“CFO’s Strategic Role in Managing Rising Tax Risks: What the CFO has to curb, rethink and forget”

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Problem Statement

Traditional approach: Reduce costs including taxes

VS

New approach: Manage risk and reputational effects

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What is happening today?

- OECD is more focus on the obligation of the board to be involved in tax matters
- There is high exposure of the board due to tax matters
- There is greater importance of reputational and criminal responsibility for tax matters
- BEPS (more control substance and scrutiny)
- More information is provided to the tax authorities (SOX, FIN 48, etc.)

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Problem Statement

- Today, stakeholders are interested in tax risk management and corporate conduct implementation (concepts such as sustainability and the management of long-term value added are assuming increased importance).
- Financial key indicators used to be the most important measures for the performance of companies **"the lower the tax charge the better"**.
- Tax avoidance strategies are increasingly in doubt (potential damage to **reputation**)
- Tax risk management is part of the corporate governance system, it is the responsibility of the whole **board**.

Problem Statement

- The board´s primary goal is achieve excellent financial results.
- Taxes are a significant cost factor (minimizing tax increase profitability).
- It exists a strong interrelation between the <u>success</u> of a business and its <u>reputation</u> (general perception of the company).
- The public interest in corporate social responsibility of businesses (CSR) is growing.

"Business practices rooted in universal values can bring social and economical gain" Ban Ki-Moon

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Managing tax risks – what is the challenge for the board?

- Tax risks include: overpaying taxes or paying less tax than legally required.
- Reputational damage from tax errors, can incur in costs which are hard to measure.
- Errors in assessing the tax effects of transactions can lead to wrong business decisions.
- Taxes are a cost factor important for competitiveness.
- **Tax risks consist of: compliance, transactional, operational and reputational risks.**
- Therefore, there are good reasons for the board to be involved in tax risk management.
- It is important that a board goal is to implement a tax risk management process with a balance between risk and opportunity.

Background

<u>Enhanced Tax Relationships</u>

- OECD creates the Forum on Tax Administration (FTA) (2002)
- Final Seoul Declaration (2006)
- 4th meeting FTA Cape Town (2008)
- 5th meeting FTA Paris (2009)
- 7th review FTA “Strengthen tax compliance through cooperation" (2012)

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Enhanced Relationships

- Enhancing relationships between tax administrations, taxpayers and tax intermediaries and encouraging good corporate governance is important for both tax administrations and large business.

- The Seoul Declaration refers to: *"Encouraging management and audit committees of large enterprises (e.g. CEOs and boards of directors) to take greater interest in, and responsibility for, their tax strategies."*

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Enhanced Relationships

- OECD Cape Town Communiqué notes as “the way forward”:

“…We also noted the work in progress to explore opportunities for the application of the OECD"s Principles of Corporate Governance in the area of taxation and will continue to share experiences in undertaking dialogue with the Chairs and Boards of listed companies about the approach they take to managing taxation risks… .”

<u>“…we will continue to encourage a global dialogue with large corporate taxpayers and their advisers….</u>”

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Enhanced Relationships

- Tax administrations and large businesses want greater certainty.

- Tax administrations look for certainty in voluntary compliance with tax laws and large businesses having good governance arrangements in place.

- Large businesses look for certainty about which of their behaviors and transactions the tax administration is likely to see as risky, and how the administration is likely to respond to those risks.

- Some tax administrations introduced and are developing initiatives encouraging that large businesses consider <u>good corporate governance</u>, enhancing relationships supporting tax risk management.

Good Governance Approach

According with OECD, a good governance approach in relation to tax might include the following features:

- A sound framework to manage tax risks and comply with tax obligations.
- A well resourced in-house tax capability.
- Reporting requirements that ensure that significant tax risks are elevated to decision makers such as the CFO, CEO, the Board or its Audit Committee.
- Appropriate review and sign off procedures for material transactions.
- An effective tax risk mitigation capability including the business relationship with the applicable tax jurisdictions.
- Capacity to regularly evaluate the effectiveness of tax governance systems.

Examples of benefits of the enhanced relationship and good corporate governance focused on taxes

- By moving to a more consultative and collaborative relationship, the tax administration can better understand the business and its environment. The administration is therefore better placed to identify risk and help business to improve certainty through ongoing open dialogue.

- By appropriately considering and working to reduce significant tax risks, boards of large businesses can increase the standard of their corporate governance and their awareness of the implications of major transactions.

- Large businesses that have good corporate governance practices and enhanced relationships with the tax administration will generally experience fewer audit interventions. This contributes to greater certainty and the potential of reduced tax compliance costs.

- Dialogue between the tax administration and large business about tax risks in „real time", can reduce the incidence of tax shortfalls and administrative penalties.

Review of tax awareness

Multinational business should analyze of how does tax risk management looks like in relation with good governance and ask themselves if they have the following:

- Strong internal control mechanisms.
- Independent external audit committee.
- Separation of the role of external auditor and external tax advisor.
- Tax operating standard/code of conduct and assurance processes to confirm adherence.
- Clear accountabilities in relation to tax decisions.
- Use of the Tax Office rulings system for material transactions.
- Openness and transparency with tax officers.
- Responsive to changes in the environment, law etc.
- Tax is considered as part of the decision making process for major transactions.

Review of tax awareness

The following questions should be asked and answered by the board of a company:

1. Are you confident that your records and control systems enable your group to meet its tax obligations properly?

2. Are the amounts of tax you are paying and your pattern of tax payments in line with your current and previous business results?

3. Is there anything to indicate that your group´s business results and tax payments are lower than would be suggested by economic conditions and the performance of others in your sector?

4. If your group is consistently reporting losses, are these real economic losses and can they be satisfactorily explained in terms of the group´s overall performance?

5. Is there a material difference between the losses reported for accounting purposes and the losses claimed for tax purposes?

6. Is your group making the necessary changes to its processes and giving proper consideration to major transactions and strategies to take account of changes in the tax laws?

7. Are you aware of any material timing or permanent differences in the group"s tax effect accounting and, if so, are you comfortable with the reasons for those differences?

8. Are there any areas of major disagreement between your group and the tax authority? If so, are you satisfied with the way they are being handled? Have any additional tax liabilities been adequately provided for?

Review of tax awareness

As well any board should answer the following questions:

1. What commercial objectives are being sought by the proposed strategy or the ownership and financial structure being proposed for a major transaction? Is there a genuine and material financial benefit for your group apart from any effect on the group´s tax position? Are the tax results at odds with the commercial results?

2. If the structure and financing for your group´s business or a major transaction is complicated, is this because the business issues are complex? Is it more complex than necessary to achieve the commercial objectives? Are there additional steps designed primarily to reduce the taxes that would ordinarily be payable? Is the form of the transaction or strategy consistent with the substance of the arrangement?

Recent developments

- Countries are introducing legislation and standards that require large business to provide greater transparency in their financial reporting. (Sarbanes-Oxley („SOX"))
- In the USA FIN 48, now requires an analysis of material tax positions in financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.*
- FIN 48 and SOX are not only relevant to USA companies, also can apply to USA foreign subsidiaries and other non USA entities registered with the USA Securities and Exchange Commission.
- Leading practice boards in many countries are mandating that tax risk be managed like any other enterprise risk. CEOs and boards are asking more complex questions about how their organization manages its tax risk exposure.

There is now a greater awareness of tax in the boardroom. As Jeffrey Owens observed:

"What is clear is that the recent spate of corporate scandals, the success of a number of tax administrations in challenging aggressive tax schemes and the general change in attitudes towards tax planning, will all combine to produce a greater awareness in the Boardroom of the importance of tax issues."

Recent developments

- Companies listed on the Dax-30 (German Index) such as Adidas, Allianz, Bayer, BMW, Henkel, VW, Lufthansa, shows that the deferred tax assets can easily amount 40% of the equity of a business. This means that if the tax asset is impaired almost half of the equity may be wiped out.

- Amazon, Google and Starbucks carried out aggressive tax practices in Europe using countries with low tax rates in order to avoid tax payments therefore the European Community took actions to prevent it (UK). https://www.youtube.com/watch?v=3TeZlt3dRig

Recent developments

- The management of tax risk more important in the light of recent changes.

- The public, shareholders and legislators <u>expect board members to address</u> these effects through the corporate governance system of a business.

- In connection with recent events, the OECD states:

"What is clear is that the recent spate of corporate scandals, the success of a number of tax administrations in challenging aggressive tax schemes and the general change in attitudes towards tax planning, will all combine to produce a greater awareness in the Boardroom of the importance of tax issues"

Key Suggestions

Strategy

- The tax strategy should be understood and approved by the board and communicated within the business.

Risk management and control

- Tax should be an integral part of the internal control and the risk management system of a business. Publishing the tax philosophy and tax strategy is important as is a control environment that ensures that deviations from rules are dealt with.

Profile, relationships and communication

- The tax department should be one of a business partner across the various business functions with clear contact points. The tax department has a role as both an external and an internal contact point and therefore needs to be aware who its stakeholders are (e.g. the tax authorities, financial market, legislators). External and internal relationship management is a key success factor.

Processes and technology

- Processes and controls in a tax department should be documented not only to comply with SOX and other corporate governance regulations but to allow regular evaluation and improvement. The tax technology system should be part of the accounting system of a business.

Planning

- Tax planning can only be effective if there is access to management information and decision makers of the business. Procedures need to be aligned with risk policies.

Conclusions

- Tax administrations have an important role in ensuring that boards understand that they are responsible for their business´s tax strategies and outcomes.

- Tax has become an ethical and reputational issue and the board is responsible to ensure awareness of tax issues throughout the organization.

- Whilst still work in progress, the experiences in diverse countries in encouraging good corporate governance and enhancing relationships with large businesses highlight a number of common benefits, challenges, and suggested best practice considerations that other tax administrations may find helpful.