

Tax Risk Management



Tony Elgood
Tax Partner
United Kingdom

Tony Elgood is the author of The 'Best Practice' tax function guide. He is based in the UK and is part of PwC's Global Compliance Services team. He works regularly with leading tax functions in helping them set their strategies and manage their tax functions.

For further information:
anthony.b.elgood@uk.pwc.com



Ian Paroissien
Tax Partner
Australia

Ian Paroissien is the leader of PwC's Global Compliance Services for Australia and the Asia Pacific theatre. Ian advises many leading companies on best practices and developments in tax management and compliance systems.

For further information:
ian.paroissien@au.pwc.com



Larry Quimby
Tax Partner
United States

Larry Quimby, is a US based tax engagement partner working with a number of our Philadelphia based clients. He is currently the national lead for an initiative addressing the application of the Sarbanes Oxley Act to the tax function.

For further information:
larry.b.quimby@us.pwc.com

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1 INTRODUCTION

In early 2002 we published a guide entitled the 'Best Practice' tax function. In that guide there was one chapter (seven pages) on Tax Risk Management. Since that guide was published the corporate world has changed dramatically and risk management has shot up the agenda of most organisations.

We have seen the Enron scandal in the US, and more recently the Parmalat scandal in Italy. The US has responded with the introduction of the Sarbanes-Oxley legislation, and with an ongoing increase in globalisation, similar legislation and practices are springing up in a number of different countries. Inside organisations there is an increasing awareness that risk management, and in particular, good internal control procedures is becoming more and more important.

Historically tax risk management and tax internal controls were a bit of a black art, not necessarily understood even by those in the tax function, let alone those outside. Whilst recognising that the tax area has its own unique profile, tax risk management is now increasingly being discussed inside both commercial organisations and revenue authorities. Companies are starting to document their tax risk management policies and to do this they are having to assess the different types of tax risk in their business. Some organisations have also recently appointed internal tax risk managers.

The purpose of this guide is to pull together the current thinking on tax risk management. It is aimed not only at tax directors and their teams, but also at CFOs, audit committees, chief risk officers and internal audit functions. These stakeholders, including those sitting outside the tax function, need to be comfortable that there is a tax risk management policy in their organisation, that tax, as one of the key costs in the business, is being properly managed and that the inherent risks in the tax position of the organisation are being both understood and properly controlled.

Tax risk management has come a long way over the last couple of years and will continue to evolve. This is not a manual about how to manage tax risk – different businesses will address their issues in different ways. What we have tried to do is to set out firstly the issues that need to be discussed when a company is deciding on its policy and addressing its approach to tax risk management, secondly a framework for managing the risks and finally some specific tools and techniques that can be used in doing so.

We look forward to being part of the debate as this area of tax management continues to develop in the fast changing commercial world in which we find ourselves.

2 WHAT IS TAX RISK?

The term tax risk means different things to different people and we need to start with a common understanding of what it is we are talking about. Only then can we address how tax risk can be managed.

The decisions, activities and operations undertaken by an organisation give rise to various areas of uncertainty – business risks. Some of these uncertainties will be in respect of tax. These tax uncertainties may be in relation to the application of tax law and practice to particular facts, it may be uncertainty over the facts themselves or it may be uncertainty as to how well systems operate to arrive at the tax results of the business activities and operations. These uncertainties give rise to tax risk.

Managing tax risk is therefore about managing these uncertainties. Due to the very nature of these uncertainties, there is often no one right answer. Tax risk management is about understanding where these risks arise and making judgement calls as to how they are dealt with.

We have sought in this chapter to provide an explanation of where we see the main areas of tax uncertainty arising. This has led us to define seven main areas of tax risk. We have quite intentionally not tried to do any analysis by type of tax – suffice it to say that we include all types of tax

under the umbrella of tax risk management, irrespective of whether they are taxes managed by the tax function or not. They all give rise to uncertainty and hence to tax risk.

For any type of risk, you not only need to understand what it is but you also need to decide how much risk you are willing and prepared to take. To our mind tax risk management is not necessarily therefore about minimising risk. Businesses make profits by taking risks and a no-risk strategy is probably neither cost effective nor right for any business. By setting a framework scale (or a score out of 10), against where you either want to be or are prepared to be for each type of tax risk, you give yourself some criteria against which to decide what actions need to be taken, what risks you are prepared to take and how any particular type of tax risk is to be managed. For each area of tax risk this chapter provides such a framework scale.

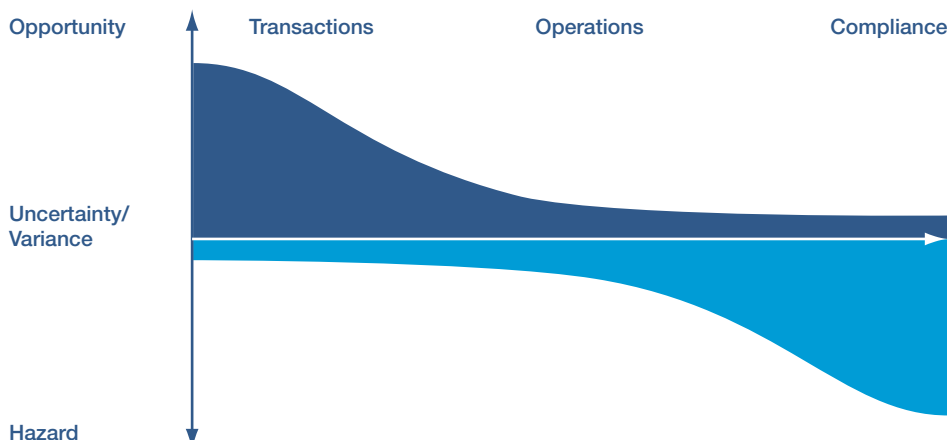
The tax risk spectrum below shows where the major tax uncertainties can arise. It shows the upside opportunity

that can arise from business transactions, the downside hazard which can arise from the compliance process and the fact that the operational part of the business can give rise to both opportunities and hazards. Ensuring that the opportunities are maximised can be as important as managing the hazards.

A company's policy on tax risk management will therefore determine:

- The value that can be achieved by taking risks,
- The costs that can be saved by reducing risks, and
- The resources needed to manage both the upside opportunities and the downside risks

Before we proceed, we should make it clear that we believe each business has a responsibility and duty to pay the appropriate taxes on its business transactions. We also feel strongly that it is important for organisations to manage and plan their tax affairs. However we do not believe it is right for a business to play the 'tax audit lottery' with the revenue authorities. This chapter and, indeed, the whole guide, are based on the fundamental premise that non disclosure to authorities is not an acceptable approach and that the 'risk of getting caught' is therefore not a consideration or risk to be 'managed'.



Types of Tax Risk

In our view there are seven broad categories of risk associated with taxes, four that are specific risk areas and three that are rather broader and more generic.



These are:

Specific risk areas

- 1 Transactional risk
- 2 Operational risk
- 3 Compliance risk
- 4 Financial accounting risk

Generic risk areas

- 5 Portfolio risk
- 6 Management risk, and
- 7 Reputational risk

Specific risk areas

Transactional risk

This concerns the risks and exposures associated with specific transactions undertaken by a company. In any transaction there may be uncertainty as to how the relevant tax law will apply and uncertainty arising from specific judgement calls – particularly in the more complex areas.

The more unusual and less routine a particular transaction is, then generally, the greater the tax risks associated with the transaction are likely to be. One-off, non-routine transactions, such as acquisitions/disposals of businesses or parts of a business, or significant restructuring projects and reorganisations, will generally bear greater tax risks than the routine every day business such as selling products and services. In addition there are likely to be well-designed procedures and systems in place for the processing of routine transactions, which would usually not apply to non-routine, one-off

transactions. From a tax point of view the highest risk transactions are often those that are happening specifically for tax purposes e.g. a tax driven reorganisation.

In any transaction there will be views taken during the process as to what is acceptable and what is not – risks will undoubtedly be taken. This is in the very nature of the way transactions and negotiations are carried out. Some parts of a transaction may be carried out to achieve a particular tax result (for example to preserve tax losses). The steps taken to achieve the hoped for tax result may be low risk or they may be more aggressive with more chance of being challenged by a revenue authority.

Major transactions have for some time been a key focus for tax authorities but the signs are that this is increasing. In Australia for example, the Commissioner of Taxation has just written to the boards of all public companies indicating that as part of their governance responsibilities they should be signing-off that the tax

risks have been properly assessed and are appropriate. In doing so the Commissioner has provided boards with 10 questions or criteria against which to judge this. (For more details on the Australian Commissioner's position see Chapter 3.) The appropriateness of this and the issues it raises are a major discussion point in themselves but it does highlight the growing profile and importance of tax risk management in this area.

Additionally tax risks can arise from failures, such as:

- The tax department is not involved in the transaction or are brought in only at the last minute;
- There is no organisational agreed framework against which to judge acceptable risk; and/or
- There is a failure to properly document and implement a transaction.

In our view this last point often carries the greatest risk in the transactional area. Failure to implement and document properly what has been planned and agreed is in our experience the cause of more tax authority challenges in this area than any other. Where the tax result depends on a particular sequence of events, board meeting or wording in a documentation there is often the risk that the 'i's are not dotted and the 't's are not crossed – and all the best planning falls down due to inadequate implementation and monitoring over the life of the issue to ensure nothing is done to prejudice the tax result. Revenue authorities are increasingly asking to see the full documentation relating to a particular transaction to test out whether the implementation has achieved the result the company is claiming.

The question then arises as to how much tax risk are you prepared to take in particular transactions and how much risk are you actually taking over the correct implementation of the transactions? What is your profile in relation to transactional risk?

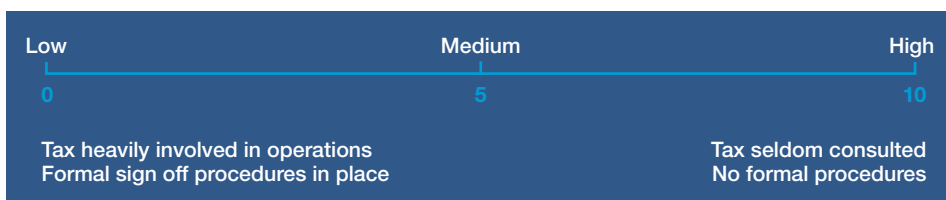


It is important in considering this scale to indicate where you want to end up as distinct from the inherent risk in the transaction or planning idea. Risks identified can in many cases be managed, such that a risk initially identified as above an acceptable level may be capable of being brought within it by a tax ruling or some other approach. This recognises that risks can be managed so that the potential upside benefit is not lost.

Operational risk

Operational risk concerns the underlying risks of applying the tax laws, regulations and decisions to the routine every day business operations of a company. Different types of operation will have different levels of tax risk associated with them. For example, compare normal third party product sales with intra-group cross-border products sales; there are greater tax risks associated with connected party cross-border transactions (primarily transfer pricing issues). With increasing globalisation of trade there is an ever increasing risk of operational people inadvertently creating a taxable presence in a country in which they are operating. These are just two examples of tax risks that can occur from the normal ongoing business of a company.

In our experience the closer the tax function is to the business operations the better these types of risks are managed. Communication between the various parties is key. The standing of the tax function in the organisation will be an important point here; if the people are well respected, then they are more likely to be contacted at the appropriate time. Where are you today on the operational risk scale – and where would you like to be?



Compliance risk

Compliance risk concerns the risks associated with meeting an organisation's tax compliance obligations. (As we noted earlier, we do not believe risk of discovery by tax authorities is a factor. One must assume full disclosure and that the authorities are aware of and will review your activities.) From a tax perspective compliance risk would primarily relate to the preparation, completion and review of an organisation's tax returns (of whatever type and not only corporate tax returns) and the risks within those processes.

Compliance risk addresses the risks implicit in the systems, processes and procedures adopted by a company to prepare and submit its tax returns and in responding to any enquiries/issues raised in the process of reaching an agreed position with the authorities.

What we are talking about here is:

- the integrity of the underlying accounting systems and information,
- the processes of extracting tax sensitive information from the accounting system,
- ensuring the tax compliance analysis processes are based on up to date knowledge of the latest tax law and practice, and
- the proper and efficient use of technology in the processes.

There are clearly cost implications in where you position yourself on the scale below and there will be a trade off between costs spent and risks taken. To achieve no errors in any tax return will undoubtedly be cost prohibitive. Alternatively, are you over engineering the process and could you reduce the cost with little or no impact on your risk position? What is your attitude to tax penalties? Where do you want to be on the scale above – and what changes need to happen in the way you operate to get you there?



Tax compliance risk also includes the risks arising from agreement of tax returns and from enquiries on, or the audit of, submitted tax returns by fiscal authorities. In a number of countries the final agreement of a tax return often ends in a 'horse trade' between the taxpayer and the relevant revenue authority; it may make sense to have a number of aggressive positions in the return so that there is something to give as part of any negotiations.

Additionally, and we will come back to this point later on, how many of the group's tax returns is the tax function actively involved with? What about payroll tax returns, indirect tax returns, and customs and duty returns? If it is not the tax function, who is managing the risks associated with these returns?

There is also an interaction between compliance risk and reputational risk (see below). How do the revenue authorities rate you on a risk scale? Do they see you as an aggressive tax planning group and have 'marked your card' as one where they have to do a lot of work – or are you seen as a more conservative group where they have little to go for?

Financial accounting risk

The Sarbanes-Oxley Act of 2002 has brought the risks in the financial accounting area into sharper focus. A particular challenge for many tax departments is the requirement in Sarbanes-Oxley Section 404 requiring documented and tested internal controls over financial reporting.

At this point one should note that in most jurisdictions the figures included in the tax accounts, at the time the financial statements are issued, are 'estimates'. In fact, deferred tax accounting generally calls for the estimation of future taxes to be paid under tax regimes on transactions that are recorded in the accounts in the current year. Avoiding negative prior year adjustments to the tax accounts has always been high on most tax directors' agendas. We have lost count of the number of times we have been told by tax directors that what the CFO and board are looking for is 'no surprises'. This has probably led tax directors to be more risk averse than they might have been (and to miss upside opportunities?) This conservative view as to what should be provided for in the accounts may lead to a debate with the auditors as to whether a provision is justified or is perhaps a touch over prudent.

As well as looking at the processes in arriving at the accounts figures, and the internal controls around these processes, the following questions need to be asked:

- How much uncertainty is there in the interpretation or application of the tax law(s) used to compute the tax figures?
- What is the quality of the data received from or used in the transactional, operational and compliance areas?
- Are there issues or questions as to the application of the tax law to the data?
- What provisions are needed to cover these uncertainties and what level of materiality is acceptable?



It will be interesting to see how companies apply Section 404 to the tax accounts. The 'spirit' of the law would suggest that better information and more timely consideration of risk will evolve. Some have suggested a mechanical 'check the box approach' to the adoption of the requirements of Section 404. We believe that the mechanical approach may cause a number of tax functions to focus too heavily on the processes in arriving at the tax figures in the financial accounts – at the expense of the processes of managing the other tax risks considered in this chapter. These other tax risks are potentially the ones that have been less well managed and are where there are both larger opportunities and greater risks.

Clearly it is not only the statutory financial accounts where financial accounting risk arises. Tax figures appear in cash flow planning, forecasting, and in managing investor expectations of the future.

Generic risk areas

You could argue that the four specific tax risks set out above are the only ones that really exist, and the risks we set out below are more about managing these risks than risks themselves. However we believe them to be sufficiently important to be treated as separate risks in their own right and to be reviewed as part of the tax risk management process. If you disagree with us then some of the tools introduced later in this guide will need adapting to show four risk areas, not seven. However whichever way we go on this point, the general principles of tax risk management will not change. The three areas of tax risk that we are calling the generic tax risks are explained below.

Portfolio risk

Portfolio risk concerns the overall aggregate level of risk when looking at transactional, operational and compliance risks as a whole and considers the interaction of these three different specific risk areas. This is of particular concern to those organisations that are involved in a number of transactions, whether tax driven or business driven. One might argue that the financial reporting is the measure of the portfolio risk and well it might be. However, we believe that a conscious consideration of the aggregation of the three risks should be considered.

Each particular transaction may be below the 'risk threshold', but when combined together with positions taken with various revenue authorities the cumulative risk profile becomes unacceptable.

What would be the impact if all the areas of tax risk went wrong at the same time? What would be the financial implications and what would be the resourcing implications to deal with the issues?

Have you given each key tax risk in your organisation a percentage chance of going wrong and aggregated the result? Have you considered the worst-case scenario and the impact of this on the profit and loss account and the balance sheet? Is this acceptable?

We look later, in Chapter 6 and Appendix 2, at how you might measure portfolio risk by considering both the impact and the probability of particular risks actually happening.



Management risk

The second generic area of tax risk is one of not properly managing the various risks set out above. In our experience, few tax functions actually have a documented tax risk management policy, though we are starting to see tax risk managers being appointed. Risk management is something that historically has not specifically been on the agenda for many tax functions. While some of the risks above will have been managed, we suspect few people will claim that all their tax risks have been managed in a systematic way. Even where it has, a lot of the information about tax issues is carried around in people's heads and if these people leave the organisation then the information leaves with them.

In this new world, with tax risk management becoming increasingly important, it is clear that organisations need to put some time and resources behind this issue. They also need to ensure that those charged with managing tax risks have the skills and the ability to do so. 'Under-managing' these issues, either through a lack of skill, resource or time can lead to unexpected 'surprises' or possibly worse, missed opportunities. Tax risk management will need to become a higher management priority for many organisations.



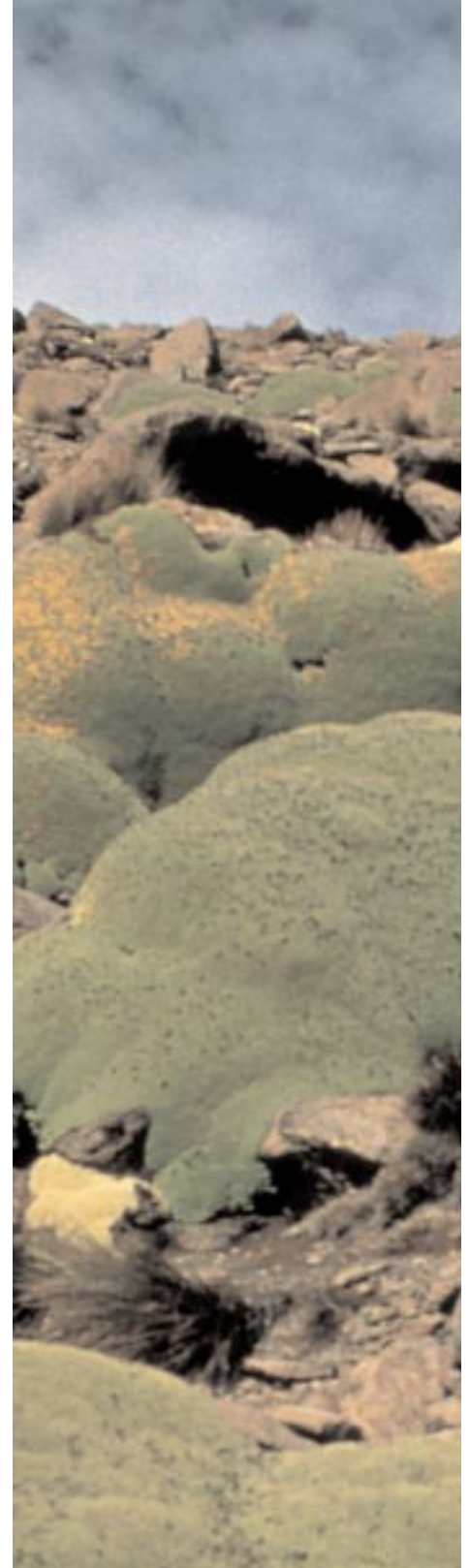
Reputational risk

We have collected a file of press cuttings relating to the tax affairs of companies – and this file is becoming increasingly bulky. How will your CEO or the board react to seeing your tax affairs splashed all over the front page of a national newspaper (or even on the inside pages)?

issue through a public arena such as the courts, information about the company's activities or practices result in changes to the perception of the company by its customers, suppliers, or employees.

Reputational risk concerns the wider impact on the organisation that might arise from an organisation's actions if they become a matter of public knowledge. By their very nature such risks will impact wider business interests. For example, consider the impact on a company if, as a result of pursuing a tax

Consider also the impact of being seen to pursue considerably more aggressive tax planning and ideas than the norm – does this matter to you?



More than one tax strategy we have seen have included policies such as “We will not undertake any tax planning transaction which would reflect adversely on the group if details of it were to be published in the business pages of [Daily Newspaper Title].”

By way of an example, in the US it is proposed that failure to disclose certain ‘listed transactions’ under the Reportable Transaction Regulations will result in a fine. For an SEC listed company, the fact that a fine has been levied may have to be disclosed in the published accounts. The potential disclosure of the failure to report properly certain transactions to the Inland Revenue Service could however be more concerning than the fine itself.

For MNCs (multi national corporations) this issue may also go to the heart of good corporate citizenship, particularly in foreign jurisdictions where reputational risks may be more important in some countries than at home. It is also where cultural differences and policy clashes can occur. Identifying and managing issues such as the impact of aggressive tax planning, reputational issues just from major tax authority challenges, and policy and practices around corruption, are all elements of reputational tax risk management.

This leads on to the question of tax ‘ethics’ and whether companies have an obligation to pay their ‘fair share’ of tax – whatever that might mean. There is a debate taking place in many countries around this point – and whether companies should pay the tax that is in accordance with the letter of the law, the spirit of the law or both (if that is possible). To be seen to be doing anything different can impact on a company’s wider reputation. Is transparency of your tax position an important part of managing your reputational risk?

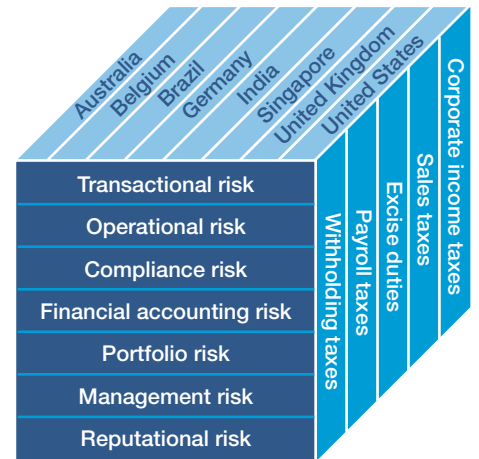
External risks

The comments so far have focused on the risks that are manageable inside an organisation. There will also be risks that are external and by their very nature are unmanageable – but are very real and equally important nevertheless. Examples under this heading are a change of legislation, an unexpected court decision on a particular point, or even a change of government. The rest of this guide focuses on those risks that a business has some control over – but perhaps portfolio risk should be deemed to include this extra layer of external risk.

Use of the scale frameworks

In our discussions so far, there is an assumption that there is one point on the scale for each of the different types of risk. However we recognise that this assumption may not be valid when you look across the spectrum of different taxes and different countries. For example you may well decide that the compliance risk you are prepared to take for one particular tax in country A is very different from that for another type of tax in country B.

You may wish to put the different taxes and countries at different points on the scales. This leads us to a three dimensional matrix, covering the types of risk, the types of tax and the different countries in which you operate.



It is likely that the mere exercise of compiling the information and considering the areas of tax risk that we have discussed in this chapter will significantly enhance a company’s management of tax risks.





Other activities

In our experience tax functions often have a wider remit than just tax. Tax and treasury are sometimes the same department; tax functions are often responsible for the preparation of statutory accounts as they are the people who need them most – to enable them to file the tax returns.

The purpose of this guide is to focus on tax risk management and we have not sought to stray into the other activities that may be carried out by the tax function. That is not to say that the risks in these areas do not need managing.

Summary

We have set out the seven areas of tax risk, together with a scale of one to ten for each one. By reviewing all seven scales, it should be possible to produce one overall scale summarising your organisation's attitude to tax risk management. You should be able to consider where you want to be on the scale – and where you are today. This will give you a template to consider further what actions you need to take going forward.



Very few organisations will be positioned at either end of this scale.

The organisations on the left hand side might be the ones who:

- Are inherently cautious
- Spend more time managing risk
- Are more concerned about compliance risk
- Are concerned about their reputation

The organisations that position themselves on the right hand side of the scale:

- Are more aggressive
- Accept that they will have more compliance risks
- Have a higher materiality level
- Are less concerned about upsetting revenue authorities
- Spend less time managing tax risk

We look in more detail in Chapter 4 as to how tax risk management fits into the bigger picture both in terms of managing tax and managing risk in the organisation as a whole. However before doing so can you answer the question below specifically in terms of tax risk management.

Where are you today – and, more importantly, are you where you want to be?

3 WHY IS TAX RISK MANAGEMENT IMPORTANT – AND WHO TO?

We have set out in the previous chapter our view of the different types of tax risk. This chapter seeks to identify the different parties who have an interest in an organisation’s tax risk management. We will explore why they are, or should be, interested in this subject. We are also presenting a view as to who should focus on (or take ownership for) each of the various risks outlined in Chapter 2. Our analysis of this latter point is undoubtedly open to challenge – but if it gets the reader thinking through their role and responsibilities with respect to tax risk management then our objective will have been achieved.

There are (or should be) many stakeholders, both inside and outside the organisation, involved in managing risk, and in particular managing tax risk. The first

point therefore is to consider who, in addition to the tax function, are the stakeholders in a business’s tax risk management?



The board

There is a tendency to equate the board’s view on tax risk management closely with their view on corporate governance. However a board’s role is first and foremost to give direction to the overall running of the business so let us look at this aspect first.

We would suggest that until now there has been little or no engagement or understanding around tax risk management at board level – with such matters normally being delegated to the CFO and the head of tax. We question how many boards of companies have seen and considered a documented tax

risk management policy. This, we believe, is the starting point for effective tax risk management.

(We recognise that the role and responsibilities of the board of directors may vary by country. While the level of involvement of the board in day-to-day operations may be different, it is clear that the board is and must be the key stakeholder in the management of risk. As noted below, the board could be the entire board of directors or if applicable the audit committee of the board. The key point is involvement by persons not responsible for ‘day-to-day’ management.)

The templates in Chapter 2 might be used as a starting point for engaging the board in the debate as to what is the group's tax risk management policy. Have they properly considered both the benefits and the costs of the various approaches to tax risk management – how aggressive or conservative do they want the group to be? How does this fit in with the risk management policy for the group as a whole? How does this fit in with the group's overall tax strategy?

Historically, we have found that, when asked, boards may have perceived that the tax function was one where there was 'low risk'. In fact, the board may have perceived (and expected) the company to be taking a more aggressive approach to tax risk management than the tax function was actually adopting. The process of discussing a tax strategy with the board is, in our recent experience, changing and adding direction to and support for what the tax function is expected to do. Whatever the view of the board, getting the tax strategy in front of them is good for the profile of the tax function.

Perhaps the two key tax risks the board should focus on are portfolio risk and reputational risk. The board should have a general understanding of the organisations 'risk profile'. The portfolio risk addresses this 'profile' for tax. Of equal or possibly of greater importance is a view on reputational risk. It is important that the board understands the impact on reputation that the organisation's tax positions (or lack thereof) may have within the business community or the community at large. A consistent position, along with board support for the resources needed to manage reputational risk, are key to successfully addressing this area.

A documented tax risk policy that is embraced by the board is also crucial for good corporate governance. The board not only sets the tax risk/reward philosophy of the business, it also sets the tax risk management framework and the whole ethos as to how risk is assessed, how management controls operate within the business and how they are monitored.

The rules, regulations and commentary generated by Sarbanes-Oxley have been driving most of the current thinking in this area, even where a group is not SEC listed. The Sarbanes-Oxley rules require detailed documentation of the design and operational effectiveness of internal controls to be in place – and documentation of tax risk management policies and controls is not something we have seen in many organisations. Best practice would suggest that whatever the tax function (or others) produces in this area should be acknowledged and embraced by the board.

In some countries revenue authorities have also been driving thinking in this area. In Australia for example, the Commissioner of Taxation has written to public company boards stating, "It is important that the board identify the taxation risks associated with their organisation's operations, which risks are acceptable and appropriate, and which are not, and put in place a process for the management of those risks."

The view expressed was that in respect of major transactions and arrangements it was not sufficient for boards to rely simply on tax functions and external advice but should focus beyond tax outcomes to questions of probability, level of aggressiveness, likely tax office response and the implications of alternative outcomes.



In this context the Australian Commissioner posed 10 questions boards should be asking in this area:

1. What level of confidence do you have in the correctness of your advice?
2. How likely is it that the tax office will take a different view of the application of the law and assess the company accordingly?
3. If the Australian Tax Office takes a different view and the matter proceeds to litigation, what is the risk of the Federal Court or the High Court deciding the matter in favour of the tax office?
4. What is the potential downside if the company is unsuccessful in litigation with the tax office?
5. If there is a dispute, what is the likelihood of the tax office being prepared to settle the dispute and, if so, on what terms?
6. How likely is it that the tax office will identify the tax issues that arise from the proposed course of action? Allied with that, to what extent will embarking on the proposed course of action increase the tax risk profile of the company and increase the possibility of audit scrutiny?
7. In light of the potential risk, would it be desirable to approach the tax office for guidance in the form of a private binding ruling?
8. Where a position has been taken on a tax issue, would it be desirable, in the interests of appropriately managing any risk, to be up front with the tax office in identifying the issues before or when lodging the tax return and endeavouring to constructively handle any disagreements which may ensue?
9. Is the advice based on the actual transaction or on an expectation of how the transaction will be implemented?
10. Are you satisfied that the factual basis for your opinion to the board has been properly checked?

This of course raises a whole series of issues and questions to be addressed. These range from whether these are the right questions and whether this is in fact the right level to be asking these questions. (Should it be the audit committee, CEO, CFO or the tax director?) Issues range from the capacity of the board to make appropriate judgements to content and tax office access to board papers. In our view many of the matters raised in these questions can be dealt with by appropriate policies that the board has signed off on, and controls to ensure those policies are adhered to.

Just how far the board should go is an open question, the discussion on which has only just begun. We would say that, in this new world of greater governance and responsibility of boards, greater involvement than we currently have seen does seem appropriate. In this regard, involvement in ensuring there is an appropriate risk management framework and policy in place, that it fits in with the organisation's overall attitude to risk management and that a process for ensuring that this is functioning as intended, would be an important place to start.

The CEO and CFO

Historically it has been the CFO who represents tax at board level and to whom most heads of tax report. However we are seeing pressure in some countries for CEOs to become more actively engaged in the tax area – whether because of the need to sign off on accounts or from external pressures (e.g. the above debate being initiated at CEO level by the Australian Tax Office). We have therefore combined these two positions in terms of stakeholder consideration – whilst recognising that more of the responsibility for tax risk management will likely fall on the shoulders of the CFO than the CEO.

The points discussed above concerning the board's involvement in tax risk management obviously apply to the CEO and CFO as members of the board. However their interest in tax risk management will go further. The CEO and CFO, having had high level input into the strategy design, should be using it as a framework for participating in significant tax related decisions both on the transactional side and possibly also on the operational side.

They clearly have an interest in the figures in the accounts and hence in financial accounting risk. They may even be personally at risk if major restatements or prior year adjustments arise in the accounts.

They are also responsible for monitoring how tax risk is being managed and how the tax department is performing (tax management risk). We come back to the point that in today's environment it is important that the leadership view of the tax function's risk profile is consistent with practice. Where there is a disconnect there can be surprises for the CEO and CFO from adjustments to the accounts or missed tax savings, and frustrations on the part of the tax function when information provided or resources allocated are not sufficient to achieve the risk management targets established.



The head of tax and his/her team

Obviously the tax function is responsible for managing the majority of tax outcomes, and the actions and activities that create tax risk. It is also the first point of contact in tax risk management. What therefore are the head of tax's objectives in relation to tax risk management? Do they buy in to the concept that tax risk can be managed? How do their objectives on risk management fit in with those set out by the chief risk officer? What framework is used to measure risk and does the tax function participate in developing the scores? Is the head of tax trying to make a name for themselves by taking risk – or do they come from the 'no surprises' school where tax risk management is about avoiding potentially contentious or aggressive positions? How secure do they feel in their jobs? Will they now be signing off, to the CEO or CFO, that the tax figures in the accounts are acceptable – and if the group is SEC listed, also on the internal controls over tax?

Whilst the board will agree the strategy, in practice it is the head of tax who will set the whole tone on tax risk management for the rest of the organisation – whether it is the tax team doing the tax returns or the advice and support provided to operational and other teams doing their jobs. It is therefore vitally important that the head of tax, CEO and CFO, and the board are in agreement on the group's tax risk management policy.

The one area where we see some gaps is with MNC's foreign subsidiaries. In many cases tax is the responsibility of the local CFO in the foreign subsidiary with indirect line responsibility to the head of tax. In these circumstances there is a real risk that tax risk management is falling between the cracks and it is important that clear responsibilities are established. This point is explored in more detail in a later chapter.

The head of tax will, or should, be involved in all areas of tax risk management. However they will usually have prime responsibility for the

management risk – ensuring that the right people are in place to manage tax, ensuring these people have the right skills, and ensuring that the appropriate processes and procedures are in place.

But however good the tax risk management policy of an organisation is and however much leadership and discussion there is at board level, the head of tax and his/her team will deliver what they are being measured on. This begs the question as to what are they measured on – and what are the consequences for them personally if, having taken a risk, revenue authorities take different positions or impose arbitrary adjustments.

We would encourage those setting objectives for tax functions to build tax risk management into such objectives – and to identify acceptable levels of risk (whatever that might be for that organisation) in order to add value to the business. Once risks have been taken, tax functions will need support if things go wrong – and praise when things go well. We will look at how tax risk management can be monitored in a later chapter.

Business units and functional areas

The interest in the management of tax risks by the other business units and functional areas of the organisation will vary based on the broader management and risk profile of the organisation. For example, the level of interest by management of a business unit will be closely aligned with whether the unit is measured on a pre-tax or after-tax basis. The business unit's accountability for information provided to the tax function (or responsibility for transaction taxes within the unit) will also drive the level of interest. In a similar manner the legal department will need to understand where the business sits on transactional risk. The treasury department will want to know what tax is payable – and what tax might be payable if some of the risks taken do actually crystallise. This may include both transactional risk and compliance risk. The

business planning team may well be dealing with forecasting, both of tax charges in the accounts and cash going out of the business.

The finance department will nearly always play a key role because it is impacted by tax in many ways. Its own responsibilities can vary from managing expectations around the effective tax rate through processing the results of operational activities to full responsibility for tax in foreign jurisdictions. The finance department is nearly always involved in the implementation of significant transactions and will also often be involved in producing detailed information for the tax returns – how much detail does it need to go into, what level of materiality is appropriate for different tax returns? In all these areas it will need to understand the full range of the tax risk profile of the business.

To do their job properly internal auditors will need to understand the group's position on tax risk. This is applicable to any role they may have in monitoring controls or in reviewing the tax function. Historically we believe that internal auditors may have found reviewing the tax function as one of those items that goes in the 'too specialised' basket. Perhaps this will have to change. Indeed where internal audit functions undertake broader reviews of the tax function, which we have seen in a small number of cases, they can help raise the profile of the tax function by highlighting where the tax function is adding value to the business.

Moving away from the functional areas of a business to the operational people we come to people who are responsible for making decisions with potentially significant tax implications. This is the operational tax risk area, and the question arises as to whether operational people understand what risks they are taking, when they need to consult, when they can act without consulting – and what happens when something goes wrong? In businesses that are measured on a profit before tax basis, operational people will

often be more focused on sales taxes and payroll taxes and will often ignore corporate income taxes. This in itself is a risk – tax management risk.

This brief list skims the surface of the many potential interactions between tax and the different areas of your organisation – which other functional areas are making decisions that have a tax impact and hence carry tax risk? If these people are to take responsibility for the tax impact of their actions they need to understand both where the risk areas are and how they are expected to manage their tax risks. You need to be able to answer the question below.

Who are the tax risk management internal stakeholders in your business?

External auditors and other external advisors

Let us now consider the stakeholders outside your organisation. The external auditors clearly have an interest in a group's tax risk policy. They need to understand both the policy and where risks are being taken so they can plan their audit of the financial accounts. We would suggest the auditors have an interest in all seven of the areas of tax risk.

One of the effects of the current corporate governance concerns is that some groups are not using the tax departments of their auditors as much as they used to for tax planning advice. Where the auditors are not the tax advisors to the company, they will have less familiarity with the client's tax affairs. This is likely to be particularly significant where the group has, for example, made large acquisitions or disposals, undertaken new financing arrangements, implemented a group reorganisation, or implemented tax mitigation strategies. As a result the

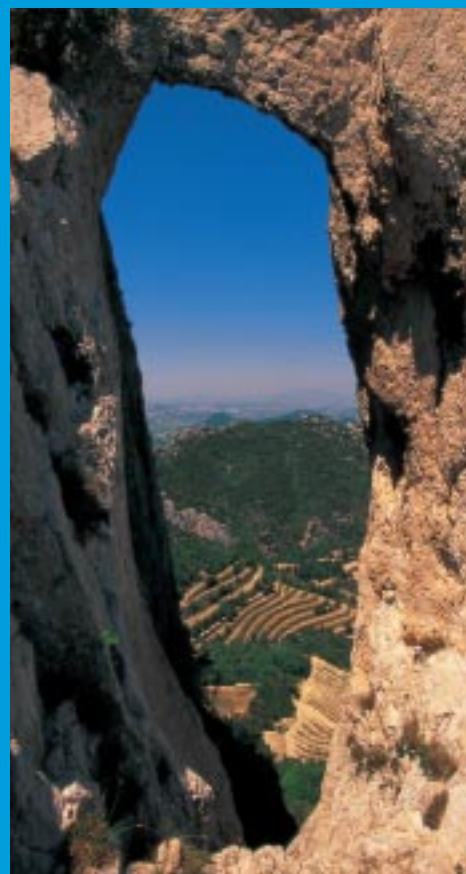
auditors will require more time and effort to understand where the risks lie and the implications for them in reaching their opinion on the financial statements – with corresponding additional costs for the group concerned.

This leads on to the point as to the board's and the audit committee's view of using their audit firm for tax work. Different businesses have taken different views here. Our view is that the audit firm is generally the best placed provider of both tax planning and tax compliance services. There is a strong linkage between a company's accounts and its tax affairs that has led to the audit firm generally also providing tax services to its audit clients. The audit firm will have a deep understanding of the company's business and therefore generally be best placed to provide related tax services. Additionally, the tax charge will generally be a material component of the company's profit and loss account and therefore needs to be carefully considered by the auditor. This process is made easier where the audit firm provides tax services on an ongoing basis; with its deep involvement with the company this leads to a better quality audit. It therefore follows that we believe that the company's management of its tax risk is improved by the involvement of its auditors in the provision of tax services as opposed to the provision of such services by others.

In addition to issuing an opinion on the financial statements, there are specific requirements for auditor attestation of internal control procedures over financial reporting for SEC registered clients (as required by Section 404 of Sarbanes-Oxley Act of 2002). As with the necessity to consider the impact of the tax accounts on the financial statements, the internal controls applicable to the tax accounts will need to be considered in the attestation on a company's internal controls over financial reporting. These requirements will first apply, broadly, for accounting periods ending on or after 15 November 2004 for US registrants and 15 July 2005 for non-US registrants. The Public Company Accounting Oversight Board (PCAOB) rules, which govern the audits of internal controls over financial reporting, will also have a significant impact on both auditors and registrants.

External advisors, who may or may not be your auditors, need to understand your appetite for tax risk. This will help them to deliver more appropriate advice and filter out unsuitable ideas they might be thinking of bringing to you. They will also need to understand the accounting implications of what they are advising on – this is perhaps more of an issue for lawyers than accountants, but still a point to be considered if the advisor is not the auditor.

The understanding of the corporate appetite for risk is particularly important for tax advisors in foreign jurisdictions where tax in these jurisdictions is often the responsibility of the finance functions. In these circumstances local risks and issues need to be understood and tax risk policies adapted to local circumstances. In some cases policies that do not have to be enunciated at home may need to be overseas, to ensure that different cultural circumstances and local practices do not inadvertently breach corporate policy.



Revenue and other regulatory authorities

Tax authorities are taking an increasingly sophisticated approach to tax risk management. If they can be clear where the tax risks are in any organisation they will know where to focus their resources.

The Australian Tax Office has, for example, published a list of seven criteria they use when assessing an organisation's tax risk profile and listed the six key areas they are going to focus on. The seven criteria for risk assessment are:

- Business and transactions
- Globalisation
- Attitude
- Systems of compliance
- Perceptions of stakeholders
- Materiality
- Application of the law

For each category they rate the business, and from this they can build up a picture of the organisation they are looking at. With this analysis they are focusing on the following questions to decide how detailed a review they need to do.

- Whether the group's financial or tax performance varies substantially from industry norms?
- Are there significant variations in the amounts or patterns of tax payments?
- Are there unexplained variations between economic performance, productivity and tax performance?
- Are there unexplained losses, low effective tax rates, and cases where part or all of the group consistently pays low tax?
- Is there a history of aggressive tax planning?
- Are there weaknesses in the group's structure, processes and approaches to tax compliance?

Additionally a number of revenue authorities are keen to discuss a group's risk assessment with that organisation and discuss with them which areas will come under particular scrutiny this year or next. The US authorities have moved to a very specific series of regulations requiring specific identification and disclosure of transactions that they (the authorities) view as giving an indication of aggressive or inappropriate tax positions. The UK Inland Revenue instigated a specific initiative entitled 'Spend to Save' that particularly focused on where their resources should best be concentrated to achieve maximum revenue raising benefit. They have now announced a crackdown on tax avoidance by introducing a package of measures targeted at perceived loopholes, in addition to specific anti-avoidance legislation.

The issue here is not to be unduly influenced by either aggressive or dormant revenue activity but rather to build the revenue authorities' approach and information requirements into your risk assessment, strategy and policies. We are aware of some businesses that have shared their tax strategy with tax authorities in order to help demonstrate 'lower risks' than may have otherwise have been perceived; however this is not a common approach.

As well as revenue authorities there are a number of other regulatory authorities in different industries (e.g. financial services) and countries (e.g. in the US, the SEC) that will be interested in the tax risk profile of a business. We have not attempted to list these out – but are you aware of which other authorities are looking at your figures and possibly also your risk management systems?

Investors and analysts

One of the prime sources of information for investors and analysts is the accounts and other quarterly/half yearly statements. The element of uncertainty in the financial accounts is therefore of interest to them – and as such they are interested in financial accounting tax risk. To the extent that the tax charge tends to fluctuate they will wish to understand why this is so and how it might fluctuate in the future. Portfolio tax risk may also be of interest to them – is there a high portfolio of tax risk that could cause significant fluctuations in the tax figures or is there a small portfolio of risk and a steady tax charge is to be expected?

There seems to be an increasing focus on cash tax as opposed to the accounting tax charge – the comments above are equally relevant to cash tax as they are to the accounting charge. Finally reputational tax risk is something investors will be interested in – what is the effect on the share price if, for example, a major revenue investigation becomes public knowledge?

Documentation and communication

A theme that has been running through the above discussion is the width of impact that taxes and tax risk management has in the organisation and therefore the importance of documenting policies and disseminating them through an appropriate communication strategy. Word of mouth and informal communications are unlikely to be appropriate for such a wide range of different stakeholders. We will explore this in more detail in later chapters.

Summary

We have attempted to summarise which tax risks will be important to the various different stakeholders in tax risk management. The summary below will not be right for all businesses; however a discussion around the grid below will help people focus on who should be considering and is responsible for the various areas of tax risk.

Types of tax risk

Stakeholders	Transactional	Operational	Compliance	Financial accounting	Portfolio	Management	Reputational
Board				✓	✓		✓
CEO/CFO	✓	?		✓	✓	✓	✓
Tax function	✓	✓	✓	✓	✓	✓	✓
Legal & treasury	✓		✓				
Business units		✓		?			
Auditors & tax advisors	✓	✓	✓	✓	✓	✓	✓
Revenue & other regulatory bodies	✓	✓	✓			✓	
Investors & analysts				✓	✓		✓

4 WHERE DOES MANAGING TAX RISK FIT INTO THE OVERALL TAX STRATEGY?

Tax risk cannot be looked at in isolation. Tax risk management needs to be part of a business' overall risk management policy as well as being part of an overall tax strategy. It is not the purpose of this guide to stray outside of the tax arena and we will therefore leave others to consider how their tax risk policy and management fit in with what the business is doing by way of risk management in other, non tax, areas.

However we can consider how tax risk management fits within an overall tax strategy. Indeed it is the overall tax strategy that should drive the approach to tax risk management – and not the other way around.

It is our view that there are only three basic areas of tax that can be managed and controlled. These are:

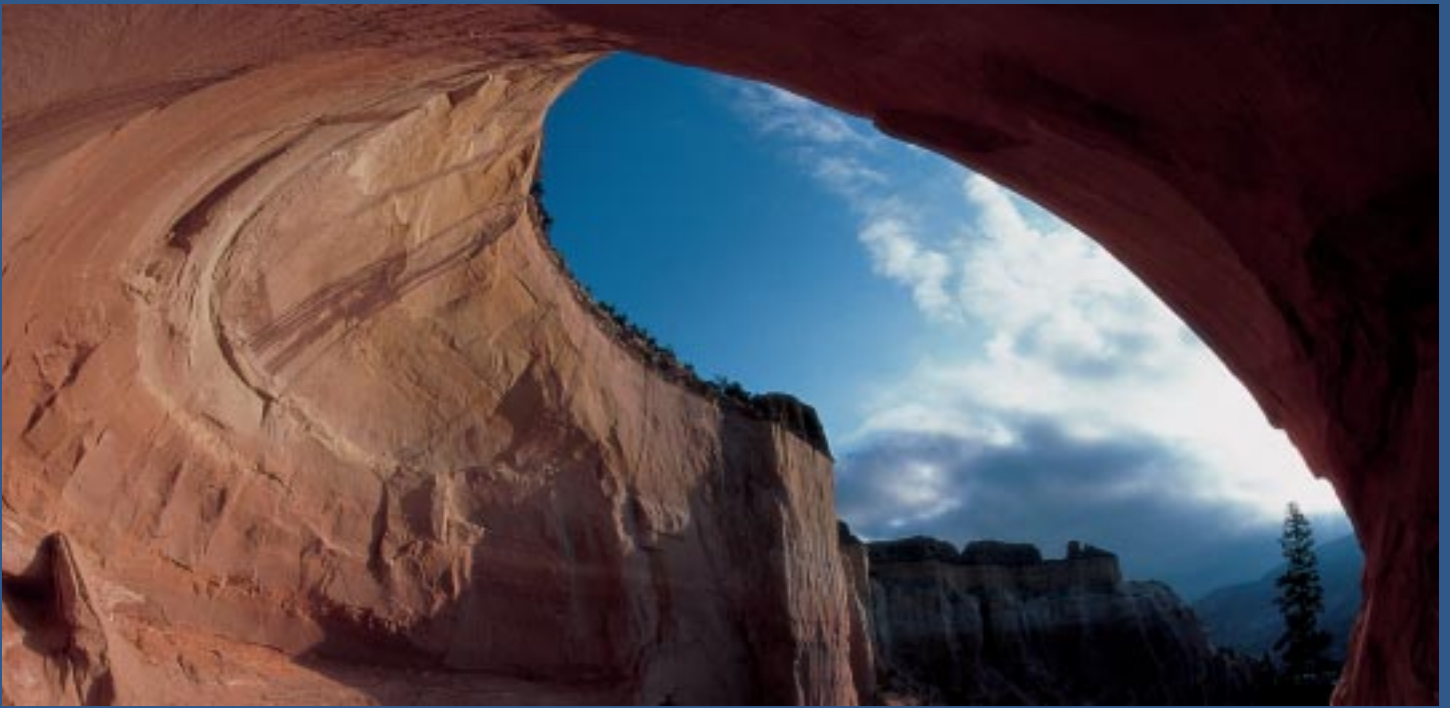
- The tax charge (some groups may segregate the total charge and current cash taxes)
- Tax risk
- The cost of running and managing the tax affairs of the group

There is clearly a trade off between these three. One cannot have a very aggressive approach to managing the tax charge without incurring some (legitimate) tax risk and some extra costs. In our earlier guide 'The 'Best Practice' Tax Function' we introduced the Tax Strategy Template to stimulate debate in this area.

For each of the three areas there is a scale, which runs from nought to ten. Nought represents a very reactive approach to tax management, probably little more than completing and submitting tax returns. Ten represents a very proactive (aggressive?) approach, where the head of tax would be

prepared to spend time fighting a case in the senior law courts. As noted above we believe that, broadly, the three scales are correlated.

	<Reactive	Proactive>
Tax charge	Not managed 0 1 2 3 4 5 6 7 8 9 10	Minimum legally achievable 0 1 2 3 4 5 6 7 8 9 10
Tax risk	Basic tax planning 0 1 2 3 4 5 6 7 8 9 10	Aggressive schemes Unaware of issues Maximum awareness of issues
Tax management costs	Minimum 0 1 2 3 4 5 6 7 8 9 10	Cost not the main issue 0 1 2 3 4 5 6 7 8 9 10
	Completed by date	Next to be reviewed



To get an overall view of someone’s approach to their tax strategy, and because of the correlation noted above, we ask people to draw a vertical line down the template giving a single overall ‘score’ between nought and ten. The more conservative and reactive groups would have a lower score than those who manage their tax more aggressively and proactively – and are prepared to take greater tax risks.

This is an overview tool. It’s not meant to be a ‘scientifically perfect’ model of a tax function’s strategy. It’s a tool that helps clarify opinions as to overall approach and start discussions that draws out some of the underlying issues.

The overall score above should bear some correlation to the summary score arrived at in the last section of the second chapter of this guide. (This was the scale that summarised your organisation’s overall attitude to tax risk management.) If the two scores are not close together one of them needs revisiting. As both scales are part of your overall group tax strategy, in terms of best practice, both should be agreed with the board and getting the two scores the same should be achievable.

	<Reactive	Proactive>
Tax charge	Not managed 0 1 2 3 4	Minimum legally achievable 5 6 7 8 9 10
Tax risk	Basic tax planning 0 1 2 3 4	Aggressive schemes 5 6 7 8 9 10
	Unaware of issues	Maximum awareness of issues
Tax management costs	Minimum 0 1 2 3 4	Cost not the main issue 5 6 7 8 9 10
	Completed by date	Next to be reviewed

5 THE RISK MANAGEMENT CONTROL FRAMEWORK FOR TAX

The early chapters of this guide have focused on what is tax risk and who should be interested in it. We have looked, at a high level, at how a tax risk policy fits into the overall strategy of a business. It is time to look in a bit more detail as to how tax risk can actually be managed and what processes might be put in place to achieve this – and introduce an internal control framework for tax risk management. This chapter focuses on designing a systematic approach to tax risk management, and the following chapter then looks at how to make the systematic approach work in practice.

INTERNAL CONTROL
INTEGRATED
FRAMEWORK

COMMITTEE OF
SPONSORING
ORGANISATIONS OF
THE TREADWAY
COMMISSION

The COSO Internal Control Integrated Framework

In the early 1990s the Committee of Sponsoring Organisations of the Treadway Commission (COSO), set up in the US, called for a study to develop a framework for internal control and in 1992 the Internal Control – Integrated Framework was published. Today the most widely recognised international standard for an integrated framework of internal control is the COSO Framework. We have sought in this chapter firstly to explain how the COSO Framework operates and more importantly how it might be used to manage tax risk.

What is internal control?

The COSO Framework defines internal control as:

“A process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.”

The commentary around the COSO Framework explains that whilst internal control is a process that will change and develop over time, the effectiveness of an organisation’s internal control is a statement of the condition of that process at one or more points in time. The purpose of internal control is to help an organisation achieve its performance and profitability objectives, and safeguard assets. It can also help to ensure reliable financial reporting, compliance with laws and regulations and therefore avoid damage to its reputation and other consequences. As the COSO Framework is the leading model for internal control, and is being used on a global basis, it seems an appropriate model to consider for tax risk management.

Components of internal control

The current COSO Framework sets out five interrelated components in an integrated system of internal control that applies to organisations of all types and sizes – and hence should equally apply to tax risk management. The five components are:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

Let us look at these in a generic sense before going on to look at them specifically in terms of tax risk management.

Control environment

The control environment is the overall tone of an organisation – the culture and atmosphere of the organisation in which people conduct their activities and carry out their responsibilities, and the seriousness with which risk and compliance with controls and processes is taken. The control environment is based on the individual attributes and attitudes of the senior management of the organisation – and will reflect their integrity, ethical values, competence and authority. The control environment is a foundation for all the other components of internal control and is the nature of the platform on which the whole organisation is built. If risk management is not important in an organisation and people do not take processes and controls seriously then introducing specific risk policies, procedures and controls in an area like tax, may have little chance of being effective.

Risk assessment

This is the awareness and response of an organisation to the risks that it faces. Processes and procedures will need to be established to identify, evaluate and manage those risks. Risk objectives must be set that are integrated with the rest of the organisation.

Control activities

Control activities are the policies and procedures that are designed and operate in order to manage and address the risks to the achievement of an organisation's objectives. These control activities need to be effective in their operation in order to manage and mitigate the risks consistent with the overall objectives of the organisation.

Information and communication

Information and communication systems are required to support the other four components in order to ensure the people in an organisation understand, capture, exchange and record the information needed to manage and control risk in an organisation. Information and communication is also needed to assess how the organisation is performing and whether its goals and objectives are being achieved.

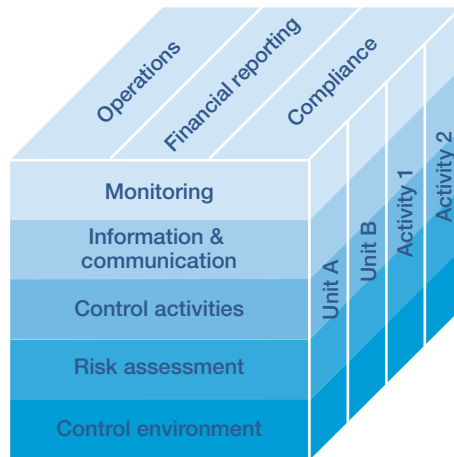
Monitoring

The entire process, but particularly controls and processes, must be monitored to assess their effectiveness and to identify where modifications or remedial actions are necessary. Monitoring allows early identification of deficiencies so that the internal control system can be responsive to changing conditions both within and from outside the organisation.

Each of these components can and will impact and influence each of the other components. The extent to which an organisation implements these components will vary from business to business and will be influenced by many different factors. However, these five components should be identifiable in any integrated system of internal control for tax risk management and should be embedded throughout the organisation in order to be effective.

There is a direct relationship between these five components and the three categories of objective set out earlier in the definition of internal control. The five components are what an organisation needs to have in place and be operating effectively, in order to achieve each of the three objectives throughout all activities and business units in the organisation.

The COSO Framework can therefore be represented generically as follows:



component in the internal control framework into three separate components – event identification, risk assessment and risk response.

In addition, the proposed new Enterprise Risk Management Framework separately distinguishes objective setting as a component separate from the control environment. The underlying philosophy itself – that senior management has a process in place to both set and align objectives within the organisation’s overall strategy consistent with their risk appetite - is not something new. This would previously have been considered to be included in the control environment component in the earlier model.

We have based this chapter on the established internal control framework because the new Enterprise Risk Management Framework is still in draft and may change as it goes through its public consultation process. That said it could be a very useful source of further information for readers wanting a more detailed analysis of risk management. What this all reinforces is that this is an area which is changing rapidly and receiving plenty of public attention.

COSO Enterprise Risk Management Framework

During the summer of 2003 COSO issued an exposure draft for public comment entitled ‘Enterprise Risk Management Framework’. This framework broadly follows the framework outlined above for internal controls, with the main difference being to expand the risk assessment

So how does the COSO Framework apply to tax risk management?

Let us now move on to consider how tax risk management can be considered in terms of the COSO Framework. We should firstly consider the three internal control **objectives** set out above and what they mean in the context of taxes and tax risk management.



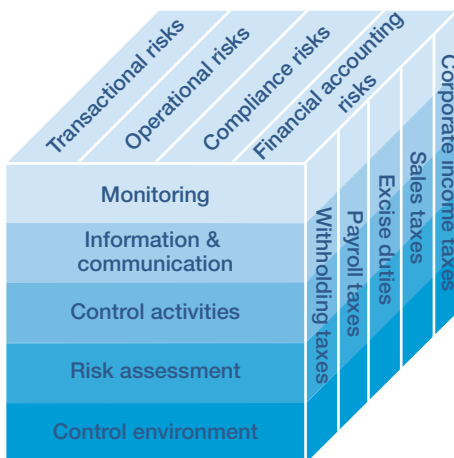
An organisation's objectives for the specific tax risk areas set out in Chapter 2 (Transactional, Operational, Compliance and Financial Accounting risks), broadly speaking, each correlate with one of the three objectives in the general COSO Framework:

- Effectiveness and efficiency of operations ↔ Transactional and operational risk
- Reliability of financial reporting ↔ Financial accounting risk
- Compliance with laws and regulations ↔ Compliance risk

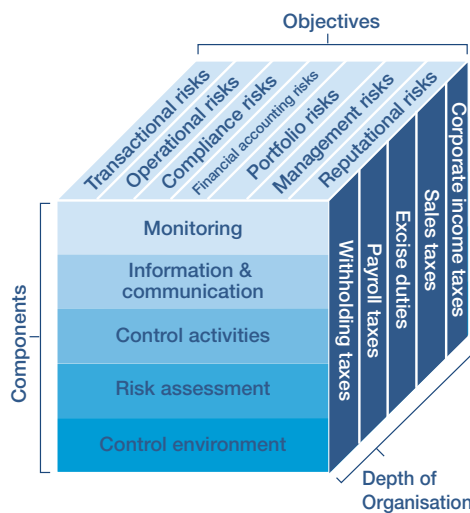
For tax purposes we are therefore proposing that we replace the three broad objective categories of internal control across the top of the COSO cube, with our four different types of specific tax risk.

We accept that there is no right answer; the whole of tax risk management is an area where the thinking is still developing. However the conclusion we reached in Chapter 2 is that the three generic risks should be treated as tax risks in their own right. Notwithstanding that the organisation's objectives in the generic risk areas will, to varying degrees, impact on all three of the framework objectives set out above, we believe it is appropriate also to add the objectives for the three generic risks to the top of the cube giving us a tax risk management equivalent of the COSO model that looks like this:

it included business units. We accept this is also a debatable point. In organisations where the internal structure is very centrally oriented, the consideration of the tax risk objectives and the internal control components for each of objective needs to be considered for each separate tax within the organisation (as shown in the diagram above).



However where does this leave us in respect of the three generic tax risk areas (portfolio, management and reputational risks)? We raised in Chapter 2 the question as to whether these three generic tax risk areas are tax risks or whether they are really ways of managing the specific types of tax risk. These generic tax risks are, by their nature, wider than any one of the individual objectives of the generic integrated internal control framework – the purists will therefore argue that they should not be included in the COSO framework when applying it directly to taxes. (Whether the top of the COSO cube should have four or seven risks is perhaps the area that has caused the most debate when writing and producing this guide.)

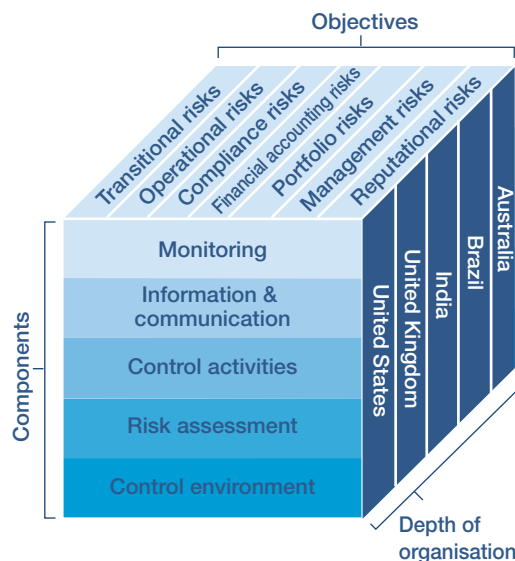


(The various tools in Chapter 6 and the appendices are based on the COSO cube having all seven tax risks across the top; if you believe that there should only be the four specific risks then the tools will need adapting accordingly.)

You will note that on the right hand side of the cube we have put the different taxes – whereas in the main COSO cube

However where an organisation is more devolved and tax operates along geographical, divisional or business unit or other lines (and where these sectors have responsibility for all the different taxes within that sector, division, etc.) it would probably be more appropriate to consider the internal control processes at the different locations, divisions or operating units level rather than through the different taxes as shown above. In fact, the current PCAOB pronouncements on auditing internal controls over financial reporting suggest that each of the taxes should be considered in each of the significant business units (at least for financial reporting).

In a best practice model, the five internal control components should be in place for each of the different types of risk objectives and each of these should apply across the whole organisation (in whichever way the organisation operates). An alternative model, on a geographic basis, would be:



We now have an integrated model for managing tax risk management which picks up each of the COSO components, each of the seven different tax risk areas and covers the whole business – whether it be by type of tax or the different business units. We now need to look in a bit more detail at what each of the COSO components means in terms of tax risk management.

What does each COSO component mean in terms of tax risk management?

Below we have summarised, from a tax risk management perspective, what each of the five internal controls components might try and address. We then set out a series of questions that you might ask of yourself under each of the five headings. The answers to the questions will enable you to start judging whether your tax risk management procedures are acceptable and fit within the COSO Framework – which as noted earlier is recognised globally as the best practice for internal control procedures.



1 Control environment

This is the attitude and culture of the board and senior management towards tax risk and their overall strategy and objectives for tax risk. This will include their commitment to tax risk management, the degree to which tax risk policies are set and communicated and the level of accountability for achieving and monitoring the performance of those policies. This also includes consideration of the compensation 'driver' for the tax function and their overall position within the organisation.

The types of questions that need considering under this heading are:

- What influence does tax risk have when the organisation's overall strategy and objectives are being established?
 - Is tax risk considered side-by-side with other business risks in evaluating proposals and making decisions about achieving the organisation's goals?
- What is the organisation's tax risk appetite/tolerance - where on the tax risk spectrum is it and where does it want to be?
 - What is the organisation's approach, management style and attitude to tax risk – what is its risk culture?
- How does the board of directors manage tax risk?
 - Is there a written and agreed tax risk policy and methodology?
 - How are the board's strategy and objectives with regard to tax risk and tax risk management delegated, communicated and embedded with the people throughout the organisation?
 - Is the board's policy understood throughout the organisation?
 - How do senior management ensure their policies and objectives are met – how do they assess to whom responsibility is delegated and that responsibility is passed to sufficiently competent and experienced personnel?
- How do senior management assess whether the organisation is in compliance with their strategy and objectives on tax risk management?
 - Is information on tax risk management and measurement of achievement against objectives gathered and regularly reviewed by senior management?
 - How do senior management respond to new tax risks and weaknesses or deficiencies over tax risk management?
 - Do senior management demonstrate their commitment to their tax risk management philosophy and strategy in their everyday activities?
- How do the compensation policies and organisation structure of the tax department support or conflict with the fundamental goals of the organisation?



Risk
assessment

2 Risk assessment

This is the awareness and response of the organisation to the different types of tax risk facing the organisation (as set out in Chapter 2). This will include the organisation's processes and procedures for identifying and evaluating the tax risks and how those risks are managed and mitigated consistent with the overall objectives of the organisation on tax risk.

The types of questions that need considering under the risk assessment heading are:

- How are tax risks identified, evaluated, and recorded?
 - How are the consequences of external factors such as economic, environmental, political, technological and social factors considered within the assessment and evaluation of tax risk?
 - What policies and procedures are there in place to ensure tax risks/issues/exposures are identified?
 - What risk assessment techniques are used and do they consider past and future events?
 - Who assesses the risk, what tax skills are brought to bear to ensure risks are properly assessed and is there an escalation process for predetermined large amounts?
 - How is information obtained/gathered on operations and other internal activities to ensure tax risks are identified?
 - Although certain tax risks may be risks to one organisation there can be instances where those risks fall on a different organisation in certain circumstances. Are such secondary risks included in the risk assessment?
- How is the effectiveness of judgements assessed?
 - How are the likelihood of events and the impact of events estimated/modelled?
 - o Is scenario planning used?
 - Are appropriate individuals with relevant experience and seniority involved?
- Are risks aggregated to enable a portfolio view to be considered?
- How are responses to identified risks designed and implemented?
 - How are the risk avoidance/risk reduction responses to mitigating tax risks assessed and evaluated – how is residual risk quantified?
- How is the tax risk assessment documented?

3 Control activities

These are the detailed procedures and processes that have been designed and established to manage the tax risks identified in the risk assessment. The design and operation of control activities should ensure that the tax risks are managed in order to achieve the organisation's tax risk objectives. The detailed control activities can take many forms but will include the detailed policies, reviews, approvals, and use of external tax opinions that are used to manage the tax risks.

The types of questions that need considering under the control activities heading are:

- What are the control activities policies of the organisation?
 - How are these policies communicated throughout and embedded in the organisation?
 - Are both preventative and detective control activities used?
 - How might control activities be circumvented?
 - Are there appropriate levels of review?
 - When are external opinions sought?
 - What controls and processes are in place to ensure tax planning, transactional issues and tax change generally is properly implemented?
 - Who is responsible for the control activities?
 - If the group is SEC listed, has consideration been given as to their adequacy against the requirements of Section 404 of the Sarbanes-Oxley Act?
- Where are the detailed control activity procedures recorded?
 - What general controls (controls over information technology and information systems) are used to mitigate risks to information technology and changes to electronic systems?
 - What application controls (controls over the completeness, accuracy, authorisation and validity of data and transaction processing) are used?
 - How is the actual operation of control activities documented/demonstrated?
- Are the activities identified for each type of tax that would address controls to assure:
 - Timely identification of changes in tax laws, regulations and decisions?
 - Timeliness and accuracy of the data to which tax law applies?
 - Accurate application of the tax laws to the data?
 - Timely and accurate reporting and payment of taxes?

4 Information and communication

This is the information and communication necessary to ensure the organisation's objectives in respect of tax risk are documented and communicated to the relevant people. It will include the operating policies and procedures within the organisation that are necessary to ensure all tax risks are identified and quantified and that the controls designed to manage those risks are documented. It will also cover the findings of the monitoring process so that the effectiveness of the controls over tax risk can be assessed, allowing appropriate development of controls and remedial action where new risks are identified or existing controls are not operating effectively.

The types of questions that need considering under information and communication are:

- How is pertinent information on tax policies, tax risk and tax control activities, identified, captured and communicated to relevant personnel?
 - Is there clear information about roles and responsibilities for provision of information on tax risk management and the operation of controls over tax risks?
 - What procedures/processes are there to ensure information is provided on a timely basis?
 - What procedures are there to communicate information requirements and provide feedback on information sources?
 - What procedures are there to ensure that when people change there is communication and a proper handover?
- How does relevant information flow up and down the organisation from board level down to relevant individuals in the organisation and vice-versa?
- How does relevant information pass around the business – so that the tax function is aware of what is happening in the rest of the organisation and so the rest of the organisation can access relevant tax information?
- How is data/information managed, controlled, aggregated and refined without losing relevance?
 - How is information stored, protected and accessed?
 - What back-up/retrieval procedures are there for valuable/critical information?
- What information is gathered from external/independent sources and how is it used to support tax risk assessment and development of internal controls over taxes?

5 Monitoring tax risk

These are the procedures put in place to review the effectiveness of the operating of the internal controls over tax risks, and to enable conclusions on the effectiveness of the controls over taxes to be reached. Monitoring will identify where controls are not operating effectively and where the organisations objectives are not being met. This allows remedial action to be taken where controls are not operating effectively and may identify where new risks are not being properly managed

The questions which need considering under this heading are:

- How is the effectiveness of the operation of internal controls over tax risks assessed?
 - How is tax risk assessment monitored on an ongoing basis?
 - What review/testing procedures are there in place that can be used as a basis for reaching conclusions as to the effectiveness of the risk assessment process and the design of controls to mitigate identified risks?
 - How are conclusions reached?
- Who receives the results of the monitoring process and what action do they take with them?
 - What remedial actions are taken if internal control procedures are found not to be operating effectively?
 - How do the findings of the monitoring process impact the control environment, risk assessment, and control activity functions?
- Is there any independent review of the monitoring process?
- How is the monitoring process documented?

It should now be apparent how closely the various components of an integrated system of internal control are interrelated. Designing and operating a tax risk management internal control system is an iterative process and not a linear task. Continual evaluation and development of each of the components is necessary to maintain a responsive up-to-date internal control system, which can deal with the uncertainties in a continually changing world.

Summary

Many features of the components of an integrated system of internal control over taxes are likely to have been considered, at some point in time, in the vast majority of organisations. However, it is our experience that this tends to have taken place in a somewhat unstructured, ad-hoc and haphazard way. It is a relatively rare occurrence to find a systematic, well planned approach to designing and documenting internal control systems over a business' tax affairs. Addressing tax risk has not been high on the agenda of most tax departments. Whilst most organisations can probably cite controls that they have in place such controls tend to be informal, somewhat lacking in design and unlikely to be documented in any level of detail.

In the current risk environment, including the Sarbanes-Oxley Act with its requirements for senior management to attest on the adequacy of design and the operational effectiveness of their internal controls over financial reporting, many organisations face a significant challenge to move to a best practice compliant regime. Documenting and monitoring internal controls over financial reporting of taxes, within a regime of standardised controls, designed by reference to a recognised framework which are periodically tested to assess their effectiveness, is likely to be a large leap forward for many organisations. The gap to be bridged in respect of internal controls over taxes is a significant one that should be focussing the minds of senior management responsible for this area in the foreseeable future.

Appendix 1 introduces a tax risk management best practice checklist to help you address where you are today in putting a best practice framework into your organisation.

6 THE TAX RISK MANAGEMENT FRAMEWORK IN PRACTICE

In Chapter 2 we highlighted that managing tax risk is about managing uncertainty. By the very nature of uncertainty, there can often be no one right or wrong answer. Managing uncertainty is about making judgement calls and the quality of your tax risk management will depend to a large extent on the quality of those judgement calls. However having a framework and system within which those judgement calls can be made is, in our opinion, vitally important to proper tax risk management.

In the last chapter we considered what makes up an integrated tax risk management system, building on the COSO internal controls. We then went on to look at how the various objectives and components of the COSO Framework might apply to tax risk management. This chapter now focuses on how we use that framework in a practical way in managing tax risk and uncertainty and, in conjunction with Appendix 2, puts forward some tools that can be used in the process.

It is also worth mentioning at the outset that the practice of using internal controls to manage tax risk is not a simple linear process where you complete one stage and move on to the next. You will need to be able to respond to the rapidly changing environment in which your business finds itself. The control environment practices of deciding on a tax risk management policy and setting tax risk objectives, carrying out a risk assessment to identifying tax risk and developing mitigating control activities to manage those risks is therefore an ongoing, evolving process – and it will need to evolve and develop in line with what is happening in the rest of the organisation. It is perhaps more of a circular process – it is certainly something that needs to be kept under constant review and should become an integral part of the day-to-day operation of the organisation.

Risk framework maturity spectrum

Before looking in detail at how the components of an integrated system of internal control can be applied in practice let us consider, at an overview level, where you are now, or in other words the maturity of your existing internal control systems over tax risk management. By reviewing where you are now on the maturity spectrum below it will help you think about where you want to be.





Level 1 – Unreliable

- Unpredictable environment where controls are not designed or in place

Level 2 – Informal

- Controls are designed and in place but are not adequately documented
- Controls mostly dependent on people
- No formal training or communication of controls

Level 3 – Standardised

- Controls are designed and in place
- Controls have been documented and communicated to employees
- Deviations from controls may not be detected

Level 4 – Monitored

- Standardised controls with periodic testing for effective design and operation with reporting to management
- Automation and tools may be used in a limited way to support controls

Level 5 – Optimized

- An integrated internal control framework with real time monitoring by management with continuous improvement
- Automation and tools are used to support controls and allow the organisation to make rapid changes to the control activities if needed

At the time of writing our experience is that most businesses are at levels 1 or 2 – i.e. in the unreliable/informal stage with respect to tax risk management. However the steps being taken to implement the provisions of the Sarbanes-Oxley Act, dealing with internal controls, have organisations, both in the US and elsewhere, focused on rapidly moving up the ‘maturity’ line. We would suggest that effective tax risk management is a minimum of level 3 and probably looking towards being at level 4. This involves having standardised controls over tax risk management that are periodically tested to ensure they have been adequately designed and are operating effectively. It is important to note that to be in compliance with COSO there should also be some monitoring of controls as discussed below.

Where on the scale do you want to be?

Let us now look at each of the five COSO framework components and consider how they can be used in practice to help manage tax risk.



a) Risk control environment

It is primarily through the policy and objectives, together with the general culture and approach of the organisation to risks and controls, that the risk culture and tone of an organisation is set. The control environment over taxes therefore manifests itself in the setting of the tax risk management policy and tax risk objectives, and the involvement of senior management in both this and the ongoing monitoring.

Building a tax risk management policy

In our view the starting point for the control environment is a documented tax risk management policy. What does this mean in a large and diverse group, particularly one operating in a multi territory environment? The answer, we believe, lies in the development of two layers of policy, namely one directed, at the strategic level, on the overall organisational appetite and framework and the second focused on operational controls.

The strategic framework or policies should set the tone for how tax risk should be managed in the organisation and therefore reflect the following:

- High level corporate policies about the level of risk across the various types of risk discussed above, outlining the position the group wants to adopt as a whole.
- Country and/or business unit policies that further develop this in the individual circumstances of that country or unit. These policies could reflect the different positions that the company may want to take on different types of taxes.

The scales for each type of tax risk as set out in Chapter 2 might be used as part of the policy. The policy should cover the entire organisation. It should be sufficiently flexible both to avoid it having to be changed too frequently and to encompass routine, day-to-day, changes in the organisation and its environment.

The formal approval of the policy is the responsibility of the board although in

practice it is likely to be CFO (or possibly the CEO) as the key stakeholder who would take ownership of it. It is likely that the head of tax will have drafted it. The policy should have the buy-in of the key interested parties such as the audit committee and the chief risk officer.

It follows that one of the key points the board should focus on is the quality, skills and attitude to risk of the head of tax (and possibly others in the tax function). Are they naturally conservative people or are they more aggressive risk takers – and how does this marry up with the board's attitude to risk? How do they rate the head of tax's judgement and management skills in relation to putting in place a structured risk management framework? Historically boards have put a lot of trust in heads of tax to 'get it right'; we are moving to an era where the board will be taking less on trust and expecting more evidence to show that it is right.

Beyond this, detailed operational tax risk policies, e.g. policies around sign off on matters such as transactions, tax review of new product development, external advisor opinions, and rulings from fiscal authorities will be important components of a control environment to manage tax risk.

When agreed, the tax risk management policy should be formally documented, approved by the board and communicated to those responsible for the implementation of the policy and to other interested stakeholders.

Key board objective: We will have a formal documented tax risk management framework and policy that will be agreed by the board and monitored by the audit committee. This will be in place by [date].

Setting specific tax risk objectives

The next stage in tax risk management, after the setting of the high level tax risk management policy, is the setting of specific tax risk objectives. The setting of tax risk objectives is effectively the development of a plan to deliver the tax risk management policy. The test of the objectives is that if these tax risk objectives are achieved the organisation should be delivering against its tax risk management policy.

As with the policy set out above, there are two layers of risk objectives – those at the strategic level and those that are operational. The strategic objectives will relate to the high level goals set out in the policy; the operational objectives will be around what happens on a day-to-day basis.

Tax risk objective	Examples
Strategic objectives	<ul style="list-style-type: none"> • The group head of tax will take responsibility for tax risk management for all taxes on a global basis • We will implement tax planning strategies that will impact positively on our day-to-day business • We aim to avoid having anything to do with our tax affairs being aired in the public domain • We will file the appropriate returns in all relevant jurisdictions in accordance with tax laws and regulations regardless of local custom
Operational objectives	<ul style="list-style-type: none"> • We will not implement more than five significant tax planning ideas in any one year • The tax function must be involved in all transactions over \$/£5m • No new subsidiaries may be set up without tax function input into the structuring/financing • External opinions will be taken on any issue where the tax at stake is greater than \$/£1m • The financial accounts tax figure needs to be accurate to within 3% (or a financial amount) • Our total portfolio risk should at no time exceed more than 10% of our annual tax charge in the accounts • The cost of any revenue authority investigation/adjustments should not exceed 1% of the tax payable • Penalties, including tax related penalties, for late filings of tax returns will not exceed \$/£20,000 in any one year

These objectives will also, to a large extent, determine where resources are focused and directed. Certain of the objectives will be more easily achieved than others – especially those objectives entirely within the organisation’s control. However just because an objective is difficult to achieve does not mean it should be left off the list! When the objectives have been established they should be documented and communicated

to the individuals in the organisation who will be involved in delivering them, and built into their own individual performance objectives. They effectively become the target in designing suitable tax risk management controls. It is also useful to develop a common means of documenting and communicating the tax risk objectives in order to create familiarity with such information throughout the organisation.



b) Risk assessment

Risk assessment is the awareness and response of the organisation to the different types of tax risk facing the organisation (as set out in Chapter 2). This will include the organisation's processes and procedures for identifying and evaluating the tax risks and how those risks are managed and mitigated consistent with the overall objectives of the organisation on tax risk.

The board and management will make decisions around events and activities that an organisation will undertake in order to meet its overall objectives and increase shareholder value. In virtually all cases these events will have tax implications for the organisation, or parts of it. Such events can be internally or externally generated, such as a decision to re-organise part of the organisation or dispose of certain assets, or, having to comply with some new laws or regulations.

It is important to establish at the outset that 'events' in the context of risk assessment means both active events where some proactive course of action is undertaken and non-active events, where a risk arises because of the failure (whether inadvertently or by design) to undertake a particular action.

Risk identification

The first step of tax risk assessment is therefore to identify the tax risks – both upside and downside risk. Looking at the causes of risk, firstly there are risks arising from changes in the business and secondly there are those arising from the on going day-to-day activities.

For those risks associated with change you might start by considering the organisation's overall strategy and its objectives for achieving that strategy, together with the planned and potential events, both in the business and externally. Board and management meetings, where decisions about the direction and key events are taken are probably the key source of identifying the items likely to have the greatest impact on tax risk assessment. Being aware of what is happening at such meetings should identify the key risks arising where there is pro-active change in the business and

should cover all significant transactional risks. A way of ensuring tax functions know what is going on might be to copy them in on minutes of meetings, capital expenditure approvals, public announcements, etc. These can be forward looking or historic and carried out on either a top-down or bottom-up basis.

Focussing on current business processes will be a useful source to identify key tax risks from the ongoing, day-to-day, business where no major changes are expected. For the risk identification to be complete it is important to consider those risks (which will largely be operational and compliance risks) arising from following a no change/business as usual approach. These risks will arise both from not properly carrying out a process through to the failure to do something at all.

On the compliance side you might also like to consider your 'compliance footprint'. This involves creating a map of the various regulatory regimes that the organisation has to deal with and the regulatory returns that have to be submitted.

On the external side, changes in tax laws and regulations – over which the organisation has no control – can give risk to significant tax costs, especially in organisations which have been more aggressive in active tax planning and exploiting loopholes. Here the likelihood and potential impact of anti-avoidance measures might have a significant impact.

Another approach to risk identification is to focus on the people. In any organisation there will be people who create risks and those who mitigate risk. The risk creators will include the decision makers, those developing new parts of the business and those driving acquisitions and disposals – you probably know who

they are in your organisation. To identify tax risks, the tax function will need to be in close contact with these people on an ongoing basis.

For those risks associated with change, the objective is to identify all future events that could potentially impact the tax risk position of the organisation. The table below sets out, at a high level, some of the typical events that need to be considered in the risk identification process.

Type of tax risk	Typical events giving rise to tax risk
Transactional	<ul style="list-style-type: none"> Acquisitions Disposals Mergers Financing transactions Tax driven cross border transactions Internal reorganisations
Operational	<ul style="list-style-type: none"> New business ventures New operating models Operating in new locations New operating structures (e.g. JVs/partnerships) Impact of technological developments (e.g. Internet trading)
Compliance	<ul style="list-style-type: none"> Lack of proper management Weak accounting records or controls Data integrity issues Insufficient resources Systems changes Legislative changes Revenue investigations Specific local in country customs, approaches and focuses in compliance
Financial accounting	<ul style="list-style-type: none"> Changes in legislation Changes in accounting systems Changes in accounting policies and GAAP
Portfolio	A combination of any of these events
Management	<ul style="list-style-type: none"> Changes in personnel – both in tax and in the business Experienced tax people leaving – and information being in their heads and not properly documented New/inexperienced resources
Reputational	<ul style="list-style-type: none"> Revenue authority raid/investigation Press comment Court hearings/legal actions Political developments

How are those managing tax risk informed of such changes in your organisation?

Whichever route you follow for risk identification, the key here is communication. Those responsible for managing tax risk need to know what is happening in the business and there needs to be a mechanism for this to take place. Whatever techniques are used it is important that the whole of the organisation is considered both at the entity and activity level and that internal and external factors, as well as the risks associated with there being no change, are taken into account. What is needed is a thorough and disciplined approach to ensure that all areas are considered and nothing falls between the cracks.

Risk quantification

Having identified the tax risks the second part of the risk assessment phase is to consider the potential tax impact of these risks and the likelihood of the underlying event occurring (especially where the events are not wholly within the control of the organisation). Once the various risks have been quantified then decisions can be made as to which ones need the most attention.

Risk quantification is an area where judgement and experience play a major role. Various qualitative and quantitative techniques can be used ranging from the broad (e.g. quantification of risk of occurrence being high, medium or low risk) to more detailed approaches to assess the likelihood of occurrence of an event (such as benchmarking and sophisticated probability analysis).

Similar judgements are also needed in estimating the tax consequence of the type of risk identified. You will need to take account of past experience, current knowledge about the future, and the impact that other events and decisions will have. The overall aim is to reach a view as to the likely tax outcome of the event, if the event giving rise to the tax risk were to take place. It is the inter-relationship of the event, the likelihood of its occurrence and its tax consequence that is important in assessing the tax risk inherent within any event.

The events of particular importance are those which have both significant or material consequences and which have a high risk of happening, since, in the absence of any measure taken to mitigate those particular risks, the consequences are likely to be significant to the organisation. However it is not only the one off events that can give rise to large tax risks. A large volume of small risks can build up into large overall risk. An example might be the regular misposting of disallowable expenditure to an allowable code.

It should be possible to build a risk assessment table outlining the various events, their consequence and their likelihood. This could be done for each type of tax risk and for each different location, operating unit, or along whichever primary organisational and reporting lines the organisation operates. However what is important is that the key events are collated and aggregated to give an overall risk assessment table for the organisation as a whole.

Appendix 2 contains two sets of risk assessment templates which have the flexibility to be used in any organisation and can be structured to follow the operational and reporting structure of any organisation. It is important to give some thought to the structure and content of such risk assessment tools before adopting them in your own organisation

to ensure that they provide meaningful information required to manage tax risk. You need to bear in mind that the key objective here is to assess tax risk so that the organisation's resources can be directed to address those risks.

The first example of a tax risk assessment template is the risk priority template. This is based on the chance of an event happening and the impact if it does. By grading both the chance and the impact high (H), medium (M) or low (L), a risk priority can be arrived at which will help focus where action needs to be taken. For example where the chance of an event happening is high and the impact if it does happen is high, then this risk is clearly priority 1 and it needs attention. An example is set out below based on the particular events in the previous table.

Event	Chance of event happening High, Medium, Low	Impact High, Medium, Low	Risk priority 1 = High, 5 = Low
Acquisitions	H	H	1
Disposals	H	M	2
Mergers	H	L	3
Financing transactions	H	H	1
Tax driven transactions	L	H	3
Internal Reorganisations	M	H	2
New business ventures	M	H	2
New operating models	M	M	3
Operating in new locations	M	L	4
New operating systems	H	M	2
Impact of technological developments (e.g. Internet trading)	M	H	2
Lack of proper management	L	H	3
Weak accounting records or controls	L	M	4
Data integrity issues	H	L	3
Insufficient resources	L	L	5
Systems changes	M	H	2
Legislative changes	H	M	2
Revenue investigations	H	M	2
Specific local in country approaches	H	L	3
Changes in legislation			
Changes in accounting systems			
Changes in accounting policy & GAAP			
Changes in personnel – both in tax and in the business			
Experienced people leaving			
Inexperience resources			
Revenue authority raid or investigation			
Press comment			
Court hearing/legal action			
Political developments			

Alternatively, the position could be looked at by type of tax risk or by country or by type of tax. A table using type of risk might look like this:

Type of tax risk	Chance of risk arising High, Medium, Low	Impact High, Medium, Low	Risk priority High, Medium, Low
Transactional	H	H	1
Operational	H	M	2
Compliance	L	L	5
Financial accounting	M	M	3
Portfolio	M	M	3
Management	M	L	4
Reputational	L	H	3

The above templates give a priority rating, but do not actually spell out the financial implications of the risks in question. The two templates below address the same points, but do put financial figures on the results, which gives an alternative way of prioritising which risks need to be addressed.

Event	Chance of event happening % A	Impact \$'m B	Potential cost \$'m AxB
Acquisitions	75	10	7.5
Disposals	25	40	10.0
Mergers	10	20	2.0
Financing transactions	60	5	3.0
Tax driven transactions	20	5	1.0
Internal Reorganisations	5	10	0.5
New business ventures	20	5	1.0
New operating models	50	8	4.0
Operating in new locations	25	2	0.5
New operating structures	20	3	0.6
Impact of technological developments (e.g. Internet trading)	80	5	4.0
Lack of proper management Weak accounting records or controls Data integrity issues Insufficient resources Systems changes Legislative changes Revenue investigations Specific local in country approaches			
Changes in legislation Changes in accounting systems Changes in accounting policy & GAAP			
Changes in personnel – both in tax and in the business Experienced people leaving Inexperienced resources			
Revenue authority raid or investigation Press comment Court hearing/legal action Political developments			
Portfolio risk – total	–	–	34.1

Using the same financial approach, but looking at the risks on a country by country basis would give the following template.

Country or Entity	Chance of risk arising % A	Impact \$m B	Risk weighted cost \$m AxB
Australia			
Belgium			
Brazil			
Germany			
India			
Singapore			
United Kingdom			
United States			
Total			

The use of scenario planning might be appropriate here. Scenario planning is too big a subject to go into in this guide but we have used it at a conference of European tax directors and would suggest that more sophisticated methods of risk assessment should include its use.

Organisations should be able to identify and quantify their key tax risks. Can you?

Response to tax risk

The risk assessment process, and the tables above, will have highlighted the key tax risks that need to be managed. The specific response to each identified risk will vary depending on factors such as:

- The ease and cost of mitigating the risk,
- Its potential impact on the business, and
- The availability of alternative mitigating techniques.

The response might be any one or a combination of the following three options:

Avoidance	<p>Taking alternative action such that the risk no longer arises, for example by operating using a different model such as:</p> <ul style="list-style-type: none"> – using arms length transfer price to avoid a transfer pricing tax risk; or – restructuring an asset disposal to be a sale of a shareholding in a company owning those same assets; or – to operate through a legal entity with a different taxable status in a particular location
Sharing	<p>Taking action to reduce the likelihood or impact of the risk by transferring or sharing the risk in some way. This generally achieved through the techniques such as the obtaining of warranties or indemnities, obtaining professional opinions, or outsourcing of tax functions</p>
Reduction	<p>Taking action to reduce the likelihood of the occurrence and/or the impact of the risk, for example by:</p> <ul style="list-style-type: none"> – carrying out appropriate tax planning; or – obtaining documentary evidence or opinions in support of the proposed tax treatment such as a tax valuation, or – restructuring the event to give a more favourable tax treatment e.g. by leasing rather than buying a capital asset; or – carrying out a detailed review of potentially disallowable expenditure to ensure all potentially allowable amounts have been identified and claimed

The cost/benefit analysis of responding to a particular risk needs to be taken into account. For example, you may decide to have a very low acceptance of errors in your compliance, but for a particular disallowable expense searching through all the various account headings is prohibitively expensive and time consuming and the better answer is to accept the risk and live with it.

It should also be borne in mind that the most effective means of mitigating the risk may be a combination of several reduction or sharing techniques and that the residual risk, (i.e. the risk remaining after mitigating action has been taken) should then be evaluated. If none of the above techniques can be or are used to mitigate or respond to the tax risk then, by default, the organisation bears the risk and accepts the consequences. These residual risks should be compared with the organisation's tax risk tolerance level and, if necessary communicated up the line.

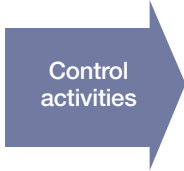
Whilst mitigating responses are generally considered on a risk-by-risk basis and need to be thought about for each tax risk identified, it is important to bear in mind the overall portfolio risk. This ensures the impact of any low outcome/low consequence risks, which may, on their own, have been considered immaterial or within the organisation's tolerance threshold, are considered. If, on a portfolio basis, the overall level of risk does not meet the organisation's tax risk objectives, then it will be necessary to consider mitigating responses to more of the risks in order to bring the overall tax risk level consistent with the objectives.

In order to document the responses to tax risks identified, it should be a fairly straightforward exercise to expand the risk assessment and risk priority templates referred to both in Appendix 2 and the risk quantification section above, in order to record the various responses that have been designed to respond to the risks identified.



An outline example of a tax controls template for corporate tax transfer pricing risks for a specific location (although it could equally be a for a subsidiary, division or an operating unit) is shown below:

Transfer pricing	Inherent tax risk	Mitigating control activity	Residual risk	Responsibility
Goods - acquired	No direct third party comparables available	Comparables transfer pricing study carried out/up-dated to confirm arm's length price being used.	Potential challenge to comparables being used.	Group tax manager
Goods – sold				
Services – acquired				
Services – sold				
Royalties – acquired				
Royalties – sold				
Interest – payable				
Interest – receivable				
Documentation				



C) Control activities

Control activities are the individual policies and procedures that are put in place to respond to the identified tax risks. Control activities also include the policies and procedures put in place over the entire tax risk management process to ensure that the process is complete and that all relevant tax risks are identified and considered. Control activities include a broad range of actions such as approvals, authorisations, reconciliations, reviews and policies on areas such as segregation of duties.

In the earlier control environment section we set out both the strategic and the operational objectives for managing tax risk. From the risk assessment section we have highlighted where the key risk areas are in the organisation. We now come to our control activities which need both to link in with these objectives and to focus on the high risk areas – being areas of known risk as well as areas where the tax function is not closely involved and which may give rise to risks which have yet to be identified.

Taking the results of some of our earlier templates we might build up a picture that looks like this:

Objective / Risk	Who is responsible?	What do they need to do?	How do they do it?	When?
Ensure there is a group tax risk management policy	Chairman of Audit committee	Agree broad parameters with rest of the Board	Delegate detail to head of tax	Immediate
The group head of tax will take responsibility for all tax risk management	Head of Tax	Full group tax risk assessment Design control activities around all major risks	Seek external advice on best practice procedures for this exercise	Next three months
The tax function must be involved in all transactions over \$/£5m	Legal department	Involve the tax function when any such transaction arises	Formal notification required	At the start of any negotiations
Revenue investigations	Head of Compliance	Monitor all involvement with revenue authorities where tax at risk is > \$/£25,000	Overview role, but involved in detail for major issues	Ongoing

So in considering the tax risk management control activities we need to look at:

- **Who** is responsible for the operation of the control activities?
- **What** do they need to do?
- **How** do they do it?
- **When** do they need to do it?

Who

Various people through an organisation will be responsible for the operation of control activities over tax risks. We call these people the 'risk mitigators' (as opposed to the risk creators mentioned earlier). Who these people are in your organisation will depend on your own management structure. The extent of these people's responsibility will depend on their role in the organisation. The table at the end of this section gives an indication of the hierarchy of responsibility for control activities over taxes and tax risk in a typical organisation and what those individuals might be expected to have responsibility for.

The important point is that there are people at appropriate levels throughout the organisation who have responsibility for both the operation of control activities and for the operation of tax risk management procedures and policies. They also need to be clear what is expected of them.

What

The answer to what those various individuals need to be doing will depend on their position and their role in the organisation. Some thoughts on this are set out below.

At the board level the 'what' would be expected to include high level oversight and review of the tax risk management policy, and consideration and development of the tax risk management policy and objectives.

The audit committee might take a slightly more detailed interest in not only the policy, but also in ensuring that the appropriate control framework is in place, is being operated and is being monitored. They should keep an oversight of the policy; they might also want to keep a close eye on reputational risk.

At the CFO level it would be expected there would be more regular review of the operation of the tax risk management

policy and involvement in setting and monitoring achievement of the tax risk objectives. The CFO would also be expected to be involved with particularly significant tax risk management issues and reporting to the board or the audit committee on tax risk management.

The head of tax would have increasingly more involvement and would be the key point for overseeing tax risk management procedures and policies with local CFOs or country tax managers. The head of tax would be expected to have significant involvement in (and may have primary responsibility for setting) the tax risk objectives and notifying the CFO on tax risk management matters. In addition the head of tax may also be responsible for specific individual control activities (such as giving input to potential major transactions, tax negotiations with fiscal authorities and in matters such as legal actions).

Local CFOs and tax managers would be expected to have a supervisory role over the operation of detailed control activities in their territory, and responsibility for reviewing and reporting up the group to the head of tax the results of the risk assessment process for their territory. They would also be responsible for the design and establishment of control activities in response to identified tax risks and for operating some of the more important control activities (such as authorising and reviewing certain transactions). The local CFO/tax manager would also be expected to have involvement in the monitoring phase, especially where detailed control activities are found not to have been operating effectively in their particular location.

The individual members of the tax team or shadow tax departments will have ongoing responsibility for the operation of the detailed control activities. These individuals will be responsible for the performance of the various reviews, approvals, reconciliations etc, as well as the first level of risk assessment, since these individuals are also likely to have the closest ongoing relationships with operational people in their locality. These

people are the 'risk mitigators' and you need to think through what support and help they will need to do their job properly. For example if you have junior account clerks coding expenses between tax allowable and tax disallowable codes, what training and/or manuals do they need to help them do this.

There is nothing new in this type of hierarchical structure. The precise roles, responsibilities and detail of it will depend on the organisation's overall management and reporting structure. There will also inevitably be additional roles which should be reflected in the list above such as internal audit and risk management personnel. What is important is that the responsibility for operation of the controls is clearly set out and understood, especially in large organisations operating in different locations, where operational, reporting and legal structures may vary considerably.

The roles listed above are all internal roles in an organisation. Businesses also use external advisors in managing tax risk, both in helping set up procedures and, perhaps more commonly, in performing mock revenue authority reviews. In the latter case they often use people who used to work for the revenue authority in question who are well placed to see things from the 'other side'. External advisors can therefore also play an important role in the area of control activities.

How

Control activities should be in place to cover the risks arising from:

- What is done in the tax function
- What is done in the rest of the business, and
- What is carried out externally

Control activities should be built into to the day-to-day operations of the business with responsibility for the activity being assigned to appropriate members of the organisation's staff. The tax risk management policy should spell out levels of authority and who has to review



what, and the ground rules for people performing tasks where there are no review procedures. Each organisation will have its own way of setting up its control activities and it is beyond the scope of this guide to try and set out all the potential controls that could be used to mitigate individual tax risks. However identifying where risks are or might be, and then considering how these risks can be managed should give a framework in which control activities can be developed.

IT and tax knowledge management systems are in themselves controls. This is particularly important where such systems are used in identifying exceptions such as significant volume changes that may indicate tax risks, or alternatively providing information that is key to decision making on tax matters. Therefore as well as including manual procedures, control activities should also include application controls within IT systems. Additionally these need to be designed to ensure the completeness, accuracy and validity of data capture. Such controls within, and over, IT systems are important activities since they impact on the systematic processing of transactions for, for example, VAT/GST tax returns.

Control activities over tax risks outside the tax function

There are many examples where responsibility for tax matters sits outside the tax function. Payroll taxes may be dealt with in the payroll/HR function, sales taxes may sit within the finance department, and treasury may deal with withholding taxes. One of our examples of a strategic tax risk management objective, under the control environment section earlier in this chapter, was that ‘the group head of tax will take responsibility for tax risk management for all taxes on a global basis’. Even if this is not the case in your organisation it is likely that the tax function will be called in if and when issues arise in respect of taxes not directly under their control.

It is therefore important to ensure when considering tax risk management that all

the relevant parts of the organisation and all its activities are considered irrespective of where in the organisation they reside. Unless it is clearly established who in the organisation has responsibility for the controls in these areas there is the potential for either duplication of work between both the tax function and the other department involved, or worse, that each assumes the other is managing the tax risk in that area when in fact neither is doing so. This is particularly important in those organisations where all the financial targets are based on the profits before tax – with the result that tax management can be very low on some people’s agendas (assuming it is there at all).

Similar duplication or omission issues can be found within the tax function especially in large organisations where there is insufficient dialogue between local tax people and the head office team. Processes and procedures are needed to ensure that all these different areas are working together and effectively. The people involved are often the risk mitigators and they need support and help in their roles.

Control activities over tax risks where using external advisors/outsourcing

Another area that needs managing is the use of external advisors and the outsourcing of certain activities. Some examples on this point might be helpful.

Where external advisors are used to provide advice on a proposed transaction it is important that there are processes in place to ensure not only that the tax risks are captured, but that there are appropriate related controls to ensure that the background and information on which the advice has been based is accurate and reflects the actual position of the organisation. In a fast moving transaction these basic procedures can often be overlooked.

Similarly, when proposed transactions are implemented there are inherent tax risks based on the transaction that took place.

A review to ensure that either the transaction was implemented as proposed by the lawyers, or, if not, to consider the tax risks inherent in the actual implementation become important in ensuring all relevant tax risks are identified and dealt with.

In outsourcing situations, where an organisation uses a third party service provider to carry out transaction processing it may not be possible to directly manage the controls in the third party organisation. In such situations, the area that is often overlooked is the development of controls to ensure that the output given to the third party is whole and complete and that the input received back is fully assimilated back into the organisation. The use of a third party itself may well be a control against an identified tax risk in itself – in that the use of specialist third party resources is how the organisation achieves the accuracy of, say, its tax computations, but this is dependent on full relevant information being provided to the third party and the organisation fully processing the information received back.

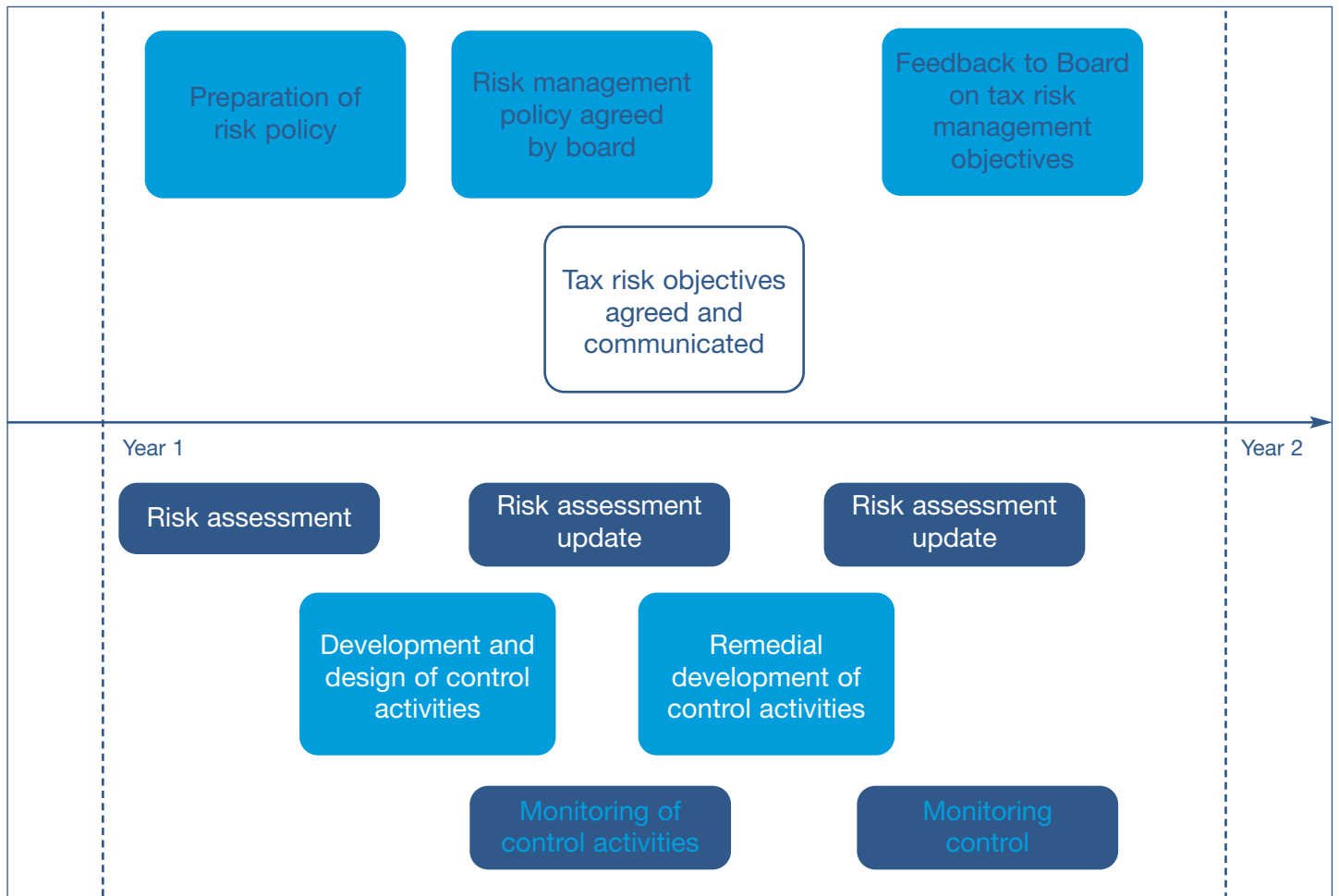
When

The regularity and frequency of involvement of the various individuals mentioned above will depend on the issues and the organisation involved. For those groups who are SEC registrants then initially there is likely to be great deal of activity to ensure that such organisations are up to speed and in compliance with the Sarbanes-Oxley rules.

For effective tax risk management, the control activities noted above do however need to be linked to a time period. For example, tax reconciliations may need to be carried out monthly (VAT or GST), and a tax analysis of a proposed transaction should be carried out before the proposed transaction is put forward for approval.

The timeframes listed in the table below, ranging from annually for the board, down to ongoing involvement for the individual staff members of the tax team, are purely indicative. The point is that there should be an agreed timetable for the control activities to take place, and progress should be monitored against this timetable.

Outline timetable for tax risk management activities



One of the purposes of having a detailed timetable is to ensure that the control activities are put in place and implemented in a timely and disciplined way.

Summary

In summary an overview of the control activities position might look like this:

Who is responsible?	What for?	Review cycle
The board	The overall control activities of the entire organisation	Annually
The audit committee	Review of tax risk management policy and confirmation that the internal control framework is being operated and monitored	Half yearly
CFO	All control activities relating to the finance function including all control activities over taxes and tax risks	Quarterly
Head of tax	Control activities over tax risk and tax risk management	Monthly
Local CFOs/ tax managers	Control activities over the finance function including taxes (in the case of CFOs) or all control activities over taxes (in the case of tax managers) for the country/subsidiary/business unit for which the CFO/tax manager has responsibility	Monthly
Individual staff members of the tax team or shadow tax dept.	Responsibility for the control activities over taxes and tax risk within their area of responsibility. For example, control activities over VAT and sales taxes are likely to be the responsibility of the local VAT/sales tax manager and their team	Ongoing/ Continual
Internal audit	Review of application of controls and procedures	Bi annually



Information & communication

d) Information and communication

We have touched in the earlier parts of this chapter on the importance of communication and information. Information and communication are effectively the oil that lubricates the whole internal control system and ensures it operates smoothly.

Information needs to flow up, down and across the organisation to ensure that:

- the tax risk management policy forms the basis for the development of the risk objectives;
- the tax risk objectives underpin the risk assessment and risk quantification;
- control activities are developed to cover the risks identified in the risk assessment consistent with the risk objectives;
- the detailed control policies and procedures are communicated and known to those responsible for operating them;
- knowledge about what is happening, and is proposed to happen, on the operational side of the organisation is considered in order to identify tax risk;
- knowledge about what is happening in the external environment feeds into the risk assessment and into the development of mitigating control activities;
- some general knowledge and understanding of the impact of taxes on the organisation are communicated to the wider organisation so that these can at least be considered at a high level when developing the wider business policy;
- support is given to those in shadow tax function roles to enable them to be effective, and
- feedback as to the effectiveness of the whole internal control system can be passed up the organisation to enable management to assess the overall effectiveness of their tax risk management activities

In practice many different forms of communication will be used, both formal and informal, manual and computerised. It is important that the information is appropriate for the purpose for which it is needed and therefore it needs to be at the right level of detail, timely, up-to-date and accurate.

The distribution method and the nature of the information will need to be considered. Some of the information such as the detailed control activities and the responsibilities of individuals will need to be widely communicated and may well be stored and managed in some central repository such as an organisation's intranet site or in documents such as a tax controls and policies manual. Where such central repositories of information are used it is important to ensure that they are kept up-to-date, consulted and followed if they are to become an integral part of the organisation's tax risk management processes. We are probably all aware of organisations where significant time and money has been spent developing tax policy and tax procedure manuals; only for them to gather dust on the top shelves of an office somewhere! Other less formal means of communicating will include e-mails, memoranda, training materials, databases, and notice boards.

To be most effective, these tools should become an integral operating tool for anyone involved in tax management. The information used and key communication methods should form part of the training for new and existing staff and when staff change roles and take on new responsibilities. This helps individuals understand how their own role and responsibilities align with the goals of the wider organisation. Tax risk management should become part of the culture.

Some types of information such as the overall tax policy and the risk objectives will probably be relevant across the entire tax function and to people responsible for taxes within other parts of the business. At the more detailed level, the results of tax risk assessments and control matrices identifying the nature of individual risks, controls and who has responsibility for them, probably need to be made known on a more localised basis.

Finally you might like to consider what sort of training is needed for the tax risk mitigators, those people from accounting staff through to the audit committee, who are responsible for managing tax risk. For example do the people who code incoming invoices understand why the correct coding is so important and the potential tax risks that arise if they do not do their jobs properly?

There can, of course, be no standard list of what information and forms of communication should or should not be used. As each organisation is different then the relevance, format and types of communication that best meets each organisation's individual needs will be different.

Generally, however, the following comments are likely to apply in all organisations:

- the tax risk policy and tax risk objectives should be known by all involved in any tax risk management role;
- individuals should know how their own roles and responsibilities align with the policy and objectives and fit with the work of others in their area;
- the results of the risk assessment process linking the risks to any mitigating controls that have been developed in response to them should be documented.



Monitoring

e) Monitoring

In order to consider the effectiveness of the operation of the control activities that have been designed and implemented in an organisation to mitigate identified tax risks, it is necessary to monitor their operation. Following the monitoring process an organisation will be able to reach a conclusion on the effectiveness of its controls over tax risks.

It is an established principle of effective review procedures that the monitoring process should be carried out by different individuals to those responsible for the design and operation of the internal controls themselves.

In many organisations this type of activity is carried out by the organisation's internal audit function. However, it is our experience that internal audit departments have tended to shy away from reviewing tax risks and controls and therefore tend to lack experience in the specific area of assessing the design and effectiveness of internal controls over tax risks. Maybe this has to change?

To be fully effective there will need to be procedures in place to ensure that the results of the monitoring activity are fed back into the whole tax risk management process in order to ensure that:

- remedial or corrective action can be taken where the results of monitoring activity reveal that controls are not operating effectively or as designed;
- there is a process to consider the impact of controls not operating effectively on
 - the achievement of the tax risk objectives, and
 - risk assessment
- the results of failures and non-compliance are communicated to the relevant people in the organisation so that appropriate effective action can be taken.

Documentation of the risk assessment and the operation of control activities is essential to enable independent testing of the operation and effectiveness of those controls. Therefore, documenting the control procedures and processes needs to be embedded into the day-to-day operations in order to be effective.

In the Sarbanes-Oxley regime, the CEO and CFO will be required to attest on the effectiveness of design and operation of an organisation's internal controls over financial reporting (which will include the financial reporting of taxes). The monitoring process is likely to be the key means by which senior management will be able to reach such a conclusion. In addition, since an SEC registrant's auditors will be required to give an opinion, a properly structured and documented monitoring process is likely to be the major area that auditors will want to consider in reaching their opinion.

Summary

Different organisations will implement internal controls in different ways. Those businesses directly impacted by the Sarbanes-Oxley Act of 2002 will be driven both by what is best practice and by the requirements of their auditors. Other organisations will need to decide what levels of internal controls are appropriate for their business. What is clear to us is that, whatever route you follow, a well defined process is needed for effective tax risk management.

7 MANAGING GLOBAL TAX RISK

In this chapter we want to focus specifically at how a group can manage the tax risk arising in countries other than the head office country.

These are the risks that are perhaps not as visible as those arising at head office level – and they are often more difficult to manage by virtue of them arising in different countries, different time zones, different cultures and sometimes in a different language. Additionally in some of the less developed countries there may be a lack of sophistication within both the tax law and the tax authorities with the result that a very different approach to tax management is needed in these countries.

The points made in earlier chapters are of course as relevant to a multinational as they are to a domestic group. However managing tax risk for a multinational group brings with it a number of specific issues and solutions that need to be addressed. We are therefore now going to consider, for a multinational group:

- What are the main local tax risks?
- Who owns the different tax risks around the world?
- How these risks might be managed, and
- The specific risks arising from the use of shared service centres.

What are the tax risks?

This chapter is about managing risk arising in local territories. It is not about managing the international tax position of a group and the risks which go with that; it is about what is happening in local territories, what tax risks might arise and how these risks can best be managed. So what are the main tax

risks that arise in local territories? Let us go back to the seven main areas of tax risk as set out in Chapter 2 and consider them in relation to what is happening in your overseas subsidiaries.

We would suggest that the three most important types of local tax risk areas are:

1. Operational risk – with local subsidiaries carrying out their business with little or no tax involvement. You might also include transfer pricing under this heading even if there is a group transfer pricing policy set at head office level. Having a policy is one thing, ensuring that it is being properly implemented is quite another.
2. Compliance risk – in respect of the various local tax returns that need to be submitted. It is important here to recognise the wide range of tax returns that are needed and that withholding taxes and sales taxes/VAT may be more important and higher risk than corporate income taxes.
3. Financial accounting risk – which may be a risk if the subsidiary in question is material to the group as a whole or where there is a lack of familiarity with group policies and non-local GAAP (especially in the context of group reporting).

The types of risk less likely to give issues are:

4. Transactional risk – on the grounds that for any significant transaction you would

expect the head office tax function to be involved.

5. Reputational risk - how much damage to the group's reputation can a local subsidiary do? This needs to be reviewed on a country by country (or subsidiary by subsidiary) basis. You also need to consider the impact your local reputation has on your ability to do business in that local country.

The types of risk that are likely to be managed at head office level, and hence are unlikely to be local country risks, are:

6. Portfolio risk – whilst the head office team needs to understand what is happening at a subsidiary level, portfolio risk is by its very nature something which is managed across the totality of the group and hence needs managing at head office level. (A regional tax manager might disagree with this statement and argue that they are running a portfolio of countries and that this risk is also a high priority.)
7. Management risk – our view is that the management of tax risk is a head office function and it is the head of tax who needs to ensure that proper management of tax risk is in place across the group.

So let us focus on the three key local tax risk areas, namely operational, compliance and financial accounting risks. Before going any further you might like to list out what you believe are the five most significant local overseas tax risks for your group.

Key overseas tax risks	Type of tax risk	Type of tax	Country in which this risk is an issue
1			
2			
3			
4			
5			

If you are struggling to complete this table, you might like to consider how good your risk assessment procedures are. Adopting a structured bottom-up approach to using the tax risk template tools referred to in Chapter 6 could be a useful tool for identifying the tax risks in your significant overseas locations. If you have completed the table, how aware is your CFO or your board that these are the group's key areas of overseas tax risk?

Ownership of tax risk

Let us now consider who is responsible for the management of the following taxes:

People responsible for tax management of:	Head office country	Country A	Country B
Corporate income taxes			
Sales taxes / VAT			
Excise duties			
Payroll taxes			
Withholding taxes			
Other taxes			

If you are a head of tax the chances are that you and your team (even if you have tax people present in some of your major territories) have little or no responsibility for the operation of some of these taxes in other countries. However when issues arise on the tax audits, the management of this inevitably shifts to the tax function. On the principle that it is better to get things right at the outset, we are seeing a trend towards more centralised control of tax matters, but most groups are still some way away from the tax function having ownership of all tax matters wherever they happen to be. For example how many head office Heads of Tax are responsible for the operation of payroll or withholding taxes in other countries? Probably none. But what about VAT or sales taxes? Still not that many. And for corporate income taxes?

However if you are a CFO reading this you may well be saying that you expect your head of tax to be responsible for all taxes and all tax risk – whatever tax that may be and wherever the tax happens to arise. We are aware of CFOs, particularly in the US, who are expecting their heads of tax to sign off on the totality of the tax position for their group. So how do we manage the expectations of the group CFO (and the board) against the reality of what is happening on the ground?

The first question therefore that we believe needs addressing for a multinational group is who has ownership of which taxes and where – and hence ownership of the relevant tax risk management issues. If, as we suspect, some of the ownership will fall to local CFOs then the second question is how well equipped they are to perform a tax risk management role. Do they understand the risks in what they are responsible for and do they understand the group's attitude to, and policy on, tax risk? Does it matter to them – particularly if they are measured on a profit before tax basis? The third question is who is accountable if something goes badly wrong – e.g. a large VAT penalty arises in an overseas territory?

Notwithstanding that ownership may lie with a local CFO, what accountability will lie at the door of the head of tax if something dramatic goes wrong? The answers to these questions will provide some initial thoughts as what structure needs to be put in place in relation to managing the group's global tax risk.

There will be some subsidiary companies that have their own tax teams, either reporting to the group head of tax or to the local CFO (or both). The questions

above are equally relevant in such situations – even if the answers may be slightly different.

The final point on ownership of tax risk is to consider the reporting structure so that the head of tax can sign off, if required to do so by the board or CFO, that the group's tax risk position is being adequately managed. We would suspect that there are very few local CFOs who report or sign off on tax risk management to the group head of tax. How is the group head of tax going to get himself/herself in a position where he/she can sign off?

You will by now appreciate the great importance of information and communication in considering many of the questions raised here as it is the strength of the information and communication processes which forms the foundation for managing global tax risk.

Before addressing some of the questions raised above, let us take a slight digression to look at an operating model which is increasingly common in an international group – the Shared Service Centre – which brings with it their own set of tax risks which need managing.

A number of international groups have set up Shared Services Centres (SSCs) – often with a focus on bringing the accounting and processing for a number of countries into one central location. The rationale behind these SSCs has been to create greater efficiencies and greater consistency across a group with often little or no accounting expertise left in the individual countries.

Tax risks associated with Shared Service Centres

The question arises as to how the various tax returns, for the particular countries covered by the SCC, are dealt with – and how, in particular, compliance tax risk is managed within an SSC environment. What local tax returns should an SSC deal with, what might they deal with and what should they not deal with? We have worked with a number of groups who operate out of SSCs and our comments below reflect the experience we have gained in this area. The key point is to analyse the risks inherent in the various alternative ways of dealing with tax returns and decide, on a cost/benefit basis, which is the most appropriate way forward for your SSC.

There are some tax returns where the position is reasonably clear-cut. For example, local withholding taxes on interest generally arise when the interest is paid. The SSC will often be the only party who knows when the interest is being paid and it makes a lot of sense for the SSC to be responsible for dealing with the withholding taxes. From a risk management point of view a system needs to be put in place to ensure the SSC knows what taxes to withhold, what forms to complete and where to make the payments. Of course in some countries this is not a simple matter as there are a range of different withholding rates depending on the nature of the payments.

At the other end of the spectrum, we have yet to come across an SSC that has the ability to complete local corporate income tax returns. In our opinion, it would be very high risk to try and deal with such returns for another country in an SSC. Such returns require significant local expertise and invariably have to be dealt with in local territories – and they are usually outsourced to a local service provider. The SSC does however continue to have a key role in providing the data to complete the returns.

However the position on some other tax returns is not so clear-cut. Let us, for example, consider VAT or sales taxes. Prima facie, these are transaction taxes, and thus should follow the withholding tax model and be dealt with in the SSC. But the in-country rules for these taxes are different in each country, even across Europe where there is, in theory, a common approach to VAT. Methodologies can be set up so that the information coming out of the SSC's accounting systems feeds through to the appropriate boxes on the return; the question is how these methodologies are kept up to date when there are changes in legislation in particular countries.

We are aware of a recent example that cost a group a lot of money. Their processes were fine and produced the right VAT information from their SSC accounting system. What they were unaware of was a change in local

legislation in a particular country, which required a specific election to be made – and this election was missed. If VAT is to be dealt with by an SSC then tax risk management procedures need to be in place to ensure that local changes are picked up and such risks are identified and managed. Alternatively, VAT can be outsourced to a local, or trans-national, service provider who will be closer to changes in the countries concerned.

The main point here is that there are a number of different ways of dealing with tax returns when the underlying information is being processed in an SSC. If we go back to our COSO model, we need a proper risk assessment of the issues and proper control activities in place for whatever course of action is decided upon. The control activities need to cover not only the processing of the information, but also the application of local tax law, both present and changes in the future.

We have set out in the table below our experience of the different types of tax activity and where they are commonly carried out when there is an SSC in existence. The driver here is the amount of local knowledge that is required to deal with the tax return – and how you ensure this local knowledge is brought to bear on the tax return before it is submitted to the relevant authority.

Where is it dealt with?	Type of activity
Usually dealt with in the SSC	Withholding taxes Tax packs/tax provision Data extraction for corporate income tax returns
Sometimes dealt with in the SSC	VAT and sales taxes European Intrastat and sales listing returns
Usually dealt with locally	Property taxes Municipal taxes Stamp duty Employee taxes
Always dealt with locally	Corporate income tax returns

Managing these risks

The framework spelt out in earlier chapters is, of course, equally valid in managing the local overseas tax risks as it was in managing domestic tax risks irrespective of whether an SSC is part of your operating model. However, in our experience, the biggest single issue in managing overseas tax risks is communication and that is where we want to focus the discussions in the rest of this chapter. Of the three tax risk areas highlighted above as being most relevant to managing global tax risk, the best communication is probably seen in the area of financial accounting, as this has to happen annually and often quarterly. Communication on compliance risk is probably next best, but on the operational side, tax functions are often struggling to find out what is happening at a local subsidiary level.

Communication is relevant to all five components in the COSO framework. Local subsidiaries need to have some understanding of the group's tax risk policy and the control environment within which the group is working. The head of tax needs to understand where the local risks lie so that they can help put control activities in place and also find some way of monitoring these activities.

We have worked with many global Heads of Tax and there are common themes around their communication issues with their overseas subsidiaries both on managing the tax position and managing the tax risk. These include:

1. How does the head of tax manage and control what is happening in other territories? For example how do you know what activities the overseas subsidiary is undertaking? How do you ensure that local tax planning is for the benefit of the group as a whole and not just for the local subsidiary? How do you know where compliance is falling behind or where the major compliance risks areas are?
2. How do you obtain good quality and timely information from overseas territories of both what they are doing

and of their tax position for use in planning and completion of home territory tax returns?

3. Once information is collected from the overseas territories how is it stored so that it is always up to date, and readily accessible to all those who need to use it wherever they happen to be, whenever they need it?
4. The more service providers you have around the world the more difficult it becomes to manage the global process. There is unlikely to be much consistency as to the way work is carried out or information is reported if you use multiple service providers around the world.
5. Managing the position around the world, in particular for financial reporting and compliance, can be a time consuming and frustrating exercise – with numerous emails and phone calls, not necessarily at sensible times of the day.
6. A lot of the time spent on managing the global issues could probably be spent on more value added activities – to the benefit of both the business and the individuals concerned.

In summary we would suggest that the following would be high on the agenda of your head of tax:

- Getting good quality information from the subsidiaries
- On a timely basis
- On a consistent basis
- Ensuring it is up to date
- Without spending hours doing so

To achieve this you clearly need to have some form of system in place. How do you do this – and are there better ways of achieving the desired result?

1. Direct communication

Face to face meetings, a lot of travel and numerous emails and telephone calls are one way for the group head of tax to keep on top of the tax risk management issues in other countries. Where there are significant

new issues such an approach may indeed be the best way forward so all the issues can be thoroughly aired and discussed. However in a large group a more systematic approach may be required.

2 Use of technology

Database and web technology lends itself very well to managing information across disparate locations. A good technology tool will help communicate what information is required (and when), standardise information formats, provide the repository for storing and sharing information and (potentially) highlight and/or chase for missing information. One caution: our experience is that provision of a good technology tool is unlikely to bring about any significant improvement in itself. It will only deliver results if the discipline surrounding its use can be instilled/enforced. It is the information content that ultimately matters, not the technology that is used to manage it.

3 Basic discipline

Easing the gathering of the appropriate information requires investment in scoping out responsibilities and ensuring all concerned take them seriously. If people in local subsidiaries are given responsibility for and clear guidance as to the information required, the format in which it is to be supplied, the timetable for provision and the reasons why the information is needed, they are more likely to provide what is needed without further chasing.

In large organisations, this discipline will need to be continually reinforced as the group structure and the tax function's contacts change. Inevitably not all information needed will be provided to timetable, but if the requirements and timetable are properly defined and documented and responsibility for the provision of the information has been given then a junior (administrative) member of staff can be charged with following up missing information, rather than having to have experienced tax staff spend time chasing it up.

4 Use of external service providers

To have an effective global tax risk management system in place it is necessary to instil the appropriate discipline into one's team in other territories. However this system and the investment in both managing and producing it does not necessarily need to be made in-house.

Certainly on the compliance side an outsourcing service provider will probably already have put similar solutions in place for other clients and will be used to liaising with local territory contacts to ensure the right information is gathered at the appropriate time. It is certainly worth considering leveraging off a service provider's investment in people, processes and technology rather than try and secure internal investment in something that is non-core to your business?

For example, we in PricewaterhouseCoopers have designed a global compliance technology tool which is used to help a number of our clients control their compliance processes and compliance risks. The sort of information which our clients are able to track using this tool include:

Reference information:

- Territory listing – it is perhaps surprising how many head offices are not clear in which territories they have subsidiaries
- Legal entity listing – names of all the companies in the group
- Status of their legal entity – dormant, operations or holding.
- Legal entity type – corporation, GmbH, SA, etc.
- Identification number – VAT, corporate income tax, other
- Address, date of formation, ownership
- Global contact information – both the client team and the PricewaterhouseCoopers team, to include email addresses, telephone numbers and fax numbers

Compliance information:

- Status of filings by legal entity
- Due dates by legal entity
- Tax payment by legal entity
- Compliance process task summary – milestones (who, when)
- Work paper store – ability to attach documents
- Document store – statutory accounts, provisions, notices, completed returns
- Tax reconciliations

Revenue authority audits:

- Queries from taxing authorities and status of responses

Other matters:

- Documented planning ideas and implementation status
- Global fees by jurisdiction
- Foreign tax attributes to facilitate head office tax planning

Whilst the technology tool provides rather more than is required from a pure risk management perspective, it does provide a mechanism or system for the group head of tax to manage better, in particular, the compliance risk within their group.

Summary

There is an increasing requirement from CFOs for their group's Head of Tax to have ownership of the tax risks and tax internal controls on a global basis. Whilst it is not only financial risk, this is particularly so in relation to internal controls over the financial reporting of taxes in SEC registrants. The Sarbanes-Oxley Act requires CEO's and CFO's to attest on the adequacy of the design and operation of internal controls over financial reporting.

For some groups this will require a fundamental shift, and perhaps an increase, in what they need to do to meet these requirements. A systematic approach with strong information and communication procedures will undoubtedly be needed and we see this as one of the bigger challenges for the global tax function over the next few years.

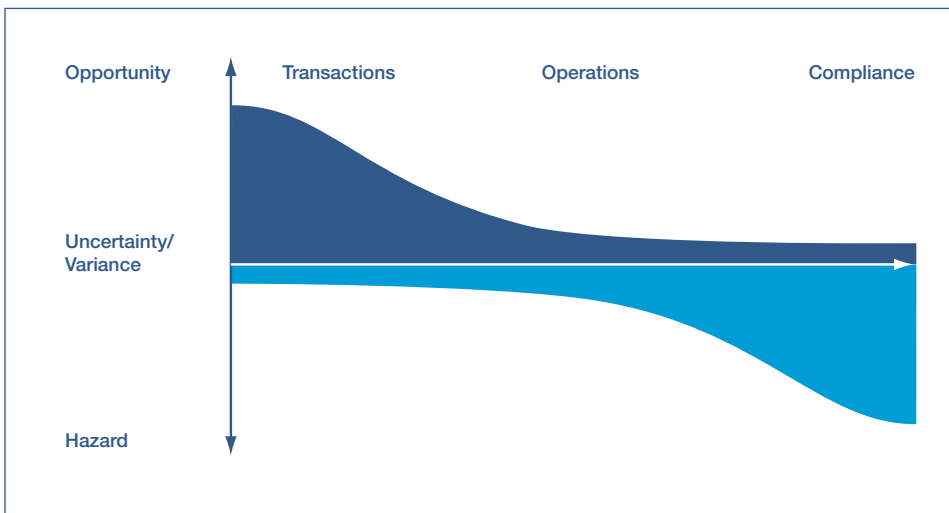
8 Summary

What is clear is that Pandora's box has been opened and tax risk management is on many more people's agendas. Whilst assessing and managing tax risk is what tax functions have been doing for many years, there is now a need for a systematic organisational approach that ensures that **all** significant tax risks are identified and managed. Communication is key and at no time has 'no surprises' been more on the agendas of senior management, boards and the external market. Where this will take us over the next few years is open to speculation. However no leading tax function, and certainly no leading head of tax, can afford to ignore the issues we have raised in this guide.

We have analysed the various types of tax risk and we have set out how a recognised internal control framework can be applied to manage these risks. We do not pretend that we have all the answers, but we are investing in this area and working through these issues with our clients to develop practical and appropriate risk systems.

What we have set out to do in this guide is to stimulate the debate around tax risk management and perhaps throw out one or two challenges for people to pick up and run with. Best practice in this area will develop and we look forward to ongoing discussions around the world with those in commerce and industry who have to address these issues in their own businesses.

By way of conclusion we would like to leave you with the diagram we used in Chapter 2 that reminds us that tax risk has an upside as well as a downside. Businesses make money by taking risks. Tax risk management is about a considered approach to your tax risks – it is not about trying to reduce them to zero.



Appendix 1

TAX RISK MANAGEMENT BEST PRACTICE CHECKLIST

Internal control component	Question	Yes	No
Control environment	Do you have a documented tax risk management policy?		
	Are there specific tax risk management objectives?		
	Have all relevant stakeholders had input to the policy?		
	Have all tax risk areas been included?		
	Has the tax risk management policy been discussed and agreed at board level?		
	Has the policy and objectives been communicated to all stakeholders?		
	Is there an appetite in the business to implement the policy?		
	Does the board review the position at least once a year?		
	Is the tax risk management policy aligned with the wider objectives of the business?		
Risk assessment	Are there procedures in place to assess the tax risks in the business?		
	Do they cover all areas of tax risk?		
	Do they cover all taxes?		
	Do they cover all significant countries in the group?		
	Do you know who are the key creators of tax risk in your organisation?		
	Do you have processes in place to manage these people?		
	Do you know what the five key tax risks are in the business?		
	Do you use scenario planning to assess risk?		
	Are tax risks considered in aggregate to allow an overall portfolio view of risks to be considered?		
	Is the tax risk assessment documented?		
Control activities	Are risk control procedures in place?		
	Are the five key tax risks in the business being properly managed?		

Internal control component	Question	Yes	No
(continued)	Is it clear to the business when they need to consult the tax function		
	Is it clear when the tax function needs to consult with the board?		
	Are control activities communicated and embedded throughout the organisation?		
	Is it clear who in the organisation has responsibility for individual control activities?		
	Are the detailed control activities documented agreed at board level?		
	Are you properly supporting those who have a risk mitigation role (e.g. the shadow tax function)?		
Information & Communication	Is the board kept aware of the key tax risks in the business?		
	Is the board consulted on major tax risk matters?		
	Is there a central place people can find out about the business' tax risk policy?		
	Is there a list of people (or roles) who need to understand their role within tax risk management?		
	Are people new to roles within tax risk management briefed on tax risk management as it affects them?		
	Is the shadow tax department briefed on tax risk management?		
	Is there training in place to ensure key individuals understand their role in tax risk management?		
	Are processes in place to ensure the tax function is kept aware of operational changes to the business?		
Monitoring	Is there a process in place to ensure that tax risk management control activities are operating effectively?		
	Are internal audit involved?		
	Are the results of monitoring activities reported back to senior management?		
	Is the monitoring process documented?		
	Is remedial action taken where risk assessment and control activities are not found to be operating effectively?		

Appendix 2

TAX RISK ASSESSMENT TEMPLATES

There are a selection of different tax risk assessment templates set out below. Individual people or businesses will choose the ones that best suit their organisation. The templates below are not the definitive tool to use in assessing tax risks in a business, but as a starter that can be adapted to suit different circumstances and different organisational structures.

1. Risk priority templates

Where such risk priority templates are used as the top level summary for the entire organisation, each line in the table would be supported by further tables analysing the risk assessment in greater levels of detail. For example in template 1.1 below, the risk summary for acquisitions could then be analysed either by location, type of tax or type of tax risk.

The aggregation of the risk assessment should follow the entity's organisational structure. So, if for example, an organisation primarily follows a geographic reporting structure, which then operates within a country using tax type as its primary reporting structure, that organisation would be expected to produce its highest level tax priority template on a country-by-country analysis. This would then be supported by a tax type analysis for that particular country, with the most detailed level of analysis for each separate tax type analysed by event or type of tax risk.

The risk priority assessment reported is based on the high (H), medium (M) or low (L) outcomes reported in the chance of event happening and the impact columns on the following basis.

HH	priority 1
HM and MH	priority 2
HL, MM and LH	priority 3
ML and LM	priority 4
LL	priority 5

1.1 Risk priority template by the type of underlying event.

Event	Chance of event happening High, Medium, Low	Impact High, Medium, Low	Risk priority 1 = High, 5 = Low
Acquisitions Disposals Mergers Financing transactions Tax driven transactions Internal Reorganisations			
New business ventures New operating models Operating in new locations New operating structures Impact of technological developments (e.g. Internet trading)			
Lack of proper management Weak accounting records or controls Data integrity issues Insufficient resources Systems changes Legislative changes Revenue investigations Specific local in country approaches			
Changes in legislation Changes in accounting systems Changes in accounting policy & GAAP			
Changes in personnel – both in tax and in the business Experienced people leaving Inexperienced resources			
Revenue authority raid or investigation Press comment Court hearing/legal action Political developments			

1.2 Risk priority template by type of tax.

Type of tax	Chance of risk arising High, Medium, Low	Impact High, Medium, Low	Risk priority 1 = High, 5 = Low
Corporate income			
Sales			
Excise			
Payroll			
Withholding			
Others			

1.3 Risk priority template by location.

Country or Entity	Chance of risk arising High, Medium, Low	Impact High, Medium, Low	Risk priority 1 = High, 5 = Low
Australia			
Belgium			
Brazil			
Germany			
India			
United Kingdom			
United States			

This template could equally be used to analyse the risk priority by entity/division/business unit etc.

1.4 Example risk priority template analysing risk by the type of tax risk.

Type of tax risk	Chance of risk arising High, Medium, Low	Impact High, Medium, Low	Risk priority 1 = High, 5 = Low
Transactional			
Operational			
Compliance			
Financial accounting			
Portfolio			
Management			
Reputational			



2. Risk weighted cost templates

A more detailed risk assessment approach, which allows resources to be directed towards areas where they will have greatest impact, is to use a probability based approach to evaluating the potential cost of tax risks.

The following templates consider the likelihood of an event happening and the potential impact of the event should it, in fact, occur. Multiplying these two factors together gives a risk weighted outcome for each event.

The flexibility mentioned when considering the risk priority templates above apply equally to this type of risk assessment so that the risk weighted costs outcome can be built up for an entire organisation. This is potentially a more valuable tool in directing resources to address tax risks. However, it must be borne in mind that this tool is only as strong as the accuracy of the underlying likelihood and impact assessment – and judgement calls are needed to arrive at these figures.

2.1 Risk weighted cost template by the type of underlying event.

Event	Chance of event happening % A	Impact \$m B	Risk weighted cost \$m AxB
Acquisitions Disposals Mergers Financing transactions Tax driven transactions Internal Reorganisations			
New business ventures New operating models Operating in new locations New operating structures Impact of technological developments (e.g. Internet trading)			
Lack of proper management Weak accounting records or controls Data integrity issues Insufficient resources Systems changes Legislative changes Revenue investigations Specific local in country approaches			
Changes in legislation Changes in accounting systems Changes in accounting policy & GAAP			
Changes in personnel – both in tax and in the business Experienced people leaving Inexperienced resources			
Revenue authority raid or investigation Press comment Court hearing/legal action Political developments			
Total			

2.2 Risk weighted cost template by type of tax

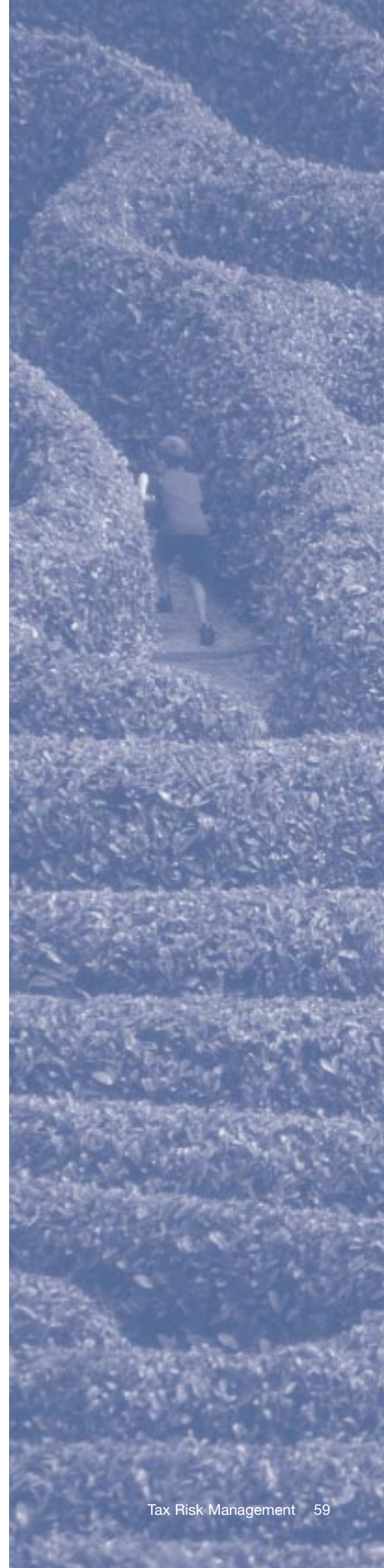
Type of tax	Chance of risk arising % A	Impact \$m B	Risk weighted cost \$m AxB
Corporate income			
Sales			
Excise			
Payroll			
Withholding			
Others			
Total			

2.3 Risk weighted cost template risk by location

Country or Entity	Chance of risk arising % A	Impact \$m B	Risk weighted cost \$m AxB
Australia			
Belgium			
Brazil			
Germany			
India			
United Kingdom			
United States			
Total			

2.4 Risk weighted cost template risk by type of tax risk

Type of tax risk	Chance of risk arising % A	Impact \$m B	Risk weighted cost \$m AxB
Transactional			
Operational			
Compliance			
Financial accounting			
Management			
Reputational			
Total/Portfolio			



3. Specific tax risk templates

A series of templates can now be built up either around a type of tax risk, or a type of tax, or the impact of a specific event, or for a particular country or entity. The options are almost infinite and we do not intend to produce all the different permutations and combinations. What is however important is that you take the items above which are either the priority risks or the highest risk weighted tax cost and break them down into their

component parts so you are clear where the largest risks arise and hence where the focus needs to be in managing these risks.

Let us, for example, look at compliance risk in country A – which has been recognised as one where there are potential significant risks from the corporate income tax returns being reviewed by the local revenue authorities. The corporate income tax templates may look something like this:

3.1 Example tax risk template for compliance risks for country A

Compliance tax risk	Chance of risk arising High, Medium, Low	Impact High, Medium, Low	Risk priority 1 = High, 5 = Low
Income recognition			
Disallowable expenditure: <ul style="list-style-type: none"> • Entertaining • Provisions • Legal 			
Interest deductions			
Capital v revenue			
Allocation of capital expenditure to tax categories			
R&D deductions			
Transfer pricing			

The aggregate assessment for Country A's tax compliance risks could then be summarised along with the other types of tax risk area (such as operations, transactions, etc) to give an overall tax risk priority assessment for Country A. Alternatively it could be aggregated with the tax compliance risk assessment for

other countries to give the organisation's overall tax risk priority assessment for tax compliance risks.

The detailed templates will take time to complete and the way forward may well be a rolling programme with the focus being on different areas at different times.



