

Reflection, inflection and direction—Tax risk management in an increasingly transparent world

Recent market turmoil resulted in government driven stimulus measures throughout the world. Who will be asked to pay the bill? One thing seems certain- politicians will need to show that the bill is being shared and that involves some difficult policy choices. A growing number of indications suggest the financial sector will be targeted to bear a significant part of this bill through a combination of new and increased taxes coupled with more stringent and internationally coordinated enforcement actions. This article examines these global trends and some of the issues financial institutions should be considering as they evaluate their reputational risk and assess whether changes are needed to their existing tax risk management policies to better integrate with the company's enterprise risk management framework.

Some recent tax policy choices

In the search for new sources of revenue designed, in part, to demonstrate that the stimulus burden is being shared, the UK and France have recently announced measures targeted at bank compensation plans presented on the basis that the banks were the primary beneficiaries of government assistance, or they were somehow responsible for the problems. The US adopted a different approach to bank compensation and has also proposed a Financial Crisis Responsibility Fee. Other

countries are promoting the imposition of a new tax on certain financial transactions.

Our Federal Government has rejected these proposals but has recently implemented measures to radically increase the GST/HST extracted from the financial sector. By introducing changes to the Excise Tax Act, GST/HST is imposed on a yet to be completely defined range of brokerage and other intermediation fees with effect from December 14, 2009. Unlike a manufacturer, a financial institution can not recover the GST/HST on costs related to an exempt supply such as a loan or insurance, and so the tax is a direct cost to the business. No revenue projections from this significant tax policy change were contained in the March 4, 2010 Federal Budget. This tax cost will be magnified by the pending provincial sales tax harmonization and profoundly affects the insurance and investment management and banking sectors. The manner in which these measures were introduced created immediate situations of non-compliance.

International tax developments and their impact on risk management

While there will likely be new taxes such as those outlined above introduced to pay for part of the stimulus spending, traditional sources of tax revenue are expected to pay for the vast bulk of

government debt. This means the income and consumption taxes will come under scrutiny and governments will need to assess which policy option least dampens economic recovery. In this regard, domestic and foreign developments will impact on how financial institutions manage their future tax obligations and their existing and future tax risks. One of the primary developments affecting risk management is in the area of international tax coordination.

On reflection, these developments included the following milestones:

- In 2002, The Organization for Economic Cooperation and Development (OECD) created the OECD Forum on Tax Administration (FTA) that includes more than 40 countries. The FTA promotes cooperation between tax administrations and developing good administration practices. The OECD has a primary role in increasing tax transparency, effective exchange of information, improving compliance and access to banking data.
- In 2004, the tax administrations of the United States, United Kingdom, Australia and Canada established a joint task force to increase the collaboration and coordination of information on abusive tax shelters. In 2007, Japan accepted an invitation to join this task force.

- In 2006, Canada and the tax administrations from 34 other countries convened under the auspices of the OECD FTA and developed what is known as the Seoul Declaration. A key element of the Declaration was to expand the published corporate governance guidelines to give greater attention to the linkage between tax and good governance. Other focal points were increased training for tax officials on international issues, developing directories of aggressive tax planning techniques and an examination of the role of financial intermediaries (tax advisors, banks and other financial institutions).
- In 2008, the 45 FTA member countries met in Cape Town where they issued a communiqué endorsing conclusions on a 2008 study of the role of tax intermediaries which recommended the need for tax administrations to have robust risk management policies to respond quickly to and optimally apply their resources to particular priority areas. Also recommended was a focus on developing a more open and efficient relationship with taxpayers.
- US accounting standards were changed to require significant disclosure of uncertain tax positions in financial statements prepared under US GAAP.
- In July, 2009, the OECD released its publication Building Transparent Tax Compliance by Banks which examines risk management practices within Banks and their impact on reputational risk.
- In December, 2009, the UK government released a UK Code of Practice on tax for banks in which it sets out its views on good governance and expectations that banks undertake planning only to support their business operations and not to achieve advantages that are contrary to the intentions of Parliament.
- On January 26, 2010, Douglas Shulman, the Commissioner of the US Internal Revenue Service announced the IRS focus on international issues including transfer pricing, offshore enforcement, joint audits with US treaty partners and a critical change to promote transparency. This latter announcement is drawing the most attention as it would see taxpayers required to disclose details of their uncertain tax positions together with the maximum amount of exposure in their tax return. In return, the IRS would retain its policy of restraint in not asking for the taxpayer's tax accrual working papers where the amount of any reserve would be recorded in respect of such exposures. The stated goal of the IRS was to bring taxpayers into compliance in a more efficient and less resource intensive way.

The Canadian environment

The chronology described above indicates that the pace of coordinated international developments is accelerating and Canada is an active participant. The evidence that the Canadian tax system is responding to these developments and is at a point of inflection is demonstrated by these recent developments:

- On October 15, 2009, the Québec Minister of Finance announced measures to counter “aggressive tax planning”. These measures contained both mandatory disclosures for certain transactions and voluntary (preventative) disclosures for other transactions. Failure to disclose these transactions extends the statute of limitations and can lead to significant penalties. The mandatory disclosure regime targets contingent fee arrangements or transactions involving confidentiality provisions. The voluntary disclosure regime allows taxpayers to avoid penalties and an extended statute of limitations if the General Anti-Avoidance Rule is found to apply.
- The March 4, 2010 Federal Budget announced public consultations on proposals to report certain tax avoidance transactions to the Canada Revenue Agency (CRA).
- Increased staffing by CRA in the area of international tax compliance and the additional staffing in the Avoidance Sections focusing on taxpayer audits.

Tax risk management in a transparent world

With governments strapped to find sources of funding focus will continue to build on compliance with the tax legislation of each country through increased audit activity. An important issue for financial institutions will be to assess their tax risk profile and ensure that the appropriate procedures are in place to accurately identify and manage tax risk. This review should be fully cognizant of the increased cohesion between governments. Is your global tax risk management less or more coordinated than the audit challenge you face?

The convergence of these factors needs to be keenly appreciated at the executive and board level. A reexamination of the risk profile, risk tolerance and tax risk management processes should be updated and integrated with reputational risk management assessments. In the new environment, it is appropriate to candidly ask:

- Is our tax risk management truly coordinated between jurisdictions in the way that is now necessary?
- Are the processes and procedures to identify, evaluate and manage extant tax risk sufficient or should they be buttressed?

- Is the existing documentation that supports positions ready to be reviewed by tax authorities and what additional documentation should be gathered in light of the new audit direction?
- How has tax risk changed for the organization as a result of existing and proposed tax legislation?
- What new tax risks are created by changes such as increased transparency in the economic, industry, regulatory and financial reporting environment and do the existing processes amplify or mitigate those risks?
- Have changes in the organization, its personnel and the focus of reducing costs adversely affected the ability to manage tax risk?
- Have the increasingly transparent reporting trends been adequately reflected in the current risk management policies?
- Do the risk management policies and procedures address issues associated with IFRS conversion and what steps are being taken to identify and update internal controls required under IFRS?
- How is the tax risk management policy developed, approved and communicated?

- What is the organization's current relationship with its tax authorities and can this relationship be managed in a way to capture additional value for the organization?

The area of tax risk management continues to evolve in response to a rapidly changing environment. There are many elements to this topic that we will continue to explore in our upcoming publications.

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