brands, are also popular with the middle class as they offer attractive discounts.

**Tax profile**
Indonesia has a 10% value-added tax (VAT) on various goods and services, including imports. There is no VAT tax on food and drinks sold at restaurants and hotels, though there is a separate 10% tax levied by local government.

**United States**
Most important export markets

- Canada 19%
- European Union 16.7%
- Mexico 14.3%
- China 7.7%
- Japan 4.1%
Each family member has a cell phone. They bought their Mito cell phones, manufactured in China, at a small, local shop. The family uses them to send messages, connect to social networking sites and take pictures. Cell phone ownership is widespread among Indonesia’s middle class, which views them as an essential item, Yulianto says. There are 125 cell phone subscriptions per 100 people in Indonesia. Increasingly, middle-class consumers are upgrading to smart-phones as declining prices make them more affordable.

**Tax profile**

Indonesia ranks 160 out of 189 countries in terms of the ease of paying taxes, according to the World Bank’s *Doing Business 2015* report. The average ranking of countries in the region is 84. On average, it takes companies 253.5 hours annually to file and pay their taxes in Indonesia.

**China**

**Most important export markets**

- Hong Kong, China 17.4%
- United States 16.7%
- European Union 15.4%
- Japan 6.8%
- Republic of Korea 4.1%
The family has a Dell computer, manufactured in Malaysia. The children use it to do their homework and play games online. The computer market, however, is still largely untapped in Indonesia, with a penetration rate of around 9%. Those who are online must be patient. The average internet connection speed of 3.7 Mbps (megabits per second) is far slower in Indonesia than in most countries in the Asia-Pacific region. Internet penetration remains low, at 15.8 users per 100 people in 2013.

Tax profile
While many countries in Asia offer R&D tax incentives, Indonesia does not. Indonesia, however, offers other tax incentives for Indonesian companies ranging from, for example, accelerated depreciation and amortization to a tax holiday incentive, which was introduced in 2011.

Malaysia
Most important export markets

Singapore 13.9%
China 13.5%
Japan 11.1%
European Union 9.1%
United States 8.1%
For daily products fulfilling their day-to-day needs, Yulianto and his family like to buy foreign brands that are made in Indonesia. A particular preference for personal care products includes Dettol soap, from a British company with operations in Jakarta. The middle class is spending more on personal care products, buying a greater variety and upgrading to more expensive, foreign brands. Indeed, foreign brands have expanded their manufacturing operations in Indonesia in recent years. Indonesia’s large population and growing middle class make it an attractive manufacturing base for foreign brands in different industries, including athletic gear and cell phones.

The British company, PT Reckitt Benckiser, manufactures Dettol in Jakarta.

**Tax profile**

Foreign companies should be aware that Indonesia is looking more closely at transfer pricing as the government seeks to stem the loss of corporate tax revenue. The country is also reviewing its tax treaties with other countries and has threatened to suspend those which it believes are being abused by tax avoiders.

**UK**

Most important export markets

- European Union 42.9%
- Switzerland 13.0%
- US 11.5%
- China 3.3%
- United Arab Emirates 2.8%

Sources: WTO, World Bank; Credits: Keystone, Laif, Donang Wahyu
Mergers and acquisitions in developing economies

While significant value can be created with the right developing economy deal, concluding one successfully often requires extra time, money, resources, patience and attention to sometimes unexpected issues.

Global M&A value soared 30% in 2014 – the fourth highest year in history – and the resurgence looks set to continue through 2015. Some of the prime targets of this activity have been in developing economies, with India, China and Brazil in the lead and meaningful activity in Southeast Asia and elsewhere.

However enticing the current climate, acquisitions in developing economies deserve careful consideration of how a target aligns to the acquirer’s M&A strategy, business purpose and fit, says Eng Ping Yeo, EY’s Asean Tax Leader. In addition, she says, more also needs to be done at the front end to understand the formal regulations and practical issues for each possible deal, and identify early deal breakers.

One challenge is dealing with uncertainties at a company level. For example, one of the most significant differences between transacting in developing economies compared with the developed world is the quality of available financial information from potential targets. “Information may vary in terms of completeness, the level of detail and, in some cases, the integrity of the information,” says Yeo. The key to addressing this gap, she says, is the ability to obtain information through other means, such as detailed discussions with the seller and target. However, she also points out that sellers may not be as well supported by the target management

Key action points

- Plan for more time, resources, early planning and local involvement to conclude deals.
- Expect differences in information availability and culture.
- Allow extended time for decision-making and approvals.
- Expect differences in approach to tax enforcement and process of obtaining rulings or other guidance from tax authorities.

by Gerri Chanel
Developing economies

Cross-border M&A deal flow
(twelve months to March 2015 – based on target asset location)

Source: Dealogic and EY analysis
partners in a joint venture pay a tax called zakat. In a structure with multiple levels of holding companies in Saudi Arabia, a rule caused the repatriation of profits to foreign investors to be taxed at each level to the extent that no profits were left. Tenaga and other companies in a similar position worked with tax consultants to file an appeal to the Saudi government; the rule was overturned but it took the better part of a year.

Potential deals also present other tax risks. “Some developing economies have historically unstable tax regimes,” says Kunz, “and others may have an inexperienced tax administration.

In some cases, interpretations and practices of the tax administration may not necessarily be in line with the wording of the law and in other countries, there may not be a clear and efficient process to clarify technical uncertainties.” As a result, he says, time and patience may be required in discussions with tax authorities about a structure or the interpretation of local laws.

Longer potential time frames for local or governmental decision-making go hand in hand with yet another uncertainty: the risk that laws may change in the meantime. “The likelihood of changes in the tax environment is larger than compared to more mature countries,” says Kunz, “and that can be a problem.”

Likewise, transfer pricing issues, deductibility of interest and countless other tax issues may be treated quite differently from one jurisdiction to another, in ways perhaps not typical in a developed market, and according to rules that may change more frequently than expected. It is also important to carefully understand a target’s historical approach to tax controversy matters. All of these tax risks “not only present cash exposures, they may also create reputational risks for companies, and need to be identified early and proactively managed in the M&A process,” says Yeo.

For companies contemplating a deal in developing economies all of this means that the M&A process will require greater attention and up-front planning, says Yeo. And it is important, she says, to recognize that each country needs to be regarded individually, due to distinct cultures and governments and varying levels of development and economic maturity. Due diligence and early tax planning are key, she says, as are careful consideration of how an acquisition aligns with the acquirer’s M&A strategy, business purpose and fit and early thinking on integration.

Taken together, this also means that a deal in a developing economy is likely to be a more time-consuming process and with more input from advisors. It also means that obtaining local expertise is essential to understand the rules and behaviors in a target’s environment.

With all the risks and uncertainties, it also means that planning for developing economy deals is a board issue. The convergence of fiscal tightening with international political and media interest in deal structuring – in particular the OECD’s Base Erosion and Profit Shifting work stream – has resulted in tax being elevated up boardroom agendas and at the front end of companies’ strategic dialogues, says David Sreter, EY’s Global Transaction Tax Leader.

Turning ambition into reality in developing economies is not always straightforward. There is no “one size fits all” model, but the economic outlook for the foreseeable future indicates that developing economies will continue to play an important role in the M&A landscape.

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**Acquisition capital targeted primarily to developed and top-tier emerging markets in the near term**

EY’s 12th Global Capital Confidence Barometer, a biannual survey of more than 1,600 senior executives in 54 countries, reports that companies are planning to invest the majority of their acquisition capital in developed markets, which will provide more near-term growth. Emerging markets remain important for the long term, but inbound acquisition activity into these markets will likely remain unchanged for the next 12 months, with 65% of executives planning to allocate less than 10% of acquisition capital to developing regions. The potential upturn in major developed markets, particularly the Eurozone, is also affecting M&A strategy.

According to the Barometer, the UK, China, the US, Germany and Australia are the top five destinations of choice for investors. In terms of buyers, the US, South Korea, UK, France, Germany and Japan will be the most prominent acquirers.

“Western Europe will be a particularly attractive M&A destination – especially from acquirers in Japan, China and the US,” says Pip McCrostie, Global Vice Chair of EY’s Transaction Advisory Services. “The European Central Bank’s planned injection of €1.1t of liquidity into the region through quantitative easing (QE) should add to downward pressure on the euro. Given recent positive economic data, that should make Eurozone-based assets attractive.”

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**Further insights**

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**Developing economies**
Vietnam

The manufacturing sector accounts for 70% of exports

Infrastructure
Vietnam’s infrastructure ranked 81 out of 144 countries in the World Economic Forum’s Global Competitiveness Report 2014–2015, with the quality of its roads, railways, ports and air transport receiving a score of 4 or less (7 is best). It is turning to public-private partnerships for new infrastructure projects to make Vietnam more attractive to investors.

Education
Vietnam has a literacy rate of 93%. A UNICEF survey of young people found that 17% of respondents had only completed elementary school, while another 50% had completed just lower secondary school.

Legal system
Vietnam’s latest constitution was adopted on 15 April 1992, and has since been amended. The legal system is based on civil law. The president, the chief of state, and the prime minister, who is the head of government, lead the executive branch. The legislative branch is composed of the National Assembly. The Supreme People’s Court is the highest court in Vietnam.

Corporate income tax
Corporations involved in the exploration and exploitation of oil and gas, along with the exploitation of rare precious natural resources, are subject to a higher corporate tax rate than other companies, ranging from 32% to 50%. The standard corporate income tax rate is set to decline to 20% from 22% on January 1, 2016.

Indirect taxes
Vietnam has a value-added tax of 10%, though certain areas, such as medical and agricultural goods, have a reduced rate of 5%. In addition, there is a consumption tax ranging from 10% to 70% on goods, such as cigarettes, beer and cars, as well as casinos and golf courses. Vietnam also has environmental and natural resources taxes.

Other taxes
Capital gains stemming from the sale of shares are subject to a tax rate of 22%, which will decline in January 2016 to 20%. There is also a withholding tax of 5% on interest.

Administration
Vietnam ranked 173 in the area of paying taxes in the World Bank’s Doing Business 2015 report. It takes companies 872 hours, on average, each year to prepare, file and pay their taxes in Vietnam.

Corporate income tax rate
22%

International organization membership
Asian Development Bank (ADB), Asia-Pacific Economic Cooperation (APEC), G-77, International Finance Corporation (IFC), Organisation internationale de la Francophonie (OIF), United Nations (UN), World Trade Organization (WTO), among others

Transparency International’s Corruption Perceptions Index:
31 out of 100 (100 is very clean)

Worldwide Corporate Tax Guide 2015

For more information:
The growth paradox

Tax incentives are widely used by developing economies – with mixed effect

To attract foreign direct investment, governments often give to receive. The challenge for both governments and businesses is not to get taken.

by Nick Huber
Developed economies have long used targeted tax incentives such as research credits, additional tax depreciation, property tax abatements and concessionary tax rates to attract businesses they hope will establish a footprint, create jobs and stimulate economic growth within their borders.

In many economies, particularly developing economies or smaller countries that lack a large domestic hinterland, advocates have believed that tax breaks, coupled with good infrastructure and skilled workforces, can give their country a competitive edge over nations with other favorable market attributes. The dilemma, critics say, is that many such tax breaks reward companies for investment decisions they would have made anyway, often at a great revenue cost to governments.

Tax incentives have become more common in developing economies. According to the Organisation of Economic Cooperation and Development (OECD), for example, no countries in sub-Saharan Africa had tax-free zones in 1980, and 40% offered tax holidays. By 2005, half of all countries in that region offered tax-free zones, and 80% offered tax holidays.

And it’s not just tax incentives. In the competitive global economy, countries, regions and cities can offer a wide range of incentives — from regulatory simplifications to subsidized access to resources — with the goal of maximizing foreign investment. But which incentives are the right ones?

A question of substance
Governments currently judge the value of foreign direct investment (FDI) incentives using a number of criteria. “It is not typical for incentives to be directly correlated to how long a foreign investor stays in the country. Instead, most countries would assess incentives on the basis of conditions such as employment generated arising from the project, the type of activities being conducted, capital investments made in the country, technology transfer and R&D activities being conducted,” according to Bin Eng Tan, leader of the ASEAN Business Incentives Advisory team at EY in Singapore.

Given the current global climate, it is naturally important for many developing countries offering incentives to attract not only the investment, but real substance to their country. Of course, the answer as to what constitutes the right package of incentives won’t be the same for each developing economy. Governments would need to ensure that the right approach and right level of benefits are tailored to suit their level of economic development. This can present a challenge for businesses.

“There is a web of complexity about incentives for FDI because so many diverse countries offer slightly different ones,” Bin Eng says. “Companies need to make an effort to keep up to date.”

Recognizing that successful attraction of FDI requires more than just offering incentives, many developing economies have taken steps to help multinationals navigate this complex landscape by establishing entities that actively promote investment in their country. Examples include the Economic Development Board in Singapore, the Malaysia Investment Development Authority (MIDA) and the Board of Investment in Thailand. A smooth and efficient experience with a country’s investment body the first time improves the likelihood of future repeat investments.

Globally, FDI flows declined by 8% in 2014 to US$1.26t from a year earlier as economic uncertainty and geopolitical risks increased, according to the United Nations Conference on Trade and Development.

In this environment FDI in developing economies, particularly China and India, bucked the global trend, reaching a record US$700b, a 4% increase over 2013.

Developing economies’ global share of FDI reached 56%.

China surge
China had the most FDI (US$128b) — overtaking the US (US$86b) as the top destination for FDI for the first time since 2003. China will also soon be the world’s largest economy.

The FDI surge has come as China has undertaken some of the most potentially significant changes to FDI incentives in recent years, especially by rolling back tax incentives for foreign-based businesses.

In 2008, China unified the corporate income tax law for both foreign investment enterprises and domestic enterprises. So incentives that might have once only benefited foreign investors now are available to domestic companies as well.

“Unlike the past, the PRC government has removed a lot of preferential tax policies that were only available to foreign investors. The PRC government is trying to put foreign investors and domestic investors on an equal footing,” says Jenson Tang, of Business Tax Services at EY in China. The core message from China, and other developing economies these days is: “We want foreign investment but not at any price,” Tang says.

Like China, other developing economies are trying to move from predominantly low-cost manufacturing to high technology and biotechnology and other service industries.

Key action points
- Do thorough research on the tax incentives offered by the country you’re considering investing in. Determine the value of the incentive minus the cost of qualifying for it — including the cost of ongoing compliance.
- Keep up to date with international reforms to tax laws, such as BEPS. They may affect developing economies’ tax incentives for FDI.
- Consider using tax and legal experts to check if there are tax incentives you are unaware of. Local experts will also explain the reality of tax rules and customs which may not be clear in official documents.
“At the beginning developing economies focus on the economic growth, they may accept investments that bring pollution or other undesirable factors,” Tang says. “However, when the economy becomes bigger and more stable, it is very natural they may change the incentive policy.” “China still offers quite some incentives to investors, but incentive policies have become more industry-driven and location-driven. They are available to both foreign and domestic investors,” explains Tang. Other economies are also refining their incentive policies. Datuk Phang Ah Tong, Deputy Chief Executive Officer at the Malaysian Investment Development Authority (MIDA), says that it’s reducing incentives for FDI and predicts that in the near future, incentives that are offered will be more policy-driven toward building a more cohesive economic and industrial ecosystem.

“Giving incentives alone is not sustainable or enough to define the competitiveness of a country,” he says. “For the first few years you can consider incentives but it is not sustainable. What happens if the company wants to expand but it is no longer eligible for more incentives?”

MIDA, which helps companies facilitate applications including manufacturing licenses and work permits, wants to enlarge its service industry. The service industry accounts for about 56% of Malaysia’s gross domestic product. It wants the figure to reach 65% by 2020.

Within the service industry, Malaysia is prioritizing investment in promoted high value-added activities, which it says are more likely to generate high-income and knowledge-intensive work.

Two of Malaysia’s main incentives for foreign investors are “pioneer status” and Investment Tax Allowance (ITA), which are based on the performance and capital investment of the company.

Companies that obtain “pioneer status” get a tax holiday – a corporate tax exemption, either partial or full for a period of 5 years or even up to 10 years for high-impact investments.

Investment allowances let companies deduct additional capital spending from investments from their income, which reduces their taxable profits. The idea is to encourage companies to invest in sustainable capital investment projects that generate long-term growth.

Company view

When Outokumpu, the world’s leading maker of stainless steel, was planning to explore the Chinese market, it examined the tax incentives offered to business.

The company, which is headquartered in Finland and employs more than 12,000 people in more than 30 countries, set up its Asia-Pacific regional headquarters in China in 2014.

The Shanghai local government gives Outokumpu tax incentives including a three-year tax holiday.

“China is the priority market for us,” Henry Zou, Outokumpu’s Asia-Pacific Tax Director, told Tax Insights. “FDI incentives were one factor in setting up an entity in China, although other factors, such as the macroeconomy and growth potential in China, were more important in our decision to invest.”

India has long competed with China for FDI but is probably another future important market for Outokumpu, and the tax incentives are generally smaller, Zou says.

The tax incentives from the Shanghai government are worth a fairly modest certain percentage of the contribution. And the amount may increase as the company expands in China, Zou says.

Obtaining the tax incentives required quite a lot of paperwork but was fairly straightforward.

“We will keep a very close eye on reviews of local governments’ tax incentives for business investment based on the circular released by the authority. I believe there would be some actions to make the incentive policies to be more efficient and effective,” Zou says.

Broader considerations

Incentives can sweeten the decision to enter a developing economy but they’re generally not as important as, for example, political and economic stability and the ease of doing business Datuk Phang says.

“(It’s about) creating an environment of business and government efficiency.”

The ASEAN Economic Community (AEC), whose members include Indonesia, Singapore, Thailand and Vietnam, aims to create a single market and production base, a “highly competitive economic region” and “equitable economic development.”

“I think the AEC economies have a lot more to gain working together rather than competing against each other,” Bin Eng says. “The AEC initiative aims to make the region more integrated economically and more attractive to investors.”

While AEC is still relatively new, companies should monitor developments there. Closer integration between member countries will enhance the operating environment and attractiveness of ASEAN as a region to investors.
Developing economies

Despite the success of some developing economies in using investment incentives to attract FDI, there is growing skepticism about the effectiveness from governments and businesses themselves that such tax incentives work as intended.

These concerns are also being voiced by international organizations.

The International Institute for Sustainable Development (IISD) has said that developing economies should gradually move away from automatic tax holidays for FDI towards “performance-related” incentives (including credits, allowances, loans, grants and bonds) which are linked to the size, duration and environmental effect of an investment. “This can be complemented by a flat corporate tax rate that will help create a level playing field for domestic and foreign investors,” a spokesperson for the institute said.

The OECD has also been critical of some tax incentives. “Ineffective tax incentives are no compensation for a poor investment climate and may actually damage a developing country’s revenue base, eroding resources for the real drivers of investment decisions: infrastructure, education and security,” according to an OECD report.

Even when they do attract FDI it may be at the expense of domestic investment or FDI into another country, the report also said. Regulators are also concerned that multinationals can use incentives for foreign investment to artificially shift profits from countries with a high tax rate to countries with a low tax rate.

The OECD is leading a reform of tax rules to restrict corporate tax avoidance, or base erosion and profit shifting (BEPS). Although its action plan does not include changes to tax incentives, the OECD has suggested that developing economies’ tax incentives may need to change or be justified.

It wants governments to calculate the amount of revenue forgone that is attributable to tax incentives, review their effects and make them clearer.

Despite these misgivings however, there are still generous incentives for companies that invest in developing economies. The landscape will remain complex and varied as countries’ needs differ. Companies may also need to update their strategy for investing in developing economies to reflect a shift in the balance of power between developed and developing economies.

R&D incentives for FDI

Brazil
Deductions of 160% to 200% to taxpayers with eligible R&D expenses. The government wants to encourage technological innovation (such as new product functions) and product innovation (in domestic or international markets) run-in and enhanced R&D activities (basic research, applied research, experimental development, basic industry technology and technical support services).

Chile
The Chilean Economic Development Agency (CORFO) programs hope to attract entrepreneurs and R&D investment to Chile and to connect it to the world’s main technology markets.

Companies are entitled to a 35% tax credit against their corporate tax liability. Expenses may be deducted by taxpayers for up to 10 consecutive commercial years, starting in the year in which the R&D contract or project is certified and the payment has been effectively made.

China
R&D incentives have been available in China for many years and are updated regularly. The government encourages R&D but is being tougher about approving them for tax incentives.

Companies need to submit all information including the R&D project budget, descriptions of specific R&D projects, categories of R&D expenditure, and management or board meeting documents authorizing R&D project(s) to the government authorities. China offers incentives to taxpayers eligible for the Technologically Advanced Service Company (TASC) and the High and New Technology Enterprise (HNTE) status.

It also provides pretax deductions of 150% on qualifying R&D expenses incurred during the year.

India
India’s tax incentives include accelerated depreciation on capital expenditure, tax exemptions, tax holidays for setting up units in specified areas and indirect-tax benefits, such as customs duty exemptions on import of specified goods for the agrochemical industry.

Indian states offer incentives, such as stamp duty waiver and concessions, VAT-related subsidies and/or refund of entry taxes.

Malaysia
Companies providing R&D services are eligible for “pioneer status” or an investment tax allowance (ITA) for qualifying R&D capital expenditure.

A double deduction is available for R&D revenue expenditures incurred by companies carrying out in-house R&D or expenditures related to the services of approved R&D service providers. There are also local-government funding programs to support companies in various industries.

round the globe, governments have increased the resources provided to tax authorities for enforcement of cross-border transactions; nowhere is that trend more pronounced than in developing economies.

These tax authorities are also becoming increasingly assertive in enforcement efforts with regard to the breadth of issues they are addressing, the depth in which they are looking at these issues, and the types of positions they are taking.

In some cases, emerging economies have been casting their tax net more widely in order to address fiscal imbalances or to support the development strategy of the economy. Other countries desire to bring their tax system in line with international best practices. Regardless of motive for change, the outcome is that the tax ground is shifting for companies with activity in developing economies.

Some of the focus on enforcement derives from global discussions about how developed countries should tax the cross-border activities of multinationals. “But developing countries have been facing these difficulties from day one,” says Kim Jacinto-Henares, the Commissioner of Internal Revenue of the Philippines. “The issues have been there for a long time and we have been complaining for a long time. But because we are a small economy and are not powerful, our voice was never heard.”

Now that voice is getting louder. The OECD’s Base Erosion and Profit Shifting (BEPS) project and the United Nations’ Tax Committee are both listening carefully to emerging-country concerns. The OECD BEPS project obtains input from such jurisdictions and more than half of the UN’s Tax Committee members are from developing economies. But developing economies are not waiting for results of these longer-term efforts. A number of them are already working together to develop recommendations, share information and help build up technical expertise to enhance enforcement. Some of these forums include Latin America’s Inter-American Center for Tax Administration, Asia-Pacific’s Study Group on Asian Tax Administration and Research, and the African Tax Administration Forum.

And individual countries have stepped up enforcement on their own, raising more issues and asking more questions than ever before. “Transfer pricing, which tends to be a relatively immature area in developing countries, is being increasingly scrutinized,” says Rob Hanson, EY’s Global Director of...
On the front lines

Kim Jacinto-Henares, the Commissioner of Internal Revenue of the Philippines, talks to *Tax Insights* about the challenges she faces.

If anyone is poised to finally dispel the media stereotype of the “tax man,” it just may be Kim Jacinto-Henares, the outspoken, gun-toting tax commissioner of the Philippines. The certified public accountant and lawyer, who also holds a master's degree in International and Comparative Law from Georgetown University and speaks not only English, but also Tagalog (Filipino), Fooienese and Mandarin, heads the Philippines Bureau of Internal Revenue (BIR). Her previous experience ranges, among other positions, from BIR deputy commissioner of special concerns to law firm partner and from VP for corporate and legal affairs at ING Bank to a senior consultant on tax matters for the World Bank. She also spent time in Kabul, Afghanistan, where she advised the Large Taxpayer Unit of the country’s Ministry of Finance. Since late 2014, Henares has also served on the UN Committee of Experts on International Cooperation in Tax Matters.

When she took the helm of the BIR in 2010, Henares faced a legacy of a deeply rooted culture of tax evasion in the country. Henares quickly made it clear that the rules of the game had changed with respect to tax enforcement and she has presented herself as a strong enforcer of the country’s tax laws.

“I’m not here to make people happy,” she says. “I’m here to collect taxes to support government expenditure, because that’s what the country needs.”

And the guns? Given the country’s level of gun violence, the country’s...
president assigned her an armed security detail when she became commissioner. She decided to learn how to shoot so if something happened, “I can help them and they won’t have to worry too much about me, because I can help myself. It was a practical decision.” Now a sharpshooter, she is even better than her bodyguards according to some accounts and can be seen at a local shooting range alongside the country’s president, who was her original weapons instructor. Here, Tax Insights speaks with Commissioner Henares about the movement of governments towards greater enforcement and her views on tax enforcement in the Philippines.

Tax Insights: Which BEPS issues are most important to the Philippines?

Kim Jacinto-Henares: Transfer pricing is a clear issue. So is the different categorization of the same income in different jurisdictions for tax purposes. Income should be declared in the same way in all jurisdictions. You should not be able to move to another jurisdiction and declare it as a different type of income. The characterization of permanent establishment is also an issue. For a long time, multinationals have fallen through the cracks, paying no taxes by taking the position, for example, that they’re just an invoicing office.

What are the key strategic priorities for the Philippines’ tax administration?

We’re very involved in the various aspects of BEPS. If you’re taking advantage of the resources of a country, then you should pay taxes in that country. We’re trying to make sure that taxpayers pay taxes, at least in one jurisdiction. If someone doesn’t pay any tax at all, it is really unfair competition; if taxes are paid, everyone is on a level playing field.

How important is effective tax administration to supporting the Philippines’ economic growth?

If you listen to investors, what they’re saying is that they need more infrastructure, including human resources. One of our advantages is that our people are well educated. To be able to work properly, they also need good health care. Government has to provide these things. But there is nothing free in the world; government has to pay for it. So you need revenue, otherwise there will be no infrastructure. If there is no infrastructure, there’s no investment. And if there’s no investment, there are no jobs.

How important is enforcement in the Philippines?

Enforcement is very important – it sends a message that we are serious in implementing the law. Taxation is part of the law. A nation can only be strong if its people are disciplined. To me, if you’re disciplined, you follow all the laws, including tax law.

What are some of the ways in which you take a tougher enforcement stance?

First, you have to be tough. People need to know there is a consequence if they don’t follow the law. In Filipino culture, the threat of being “named and shamed” is a very powerful driver of behavior. We won’t hesitate to publish data showing which taxpayers are not following the law. It is also important to tell people why they have to pay taxes, that it is really their contribution to nation-building. All these things together are important.

How have taxpayers and businesses, in particular, reacted to your approach?

Of course, there is always a lot of complaining whether you do something or you don’t do something. Collecting taxes is difficult, but I feel that I’m better situated in the sense that my country’s president and secretary of finance are very supportive. They do not have a political agenda as far as taxation is concerned. What is expected of me is just to collect the right taxes and to fund government expenses, nothing else.

What are some of the specific changes in your department in the past several years that have been made to enhance tax enforcement?

We are using a lot of third-party data to cross-check the accuracy of data reported by taxpayers. For example, we can cross-check VAT reporting of purchases and sales. If a purchase has been reported but no sale, then there must be something wrong and vice versa. We are also conducting a second wave of computerization now, which will see us upgrading to a web-based system that will consolidate all our data into one database in which items will be easier to match. This will make the process even stronger since there will be no silos and people will not be able to hide.

Have you had any unusual experiences given your reputation as a strong tax enforcer?

It has been said that when I am at parties, people remove their jewelry because they don’t want me to see them bedecked with expensive things. And an urban myth says that when I was invited to a car show for a particular brand, some people had their drivers pick them up at some distance from the entrance so I wouldn’t see them getting into their chauffeured vehicles. But that car brand never even invited me!
Tax Controversy. And a number of countries are also questioning the structures that companies are using for their inbound investments. “They’re also asking more questions,” he says, “particularly with regard to expenses deducted or paid out to the headquarters country, whether in the form of cash or simply an allocation of headquarters expenses.” Tax authorities are also increasingly raising the issue of permanent business establishments and applying greater scrutiny to recurring expenses and overall business operations, as well as the proportion of global profits that are being taxed in-country.

In addition to this increased focus on specific areas, a number of countries are increasingly challenging business arrangements on the grounds that they lack substance or business purpose, citing general anti-abuse rules (GAAR), sometimes built into a country’s tax code. While judges in several GAAR cases have defended businesses against overly broad applications of the rule, some countries that have lost in court have responded by proposing new laws to make their GAAR tougher and, in the case of India, even retroactive.

India has a history of conflicting, confusing tax laws and volatile enforcement. This environment has severely affected the country’s image as a stable tax regime, says Rajan Vora, leader of EY India’s direct tax litigation advisory practice. “India is one of the most litigious countries with respect to transfer pricing cases,” he says, with particularly prominent recent cases involving Vodafone and Shell. In both cases, says Vora, tax officers took extreme views that were finally overturned in late 2014 by India’s Supreme Court, in an unusual support of taxpayer positions. In January 2015 the government announced that it would not appeal the Vodafone decision, sending a positive signal to international investors that Prime Minister Narendra Modi appears to be following up on his party’s election manifesto promise to end “tax terrorism”.

India’s Vodafone and Shell cases and the new stated position of the country’s governing party are examples of how changes in administration and the politics of enforcement can flip dramatically, says Hanson, as well as strategies based on the amount of revenue needed. What a country’s tax administration did even six months or a year ago may not be how they approach it today.

India is not the only country with an uncertain controversy environment. “This uncertainty has increased not only from the growing number of issues addressed and the vigor with which they are pursued, but also,” says Michael Nelson, Senior Director–Global Tax Audit & Controversy at pharmaceutical giant Pfizer, “because in many markets, there may not be a well-developed treaty network, adequate resources to handle all the issues associated with transfer pricing matters, or well-understood and predictable mutual agreement procedures.”

The examination process itself in emerging economies may also be different from those in some large developed countries. “Internal processes and procedures may differ and the speed with which things occur can be quite different,” says EY’s Hanson, “and it is important for a company to have people who understand the local system and know how to deal with the local culture.” Pfizer’s Nelson adds that tactics can be unexpected. For example, “adjustments are sometimes initially proposed by examiners with little likelihood of fully succeeding but which nonetheless put pressure on the taxpayer.”

Multinationals also need to remain nimble since what a country’s tax administration did even six months or a year ago may not be how they approach it today.

With so many variables in play and with multinationals doing business in ever more jurisdictions, prudent risk management and risk mitigation are essential. Companies need a comprehensive framework for global risk and controversy management, says Hanson. “Firms need to look at their global resources, processes and systems for tax controversy risk management,” he says, “and ask whether they have the systems in place to identify current and potential disputes and manage them at a strategic, cross-border level, rather than as one-off issues, since what you do in one part of the world may have an impact somewhere else.” Managing these cross-border risks is also a board issue, he adds.

Michael Nelson concurs, noting that Pfizer has become diligent in gaining an early understanding of when tax audits arise and the issues involved as well as their progression, and has adopted technology platforms that give greater visibility and management capability. He also notes that the company also leverages its advisor networks and has developed multiple channels of communication with local markets, internal partners such as the finance group and the legal department, and with the board. “It’s been a very dynamic process,” he says, “and something that never stops, because the world looks different today than it did five years ago and will look different five years from now.

Going forward, I would anticipate an audit and controversy arena that will become more complex, not less. It is going to be more challenging, not less. And it will require a nimbleness even beyond what we’ve experienced at this point in order to be able to handle the challenges.”

**Key action points**

- Understand variations in how controversies are handled at a local level.
- Adopt a global approach to managing tax risk and controversy.
- Evaluate global resources, processes and systems for tax risk management.
- Address tax risk and controversy at a strategic level – and execute well.
- Make strong corporate governance in tax a priority.
- Stay connected with global legislative, regulatory and tax administration changes.
Fairness has long been a major principle of tax reform. In the years since the global financial crisis, concerns about widening income inequality have grown and begun to frame tax policy debates in many jurisdictions, particularly in developing markets, where income inequality increased on average by 11% between 1990 and 2010, according to the United Nations Development Program.

Designing a “fair” tax system is not an easy process. Chile, a country that has recently undertaken tax reforms, is a perfect example of this. In light of these recent reforms Tax Insights interviewed Felipe Larrain, Finance Minister under the previous government, to gain his views on the country’s past and future.

In order to present both sides of this complex debate to readers, Tax Insights also invited President Michelle Bachelet to contribute to the magazine. While President Bachelet was unable to contribute in time for this edition, we look forward to interviewing her for the next edition. Meanwhile, Tax Insights provides more background to Chile’s tax reforms and the complex debate that surrounds them.
Taxing times for an ambitious nation

Chile has just completed a major program of tax reform. While it scores well on the World Bank’s Ease of Doing Business Index, and it has an impressive record of growth in recent years, a wide income gap between rich and poor persists. And some stakeholders wonder whether Chile is at risk of losing its way.

by Giselle Weiss

Tax Insights: Chile stands out among countries in the region for its competitiveness, its per capita income, and its trade agreements with 61 countries. But, according to the OECD, it has the highest level of inequality in the world. How do you explain both its successes and its disparities?

Felipe Larrain: Chile accomplished multiple social goals during a period of sustained economic growth. For instance, our per capita income (expressed as purchasing power parity, PPP) increased sevenfold over the last 35 years; we reduced the national poverty rate from almost 40% in 1990 to 7.8% in 2013; the share of education spending in GDP increased from 2.3% in 1900–1993 to 4.1% in 2010–2013; and our life expectancy at birth is now one of the highest in the world (79 years). While it is true that income inequality is high, it is not the highest in the world. In fact, several other countries in Latin America have higher inequality levels, such as Brazil and the Dominican Republic. Moreover, income distribution gaps have gradually declined since 2000 (except for the period 2006–2009), though more slowly than we would like. Increasing job opportunities is critical.

Commodities, and especially copper, have been an engine of growth for Chile. In a time of decreasing demand for copper, especially from China, where specifically do you expect growth to come from?

Around 50% of Chilean exports are related to copper. It is a large figure, >
“The tax reform recently approved by Congress produced substantial changes in the tax system.”

Felipe Larrain
Former Minister of Finance, Chile

Felipe Larrain was Finance Minister of Chile from 2010 to 2014, and Vice President in February 2014. He received his PhD (1985) and MA (1983) in economics from Harvard University and his BA in economics from Pontificia Universidad Católica de Chile (1981). He has vast experience as an international consultant, academician, editor and author of 12 books and over 120 professional articles, published in Latin America, the US, Europe and Asia. He is currently Director of the Latin American Center for Economic and Social Policies and a professor of economics at Pontificia Universidad Católica de Chile. His many honors include the award for Finance Minister of the Year 2010 (The Banker).

Almost 14 years of growing at 5% per year, on average. At 2% annual growth, it will take 35 years.

What is the significance of Chile’s new tax regime? How is it affecting the competitiveness of the economy?

The tax reform recently approved by Congress produced substantial changes in the Chilean tax system. Those changes go in the wrong direction. We used to have a full imputation system in which corporate tax was used as credit to pay personal taxes. That way, we avoided double taxation of income. Not anymore. Although some concessions were made during the discussions in Congress, the result is much worse than the previous tax system. It is a complex mix of old and new systems, with tax disadvantages for the middle class and most SMEs. We are already seeing its impact in the Chilean economy, though it has not even been completely implemented yet. The full impact will be felt by 2018.

The current administration plans to invest roughly two thirds of the revenues gained through tax reform into overhauling the country’s education system. What is the problem with it?

I am very critical of the education reform this government is pursuing, as it is low on quality and high on ideology. Its first step, already approved in Congress, is mainly about shifting the primary and secondary education in Chile from a competitive supply of school services to state-owned schools. The quality of education will likely suffer, and the parental choices about the type of education their children have access to will be severely limited.

According to a 2012 study by the United Nation’s Economic Commission for Latin America, income tax evasion in Chile amounts to 47.4%, roughly on par with Argentina and Peru but higher than Mexico. What kinds of cultural changes are needed to make Chile more socially responsible with respect to tax?

During the previous administration, we made a concerted effort to address tax social responsibility by implementing electronic control of invoices, which ultimately will prevent VAT and income tax evasion among firms. The program
Developing economies

started in 2013 and was intended to reach completion in 36 months. That is just one step, but it is an important one.

Tax reform and tax social responsibility are just two of the components in the current government’s plan for making Chile a more equitable country. What are some of the others, why are they needed, and where are they with respect to planning?

I feel strongly that the emphasis should be on providing a better quality of education, improving access to the labor market, and increasing wages based on productivity improvements. In this regard, on-the-job training would constitute a very significant next step.

A complex debate

The debate currently taking place in Chile is how to reconcile the steady economic growth the country has enjoyed since the return of democracy with the way resources and opportunities are distributed among people. Indeed, according to the World Bank, Chile’s Gini coefficient (a measure of income inequality, where 0 represents perfect equality) stands at 50.8, which indicates a very large gap between rich and poor.

Chile’s recently enacted tax reform goes to the heart of the debate over inequality. The reform has been widely criticized, by both private-sector specialists and business, who fear that the new rules and costs of compliance will discourage investment and reduce competitiveness. But although some of these concerns are not without foundation, there are two sides to many of the questions, depending on one’s point of view.

For example, education is inarguably one of the key forces in maintaining Chile’s growth going forward. Yet many ordinary workers cannot access quality public schools as quality education is predominantly private and often too expensive for ordinary citizens. Chile’s new tax reform aims in part to address these social issues by raising US$8.2 billion, which will largely be spent on the education reform that is already being debated in Congress.

“Ancient objective of the reform is to modernize the tax system and to bring it in line with international standards,” says Victor Fenner, of EY’s Tax Controversy team in Chile. In the past, unlike in the OECD countries, Chile had no so-called “substance-over-form rule.” That is, there was no way of challenging the relationship between tax benefits and business operations. Now, as in the developed countries to which it aspires, a business in Chile will need to align its tax policy even more closely with its business strategy.

The reform also provides benefits to small and medium businesses. “They will benefit from simplified accounting, can pay VAT over a longer period and will be able to depreciate fixed assets when purchased. Some small businesses may even benefit from a full corporate tax exemption,” explains Fenner. In Chile where, according to the World Bank, small businesses provide 73% of all private sector employment, that is a huge benefit.

“The main challenge of the tax reform is technical; in other words, there are many questions and doubts about how it will play out when it is applied to day-to-day business,” says Fenner. The reform incorporates two new corporate income tax systems that will run in parallel. This dual system will pose difficulties even though its rationale appears consistent with an approach to taxation the government announced in its program.

“Still, other aspects of the reform are in line with international trends, such as the BEPS initiative. Part of the controversy playing out in Chile is the cultural change that the country will have to face,” says Fenner. For example, business leaders becoming accustomed to the idea that it is not enough that a firm’s tax policy is “legal.” It must also be oriented toward business; it should consider social tax responsibility; its approach should be based on common sense; and it should be reasonable enough for a third party to see and recognize its driving purpose is not simply tax planning.

“During the previous administration, we made a concerted effort to address tax social responsibility.”
**Developing economies**

**Chile**

- **Infrastructures**: Chile’s roads and ports rank higher than its railroads and airports, according to the World Economic Forum’s Global Competitiveness Report 2014–2015. In terms of communications infrastructure, there are 134 cell phone subscriptions per 100 people, and 67% of the population uses the internet. The government plans to invest US$28 billion in various infrastructure projects in coming years.

- **Education**: The country has a literacy rate of 98.6%. People spend, on average, 15 years in primary and secondary school, and 72% of adults aged 25–64 have a high school degree.

- **Legal system**: Chile’s current constitution was adopted on 11 September 1980. Its legal system is based on civil law. Government is made up of three branches. The president heads the executive; the legislative branch is made up of the Senate and the Chamber of Deputies; the judicial branch consists of the Supreme Court, the Constitutional Court and the Electoral Court.

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### Chile Highlights

- **GDP**: US$277.2 billion
- **GDP per capita (PPP)**: US$19,100
- **GDP growth forecast**: 2015: 3.2%; 2016: 3.7%
- **Public debt to GDP**: 13.9%
- **Balance of trade (surplus)**: US$2.38 billion
- **Unemployment rate**: 6%
- **Top export markets**: China 24.8%; European Union 14.6%; United States 12.7%
- **Foreign direct investment**: Chile recorded FDI (net inflows) of US$20.2 billion in 2013, the second highest in South America after Brazil.

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**Corporate income tax**

Companies incorporated in Chile, along with foreign corporations’ branch offices, are subject to a 20% tax on income generated around the world. There is also a 35% withholding tax on dividend distributions to nonresidents of Chile, with credit awarded for the 20% corporate income tax rate.

**Indirect taxes**

Chile has a 19% value-added tax (VAT) on goods and services, including some real estate transactions.

**Other taxes**

Mining companies pay a special tax, applied on a progressive basis based on revenue. The tax starts at 0% and goes up to 14%. Separately, there is no corporate tax on income generated from activities in Chile’s northernmost and southernmost regions.

**Administration**

The World Bank’s Doing Business 2015 report rates Chile highest in the area of paying taxes. Companies spend 291 hours, on average, annually on preparing, filing and paying their taxes in Chile.

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Worldwide Corporate Tax Guide 2015

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