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Tax Risk Management: An Emerging Trend or a Necessity?

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Abstract

Following major corporate collapses, the US Government introduced the Sarbanes-Oxley Act *of 2002 requiring, among a number of issues, management of listed companies to carry out risk assessment procedures and report this to their shareholders. This article focuses on tax risk management (TRM) and examines its evolution in Australia through the Australian Stock Exchange Principles of Good Corporate Governance provisions and the* Corporations Act of 2001. *In light of the recent focus by the Australian Commissioner of Taxation on TRM of large corporations, this article explores the benefits of TRM and considers how technology can assist in managing tax risks.*

Introduction

Many governments and government agencies around the world, including those of the US, UK and Australia, have enacted regulations for directors of listed companies to recognise that tax is an area with its own unique risk profile requiring them to manage tax risks in the same manner as any other business risk.[1] This emerging concept of tax risk management (TRM) has stemmed from a need to address the inadequate corporate governance practices which led to the collapses of large corporations around the world. This article examines the emergence of TRM, methods for managing tax risks (including the use of tax software) and the emphasis the Australian Taxation Office (ATO) has placed on improving corporate governance practices.

Following this introduction, the first part of the article explores the emergence of TRM. The second part addresses the identification of tax risks. Part three looks at establishing a TRM profile. Part four follows on to address the management of tax risks. Part five examines how a framework can be put in place to manage tax risks once a company's tax risk profile has been established. Part six explores the benefits of TRM. Part seven reports on the approach of the ATO in promoting TRM. This is followed by a conclusion.

The Emergence of Tax Risk Management

The corporate collapse of Enron and of WorldCom, together with those of other large corporations around the world, has forced regulatory authorities in many countries to improve corporate governance policies and practices of large corporations.[2] In the US, the *Sabanes-Oxley Act* (SOX) was enacted in 2002 to empower the Securities and Exchange Commission to enhance investor confidence after these collapses. This could only be achieved by real time disclosure of information and disclosure of non-financial control measures. Under Section 404 of SOX, management is required to perform a risk assessment and produce an *internal control report* on tax risks and material weaknesses. From 15 November 2004 the Australian subsidiaries with US holding companies are required to comply with Section 404 of SOX.

In the UK the Combined Code on Corporate Governance requires that the Board of Directors establish an audit committee, the main role and responsibilities of which should include a review of the company's risk management systems (Financial Reporting Council, 2006). The Combined Code necessitates that the annual reports of listed companies incorporated in the UK include a report confirming that the board has conducted a review of the group's system of internal controls with a separate section describing the work of the audit committee in fulfilling its responsibilities.

Australia has adopted a principles-based approach to risk management which is unlike the formal legislative approach of the US. The Australian Stock Exchange (ASX) Corporate Governance Council released the first edition of its Principles of Good Corporate Governance Practice and Best Practice Recommendations (Guidelines) on 31 March 2003. Good Corporate Governance Principle 7 applies to risk management including TRM and requires companies to recognise and manage risk by establishing a sound system of risk oversight and management, and internal controls. This system should identify, assess, monitor and manage risk as well as inform investors of material changes to the company's risk profile. The Board of Directors can ensure such a system is in place by establishing policies on risk oversight and management. Good Corporate Governance Principle 7 requires the chief executive officer (CEO) and the chief financial officer (CFO) to state to the board in writing that the statements made under Principle 4[3] regarding the integrity of the financial statements are founded on a sound system of risk management.

The risk management principles adopted by the ASX have been incorporated in the *Corporations Act 2001*. The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (also known as CLERP 9) became law on 1 July 2004. It includes a number of reforms to the *Corporations Act 2001* (Cth) and is based on the reform proposals contained in the CLERP 9 Discussion Paper entitled 'Corporate disclosure - Strengthening the financial reporting framework', which was released by the government in September 2002 (Commonwealth of Australia, 2002). CLERP 9 enacted section 295A of the *Corporations Act 2001* which follows a similar approach to the ASX's Good Corporate Governance Principle 7 discussed above and requires both the CEO and CFO of listed companies to make declarations regarding the integrity of the financial statements. CLERP 9 also contains a number of reforms flowing from the Federal Government's September

2003 response to the recommendations contained in the report of the HIH Royal Commission released in April 2003 (Commonwealth of Australia, 2003).

In 2007 the ASX carried out an extensive review of the Good Corporate Governance Principles and implemented revised principles from 1 January 2008, the key changes being the removal of the overlap with the *Corporations Act* and the Accounting Standards to reduce regulatory burden. The majority of the submissions received for the 2007 ASX review expressed strong support for the Australian principle-based approach. The ATO has implemented a range of support mechanisms to assist CEOs and CFOs of large corporations[4] to comply with the law and to provide guidance on how to manage tax risks.

Risk management encompasses all risks. This article, however, focuses solely on TRM in Australia. By gaining an understanding of the tax risks across all activities associated with their company, the Board of Directors should be able to satisfy their TRM obligations under the *Corporations Act* and the ASX principles of Good Corporate Governance.

Tax Risks

A Board of Directors may not have a sound understanding of the tax laws; however, in order to formulate a policy on TRM they need a certain level of understanding of tax risks across all activities associated with their company. The professional accounting firms have categorised risks associated with taxes into specific areas. According to PriceWaterhouseCoopers (2004), tax risk can be transactional, operational, compliance, financial accounting, portfolio, management or reputational. Each of these is discussed below with a statement on how they could be dealt with for TRM purposes.

Transactional tax risk refers to the application of tax laws to specific transactions. Some transactions may be executed to achieve a particular tax result and may be challenged by the tax authorities, such as taking the wrong technical position with respect to a transaction such as by claiming a deduction when none is allowable. In order to manage transactional risks the Board of Directors should implement policies and procedures to ensure that the level of risk the company is taking in any given transaction, whether routine or non-routine, is within the company's risk profile.

Operational tax risk refers to the application of tax laws to routine, everyday business operations. For example, if the daily operations involve intra-group cross-border sales, then transfer pricing policies should be assessed. Operational risk can be minimised by ensuring that the company's tax department is consulted and involved in setting the operational procedures, and that formal sign-off on the procedures is obtained.

Tax compliance risk refers to the tax compliance obligations of the company, stemming from preparation of tax returns and the processes and procedures adopted by a company to prepare and submit its tax returns. To achieve the best tax compliance risk outcome, the directors should balance risk of error against the cost of achieving a low error return. This will ensure the most economical return.

Financial accounting risk arises as the future income tax liability is normally estimated in the financial statements. Directors can minimise this risk by ensuring that sufficient internal controls are in place over financial reporting and identifying uncertainties over interpretation and application of tax laws and extraordinary transactions.

Portfolio tax risk refers to the aggregate of transactional, operational and compliance activities. Directors can minimise this risk by examining the exposure of tax risks in both routine and non-routine transactions of an organisation. Portfolio tax risks permeate at every level of business activity and affect financial statements, as illustrated in Table 1.[5]

Table 1: Exposure to Portfolio Tax Risks in the Financial Statements

FINANCIAL STATEMENT	TYPE OF TAX EXPOSURE
Sales	Goods and services tax Cross-border issues
Cost of Goods Sold	Customs duty Transfer pricing
Cost of Employment	Payroll tax Employee benefits Fringe benefits tax
Balance Sheet Assets and Liabilities	Stamp duty Capital gains tax Future income tax assets and liabilities

Source: Original table.

Management risk refers to management policies that address tax risks. These risks can be minimised by the Board of Directors ensuring that those charged with managing tax risks have the skills and the resources to do so, and by documenting their decisions. The Board of Directors should bear in mind that *key man risk* is common in organisations with old established tax functions where the tax manager may have been there for a long time and there is a lack of documentation regarding the process for making tax decisions. The risk is that if the tax manager resigns then all of his/her tacit knowledge is lost.

Reputational risk refers to the impact of adverse publicity with respect to the company's tax position. The directors may need to address both the consequences of this risk against the company's tax risk profile and how aggressively they pursue tax minimisation.

Once the tax risks are identified, the Board of Directors needs to establish a TRM profile. The next section explores what TRM is and how directors can establish a TRM profile.

Tax Risk Management Profile

According to the ATO, tax risk management is (Carmody, 2005):

> *… about the level of comfort a corporation has that they will not face substantial liabilities following a review by the Tax Office, or if they do, about the level of comfort they have that they will succeed on appeal to the courts.*

Establishing a tax risk profile will enable the Board of Directors to ensure that the outcomes of all decisions regarding tax are within the confines of a predetermined level of risk accepted by the board.

In accordance with Principle 7 of the ASX Principles of Good Corporate Governance, companies are required to recognise and manage risk by way of establishing a system which identifies, assesses, monitors and manages risk (ASX, 2003). In order to achieve this, the company must first establish its tax risk profile to determine the level of risk acceptable to its board.

In establishing the tax risk profile, boards ought to pay equal attention to understanding and seizing opportunities for tax minimisation and managing tax risk. Real value exists in the identification of a tax risk threshold that will effectively set limits on the aggregate amount of tax risk that an organisation is prepared to assume in achieving its risk-benefit balance (Stacey, 2005).

At one end of the spectrum is an aggressive risk profile which results in lower tax payments but a relatively high risk of penalties. At the other end of the spectrum is a conservative risk profile which results in a low risk of penalties but higher tax payments and missed opportunities. Somewhere in between these two extremes is the reasonably arguable position.[6] In establishing its tax risk profile, it is within this range that the board may find equilibrium between minimising tax payments and exposure to tax penalties and other tax risks. Once the company's tax risk profile has been established, a framework can be put in place to manage tax risks.

Management of Tax Risks

Once the profile has been established, the tax risks need to be managed within that profile. The following four steps may be used to appropriately consider and manage tax risks (Stacey, 2005):

Risk identification and assessment
This step involves examination of every aspect of the business with a view to identifying both tax risks inherent in the operation of the business as well as any risks of technical error.

Risk reduction
This requires management and the board to develop and test controls to mitigate risks and provide indicators of when a particular risk might arise. The controls put in place must be able to detect specific tax risks and allow management to take action to prevent any adverse consequences.

Ongoing execution
During this stage, risk owners are identified within different groups to coordinate and improve risk strategy, processes and measures. Regular testing of the controls established in the risk reduction stage is required to ensure they are still operating effectively.

Tax risk policy and strategy

Formal policies should be established to set the *tone from the top*, set the tax risk threshold for the organisation, and facilitate and communicate future tax planning opportunities.

Technology can assist directors in managing tax risks. A wide array of available tax software can be utilised to reduce operating costs and to streamline tax calculations and reporting processes. Examples of specific types of tax software available are shown in Table 2. [7]

Table 2: Software for Tax Risk Management

SOFTWARE	DESCRIPTION
Vertex	A software solution provider for business tax which helps companies streamline tax compliance processes and leverage information to discover new strategic tax savings. In addition, they enhance decision information across every major line of business tax including income, sales, consumer use, value-added, communications and payroll (Vertax, 2007).
Tax Technology	A privately held Australian enterprise which provides software for streamlining business tax planning and compliance (Tax Technology, 2005).
PowerTax	Software to manage corporate, trust and FBT compliance and management reporting, which improves the speed and accuracy of tax calculations and reduces the inefficiencies inherent in manual processing (Thomson Reuters, 2008).
Other products	Software products such as MYOB, Quicken and Handitax can be used by small companies and businesses to manage accounts and generate Business Activity Statements (BAS) and tax returns forms, thereby reducing the risk of error inherent in the performance of manual calculations.
Accounting firms	Many large tax practices produce their own in-house software. This software is provided to clients to assist in the preparation of their tax returns (Allume, 2006).[8]
ATO software	ATO software can be used to generate state and federal forms.

Source: Original table.

The Australian Government has also recognised the importance of tax software that may assist businesses in developing sound corporate governance practices. On 15 August 2006 it announced the launch of the Standard Reporting Business (SBR) initiative to develop software that would allow businesses to use their account recordkeeping software to automatically pre-fill government reports such as BAS. In January 2008, the Treasurer and Minister for Finance and Deregulation jointly extended the SBR to build the Extensible Business Reporting Language (XBLR) to include additional reporting requirements of the Australian Accounting Standards, the *Corporations Act* and the ASX Listing rules. The project is expected to be completed by 2010 (Australian Government Initiative, 2002).

Appropriate tax technology can transform a company's tax department from a reactive compliance-focused group into a proactive, value-adding department. Software can also reduce the risk of making material tax errors thereby reducing the chance of penalties and other costs including reputational costs. Following is a sample of benefits that can arise from the use of tax software (Allume, 2006):

Comprehensive integration of financial and tax information
Technology can assist in creating links to the general ledger for improved quality assurance and integrity of tax financial calculations. The risk of errors in tax calculations due to the incorrect transposition of figures from the general ledger is eliminated.

Reduced lead time and minimisation of risks
Integrated data and automated calculations reduce manual processing, workload and human error. This enables members of the tax function to spend more time considering technical issues and opportunities for minimising tax.

Ease of use
Many tax software programs are easy to navigate, featuring logical spreadsheet-based designs and practical user manuals. Comprehensive training is often included if required.

Real-time multi-user access and reporting
Changes made in any business entity by a user automatically update consolidated information at the group level. This eliminates the need for multiple entries of the same data across the group, thereby reducing the time spent in manual data entry and allowing more time for the tax function to engage in value-added activities. When changes are made in one entity within a group, these changes must be reflected at group level. By using real-time multi-user access software, the risk of changes to one entity not being transposed across the group is also eliminated.

Centralised tax data storage
This function maintains a complete record of group tax calculations across multiple versions, tax years and reporting periods in a central and single repository. The maintenance of a data repository reduces the risk of lost data and also reduces the so-called key man risk—the risk that information may be lost if a critical member of the team leaves and takes tacit knowledge (of processes and transactions) with them.

Benefits of Tax Risk Management

Although listed public companies are required by legislation or regulations to put in place a TRM policy, there are many benefits of doing so that may apply to both listed companies and unlisted companies who have no legislative requirements. By putting a TRM policy in place, the directors would not only be complying with the regulatory requirements, but also benefit from: board-level understanding of tax strategy; better internal communication between business units; a framework and process for tracking and managing tax risks; a context for the identification and approval of new tax strategies; minimised tax payments and increased earnings per share; fewer tax authority challenges; and cost savings through more efficient working practices (Deloitte, 2008).

In addition, by addressing and managing tax risks, directors discharge their duties under the *Corporations Act*. Under both common law and the *Corporations Act*, a director has a duty to exercise care and diligence, including the exercise of skill. This duty falls under the tort of negligence. It means that directors must not be negligent when making business decisions and must keep themselves informed and committed and must perform to a reasonable standard. A director may breach s180(1) of the *Corporations Act* if he/she fails to act when put upon inquiry about tax risks.

Tax risks are like any other business risks including foreign exchange risks as discussed in the case of Daniels v Anderson.[9] In Daniels v Anderson, the CEO, Hooke, failed to make inquiries of senior management regarding foreign exchange risks. The NSW Court of Appeal held that directors of listed companies are required to take reasonable steps to place themselves in a position to guide and monitor the management of a company. The Court held that Hooke was under a continuous obligation to supervise and seek satisfactory explanations about the problems and weaknesses of the foreign exchange system.

Since 2003 the ATO has promoted the importance of TRM and expects directors of large corporations with an annual turnover of AUD$200 million or more to be informed about tax matters, particularly the risk approach taken by their company.

Australian Taxation Office Focus on Tax Risk Management

The former Australian Commissioner of Taxation, Michael Carmody, raised tax compliance and corporate governance issues at a leaders lunch on 10 June 2003. The Commissioner's address on 22 September 2004 to the IQPC Conference identified that audit collections for large corporations and high wealth individuals had increased from around AUD$450 million in 1998–99 to $2.2 billion in 2003–04. The Commissioner stated that it is not the ATO's job to decide the tax position large businesses should take or how much risk they should assume, but to encourage companies to use their governance processes so that they can make conscious decisions, understand their tax risks and manage them properly. Against this background, ATO released the Large Business and Tax Compliance booklet to provide guidance to large businesses from the ATO's perspective.

In January 2004, the Commissioner of Taxation forwarded letters to the chairs of the Board of Directors of Australian listed companies involving 10 questions that the directors and their tax advisors should consider in identifying and managing relevant tax risks.

In March 2005, Michael Carmody spoke at the Tax Institute National Convention and reinforced that the risk analysis papers prepared for the chairperson of boards of listed companies would remain confidential and that the ATO was conscious of developing cooperative and time-sensitive arrangements for private rulings on issues of concern to a Board of Directors.

In August 2006 the ATO held a symposium with large corporate representatives. This was one of a number of steps taken by the ATO to build a more open and productive relationship with the business community—an invitation to move to more collaborative approaches.

On 1 September 2007 a speech by Michael D'Ascenzo (Commissioner of Taxation) to the Law Council of Australia Rule of Law Conference stated that the role of the ATO had shifted to promote voluntary compliance. He pointed to the ATO Strategic Statement 2006–10 which states that the ATO uses a risk management approach to promote voluntary compliance.

On 28 May 2008(a) a speech by Michael D'Ascenzo to the G100 function in Sydney encouraged companies to enter into an Annual Compliance Arrangements (ACA) with the ATO. ACAs are an ATO initiative designed to provide practical certainty to large corporations by jointly assessing tax risks in real time or at the time that the tax return is lodged. Through ACAs the ATO asks the companies to put their risks on the table and discuss with the ATO how the risks have been mitigated. This would give the Board of Directors a significant level of practical certainty. Under the ACA, the ATO would issue the company with a sign-off letter confirming the outcomes of a joint risk assessment.

On 24 July 2008(b) Michael D'Ascenzo spoke at the Australian Club in Melbourne to the Financial Executives International of Australia. He suggested that directors and senior managers should be confident about the reporting procedures in place to identify material tax risks and consider tax implications of major transactions and, in doing so, be comfortable that they will not face substantial liabilities following a review by the ATO.

The ATO provides support that may assist in managing risks including private binding rulings, product rulings, class rulings, advanced pricing agreements, Forward Compliance Agreements and ACAs. Managing tax risks is an absolute necessity from the ATO's perspective. These support mechanisms allow the ATO to build a cooperative, transparent and constructive relationship to improve corporate taxpayer compliance.

Conclusion

TRM is not an emerging trend, but a necessity. It is not only a legal requirement which can impinge on directors' duties, but is also beneficial as unanticipated tax risks can derail the company's strategic goals and objectives. This is not just an Australian trend, but a worldwide trend towards greater transparency in financial reporting with an emphasis on increased corporate governance and social responsibility.

In October 2004 the OECD released a guidance note to provide a framework for the application of modern compliance risk management principles to the management of tax compliance risks. In September 2006, representatives of 30 countries committed themselves to expanding the OECD 2004 Corporate Governance Guidelines. This is expected to strengthen the links between corporate tax arrangements and good governance.

The increasingly complex regulatory environment has made strategic planning and risk management an essential element of a corporate tax department. External business forces and regulatory changes are pressing the tax function of listed companies to stretch beyond their traditional bounds to participate in broad business management and risk management activities. However, it may be beneficial for all companies to effectively integrate the tax function into business operations outside tax by executing an effective

TRM policy and investing in tax information technology, thus creating an asset of the business. Modern information technologies have become a very important part of our everyday lives. The rapid development of hardware, software, internet, information systems, e-commerce and other tools can assist in reducing tax risks.

TRM is important to Boards of Directors who are required to take reasonable care in their tax affairs. TRM is not just an emerging trend, but a necessity that can improve certainty, minimise costs and give companies a competitive advantage.

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Vertax (2007) Income Tax Solutions. Available at: www.Income%20Tax%20Brochure_0407.pdf – Adobe Reader> at 5 April 2008. Many other US software companies include TaxDecisionERP, CertisoftCM and Sabrix.

Notes

1 See the *Sarbanes-Oxley Act 2002* in the US, the UK's Combined Code on Corporate Governance June 2006 and the Australian Stock Exchange Principles of Good Corporate Governance Practice and Best Practice Recommendations (Guidelines), 31 March 2003.

2 See comments made by Centre for Audit Quality. Retrieved 10 Dec 2008 from http://thecaq.aicpa.org/Resources/Sarbanes+Oxley/.

3 ASX Good Corporate Governance Principle 4 requires the company to put in place a structure of review and authorisation designed to ensure the truthful and factual presentation of the company's financial position.

4 Although the ATO guidance is for large corporations, the TRM principles adopted by the ASX and CLERP 9 only apply to listed public companies.

5 In Table 1 the author has listed the categories within the financial statement and broadly identified the types of tax exposure where risks may need to be assessed and managed.

6 The tax law defines what is meant by the phrase *reasonably arguable*. Under the present definition applicable to the 2004–05, and later income years, a matter is reasonably arguable if it would be concluded in the circumstances, having regard to the relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect. Available at www.pwclegal.com.au/legal/pwclegal.nsf/pages/B094528B57798FDDCA2571B9002595F6.

7 The author has researched some available software products that may assist in identifying, assessing and managing tax risks. However, the author has not tested these products and is not responsible for their appropriateness.

8 Allume Technology Partners Pty Limited is a tax technology company jointly owned by Deloitte and KPMG which provides technology solutions in taxation compliance reporting and management.

9 (1995) 37 NSWLR 438.