

Tax and regulatory services

# Tax Risks in India\*

Survey insights & perspectives



\*connectedthinking

PRICEWATERHOUSECOOPERS 





# Table of contents

<b>01</b>	Preface	2
<b>02</b>	Executive Summary	3
<b>03</b>	Key areas of tax risk	6
<b>04</b>	Methodology and Respondents' Profile	9
Survey Findings		
<b>05</b>	Risk Classification	11
<b>06</b>	Risk Management	15
<b>07</b>	Tax Risk: Perception & Challenges	19
<b>08</b>	Tax Risk Management: Experiences Across Firms	23
<b>09</b>	Use of External Advisors	26
<b>10</b>	Conclusion	30

# 01 Preface

In an increasingly complex and dynamic business landscape, businesses are faced with a bewildering variety of risks ranging from product/service performance and security, to sub prime crisis, oil prices and many more. Additionally, there are risks relating to management bandwidth and infrastructure. In this spectrum, where do tax risks feature? Are they at the bottom of the risk pyramid?

“Taxes are what we pay for a civilised society” said Oliver Wendell Homes Jr a judge of the US Supreme Court, in 1904. While clearly, taxes are an important price to pay for civilisation, over the years, the tax system has become extremely complex. This is so not only in India, but all over the world. However, in a large democracy like India, especially with its federal structure, multiplicity and complexity of taxes has become a reality and the myriad nature of compliances has significantly added to that complexity.

The complexity of tax issues has been further heightened by evolving industries. The media and entertainment industry and B2B e-commerce and financial services are cases in point. At the point of time when tax legislations were drafted, several of these dimensions were not present on the business landscape. Clearly, they present their own challenges to tax authorities and create uncertainty in administration of tax laws which are anyway complex and difficult to comprehend. Coming to a more mundane level, a constant tug of war between the tax payer and the tax gatherer is a reality; this includes issues arising out of expense disallowances, denial of exemptions and rigorous tax audits. The fact that the judicial process in India is arduous and that litigation develops a life on its own has significantly heightened the risks inherent in the context of a business entity dealing with tax matters.

This scenario can create significant challenges and often leads to large tax demands impacting cash flows and indeed, at times, impacting the entire business model. Additionally, procedural compliances are becoming very harsh; a case in point is in relation to withholding taxes which extends to a majority of payments made by corporates.

In the light of the above backdrop, corporates are faced with the unenviable task of managing the whole gamut of tax issues, including risk management. It is in this context that this initiative at PricewaterhouseCoopers assumes considerable importance.



Ketan Dalal  
Executive Director  
PricewaterhouseCoopers, India  
Date: December 13, 2007

This survey is aimed at understanding the criticality of tax as a risk factor to a corporate entity's operations and business at large. The attempt is to map issues that concern and challenge CFOs, tax department heads, board members and other stakeholders as they weave their way through the tax system. The aim is also to bring out various approaches to mitigate tax risks and to highlight the increased responsibility of stakeholders to implement tax risk management policies and create transparent tax practices leading to better corporate governance. The survey raised questions on how companies sharpen their focus on tax issues and seeks to address the following issues:

- Importance of tax risk management in the overall risk management process;
- Classification and importance level of tax risks and tax risk management;
- Impact of tax risks on business;
- Key practices adopted by corporates to address & mitigate tax risks;
- Concerns and perceptions of companies related to tax risks.

Over 80 corporates from across a wide spectrum of companies participated in the survey. The chosen companies represented the gamut of verticals across Services, Manufacturing, Banking & Financial Services, etc. A representative coverage of the Indian industry was ensured through this sample.

These insights are intended to the tax regulators to evolve a perspective on tax related issues in the country. It will provide practitioners and advisors to evolve suitable methodologies to assist clients in coping with tax laws and issues.

I hope that results of this survey will help all stakeholders in the tax loop – law makers, tax payers, interpreters and advisors to strengthen their own practices of dealing with tax issues.

02



# Executive Summary

## 4 Executive Summary



Changing legislations, heightened scrutiny by tax authorities and increasing public attention are combining and interacting to create a whole new context for tax risk management decisions. There is an increasing urgency on part of firms to manage their tax affairs efficiently as to minimise tax risks. The same is manifest in creation of positions like “tax director”, more interaction between corporate boards and tax departments, and documented policies for managing tax risk. The survey is aimed at pinpointing the importance and impact of tax as a risk in the overall risk management process and the practices Indian and multinational companies have regarding its management and mitigation. At the same time, it qualitatively evaluates concerns and perceptions of companies related to tax risks. Broadly the survey findings are as follows:

### A key risk across industry verticals

A majority of firms (95%) surveyed acknowledge the importance of managing tax risk as “very important” to “important”. Tax risk is considered as the fourth most important risk in the entire gamut of risks a corporate entity faces in its day-to-day operation. Tax risk comes just behind risks like data security, product failure and fraud. In particular, the IT and IT Enabled Services (IT/ITES) and the Banking and Financial Services (BFSI) sectors were particularly keen on managing risks related to tax.

Direct taxes were considered high impact by a majority of firms as opposed to indirect taxes. In particular, income tax (73.1%) and service tax (56.7%) were rated as the most worrisome risks.

### Tax Risk Perception & Challenges

Damage to image was the key reason for firms across sectors to manage tax risks. Loss of investor confidence, and financial penalties due to non-compliance with tax regulations were the other two most likely reasons for firms giving importance to tax related risks. Transfer pricing emerged as the most significant event for MNC firms leading to potential tax risk, while for Indian firms, the same was setting up operations abroad. Differing interpretations by tax authorities and corporates and the resultant scope for litigation was also a key concern.

### Risk Management Approach

Firms mostly managed risks via functional departments with most firms being moderate to conservative when it came to approaching courts for dispute resolution. Most often, it was the CFO who shouldered the responsibility of tax management policy and planning with the finance and tax departments looking after execution and monitoring. Most companies reviewed risks leading to damage of reputation and transactions on a real time basis. Firms from the service sector were most likely to conduct reviews every month.

## Risk Management Practices

While the board and senior management were kept informed of potential risks in most cases, there were differing practices when it came to actively managing risks associated with tax. While some appointed specific people to manage tax risk as a top practice, some assured that they had the management commitment towards allocating resources for the same. Securing competent tax advisor was a priority with almost all firms. However, a well documented tax risk management policy and effective operative controls were areas where most firms lagged behind.

## Use of External Advisors

Majority of firms used external tax advisors and were satisfied with their services. Their key contribution for risk management was seen in their capability to bring in learnings from other industry disciplines and sectors. The value in appointing external advisors was also considered in their ability to keep track of changing laws and making recommendations considering other statutory requirements.

A majority of MNCs (87%) and Indian firms (69%) claimed to have effective contingency planning procedures. More MNCs (50%) carried out potential impact analysis of tax risks, as compared to only 30% in case of Indian firms.

The following pages carry brief extracts defining seven main areas of tax risks from an earlier PricewaterhouseCoopers publication titled "Tax Risk Management Guide". Also given is the methodology we followed while conducting the survey. We hope they will give one the necessary context for reading the survey findings disclosed in detail in subsequent pages.

Ninety five per cent of firms acknowledge managing tax as "very important" to "important".

Damage to image is the key reason for corporate India to manage tax risk.

CFO and tax departments still the ones to frame tax policy and plan, implement and monitor tax management.

Most firms use external tax advisors and are satisfied with their services.

03



# Key areas of tax risk

Tax risk can be categorised into seven main areas as follows:

**Transactional risk** – refers to risks and exposure associated with specific transactions undertaken by a company. 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.

**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.

**Compliance risk** - concerns the risks associated with meeting an organisation's tax compliance obligations. 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. These include:

- 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
- The proper and efficient use of technology in the processes

**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 sections requiring documented and tested internal controls over financial reporting.

To manage the risk in this category the processes used in arriving at the accounts figures and the internal controls around these processes need to be reviewed by answering the following questions:

## 8 Key areas of tax risk

- 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?

**Portfolio risk** - concerns the overall aggregate level of risk when ones takes 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. 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.

**Management risk** - is one of not properly managing the various risks listed above. 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, few can claim that all 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.

**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 issue through a public arena such as the courts, information about the company's activities or practices result in changes to

### Risk table classifying seven core risk areas

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

(Source: PwC Tax Risk Management Guide)

04



# Methodology and Respondents' Profile

# 10 Methodology and Respondents' Profile

The survey is a comprehensive study of tax risk management trends and perceptions among business organisations in India. This study was conducted over a period of eight months. Eighty one large Indian and multinational companies (MNCs) across industry sectors participated in the survey.

The survey respondents include CEOs, CFOs, tax heads and senior professionals from finance, tax and audit functions of legal departments. Responses were received via an online questionnaire administered through a survey portal. Telephonic calls and personal visits were also made to get additional insights from the respondents. To preserve confidentiality, no individual company has been identified in this survey.

## Respondent classification

Seventy four per cent of the respondents comprise of multinationals including joint ventures with domestic Indian companies while the rest are Indian firms. The participation is indicative of the seriousness towards tax risk management and the perceived impact it may have on global operations. Consider the impact on a company if, as a result of pursuing a tax 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 (Table 1).

**Table 1 - Respondent Classification**

Respondent classification	Nos.
Multinationals	56
Indian corporates	21
Joint Ventures	4
<b>Total</b>	<b>81</b>

**Table 2 - Respondent organisation's turnover**

Turnover Range	Nos.
Rs 1 – 5 billion (USD 25 – 125 million)	25
Rs 5 – 30 billion (USD 125 – 750 million)	32
> Rs 30 billion (> USD 750 million)	24
<b>Total</b>	<b>81</b>

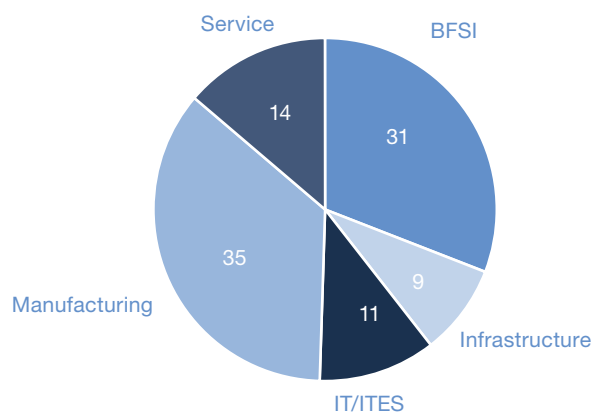
## Industry response

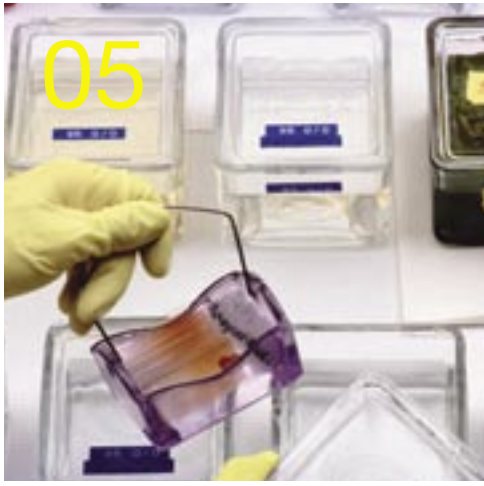
Special care was taken to ensure adequate representation from all types of industries and businesses to ensure non-partial results. The manufacturing sector contributed 35% of all responses, followed by BFSI at 31%. Overall composition is depicted below (Figure 1).

## Respondent organisation's turnover

70% of respondent companies had a turnover of between Rs 5 billion and Rs 30 billion per annum, while the remaining 30% had a turnover in excess of Rs 30 billion. (Table 2)

**Figure 1 - Industry response**





# Risk Classification

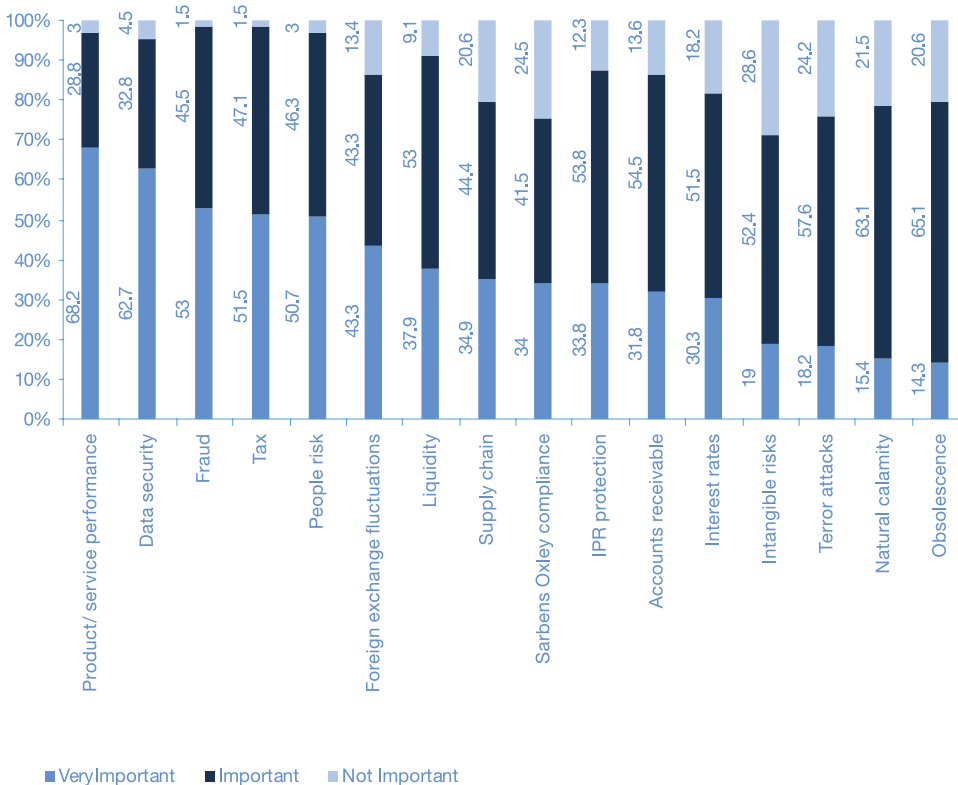
## 12 Risk Classification

In the course of conducting its everyday business operations, an organisation exposes itself to varying levels of uncertainty. The same result in perception or incidence of risk. For instance, a business entity, at any given time, has to deal with multiple risks ranging from IT malfunctions, data security, fraud, market risks to financial and taxation risks. While companies willingly undertake such risk as a consequence of doing business, they may assign different weights to these risks in order of importance and management. The CEO, CFO and other stakeholders strive to devise the most effective risk control and policy for addressing the same.

We asked our survey respondents to rate major risks their organisations face in the context of the present Indian business environment. A majority rated product or service performance followed by data security and fraud as top concerns. Tax related risks ranked fourth in the overall categorisation of potential risks at 51.5%, just slightly below fraud at 53%. They also fell at almost the same level of risk as losing key people (50.7%), a major concern for any organisation. Most respondents described key reasons for tax risk as uncertainties in the interpretation of existing tax laws and guidelines, their application and uncertainty about the fact itself or related to the systems available to arrive at tax results (Figure 2).

**Tax related risks ranked fourth in the overall categorisation of potential risks at 51.5%, just slightly below fraud at 53%.**

**Figure 2 - Risk Classification**





### Unanticipated risks affecting tax planning

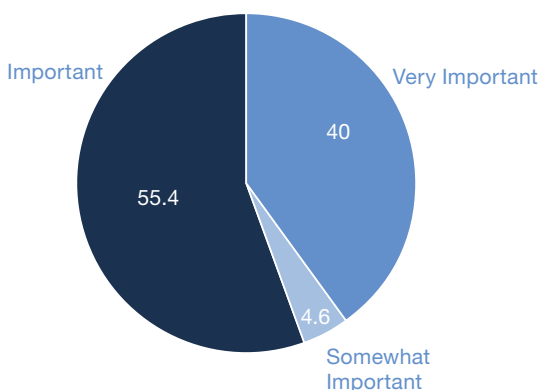
A few other risks apart from the ones stated, were also considered important. These include Indo-Mauritius tax treaty, failure to achieve targets, stock exchange fluctuations, rise in raw material prices, unexpected changes in government policies and regulatory compliance. In addition, changing market scenario with features like purchasing power parity, growth and obsolescence also formed part of risk concerns.

#### Importance of “Tax Risk” within the overall context of risk management

Tightening of regulatory framework, new legislative changes and heightened enforcement activity by the tax departments across the world has brought the importance of tax risk on the radar of the tax director/ CFO. This comes with increasing globalisation and accounting and regulatory malfunction, such as in case of Enron and WorldCom. Our findings indicate that two fifths (40%) of survey participants rated tax risk as being “Very important”. More than half (55.4%) rated the same as “Important” (Figure 3).

Not surprisingly then, there is a greater focus within MNCs and Indian companies to increase awareness regarding risks associated with tax and its management. In particular, one sees the beginning of initiatives to set up well-defined internal controls and specific roles like that of a “tax director”. With these, firms look at more transparent practices and avoiding loss of reputation due to poor tax planning strategy and its negative fallouts.

Figure 3 - Importance of Tax Risk



Two fifths (40%) of survey participants rated tax risk as being “Very important”. More than half (55.4%) rated the same as “Important”.

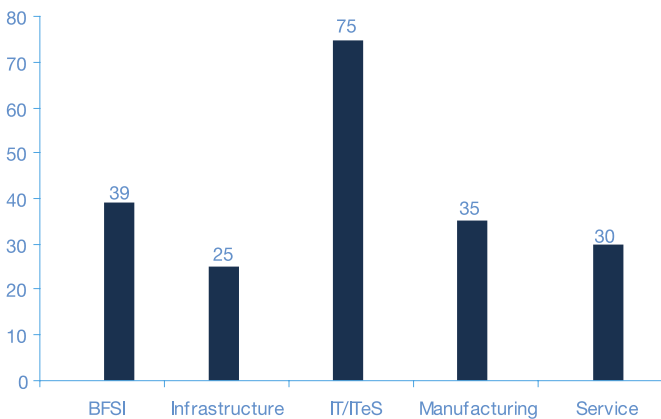
## Sector wise breakup of respondents claiming “Tax Risk” to be “Very Important” within overall gamut of risk management at the firm

The IT / ITES and BFSI sector gave more importance to tax risks among all industry verticals. Three fourths of the IT/ ITES companies indicated it as “very important”. The sector stands more exposed to both international and national tax laws as compared to sectors that have operations only within the country. IT\ITES firms perceive higher risk on account of compliance to tax regulations, accounting procedures and failure in these and transactional aspects.

Almost two fifth of respondents from BFSI (39%) and manufacturing (35%) verticals considered tax risk as very important. BFSI respondents by the nature of their industry wanted to avoid any aspersion on credibility. The manufacturing sector executives were also wary of the tax authorities’ attitude of administering taxes on a non-uniform basis and the financial penalties arising due to non-compliance. (Figure 4)

The IT / ITES and BFSI sector give more importance to tax risks among all industry verticals

Figure 4 - Industry wise importance to Tax Risk



06



# Risk Management: Approach and Practices

## 16 Risk Management: Approach and Practices

How do different companies handle risk? Who does it within the company? How often do they consider potential risk impact? To such questions, we found some interesting answers.

Presently, risk issues are primarily being managed by functional departments across industry sectors, as indicated by more than half (53%) of the survey respondents. Less than a fifth (19%) said that they had a central risk management department (RMDs). Most of these respondents belonged to the BFSI and services verticals (Figure 5).

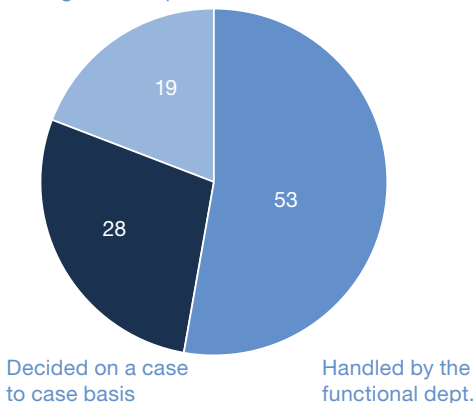
With more than half of the respondents having decentralised RMDs, the inter-departmental information flow and timely communication becomes more critical. Separate teams may also not be able to share best practices and information in case of multi-location teams / offices and the absence of a central RM team. Managing different risks in a non-aligned and unlinked manner poses greater risk if decisions are taken on a case-to-case basis due to lack of consistency and ad hoc solutions that may adversely impact the organisation at a later stage.

We also found that while it may not be a practice to have risk departments as yet in India, the trend seems to suggest that having full fledged risk management departments will be a trend in future.

Risk management is still a decentralised process with only 19% of respondents having a central risk management department. Functional departments are mostly the ones responsible

Figure 5 - Approach to Risk Management

Have a central management dept.



## CFO’s office continues to handle policy and planning with the finance and tax departments taking care of implementation and monitoring.

### Level of risk appetite

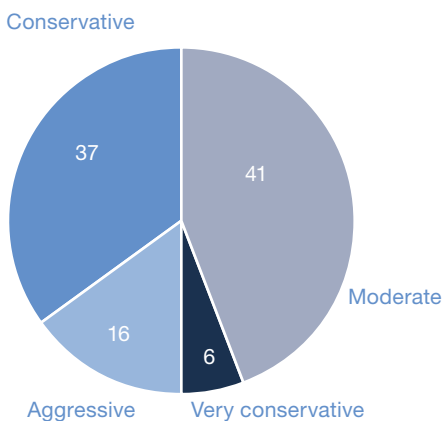
To measure the level of risk appetite, we asked firms if they would be willing to litigate for settlement of issues. Only 16% were aggressive in pursuing resolution of issues via this route (Figure 6).

Majority of organisations fell under the “Moderate” and “Conservative” category preferring out of court settlements or arbitration courts. Multinationals (40%) were more conservative than Indian companies (33%) in terms of willingness to approach courts for resolution of issues.

Firms across manufacturing (almost 62%) were found to be moderate in terms of litigation for resolution of issues. Most of the firms in services (50%) and BFSI (56%) were found to be conservative.

While corporates do perceive tax risk as important, the approach to addressing risk issues is still conservative and adhoc. Long drawn and arduous litigation is also a constraint. Many companies do not want to spare valuable manpower and other resources for a tax dispute resolution process where the tax laws themselves are open to differing interpretations and applications.

Figure 6 - Level of Risk Appetite



### Stakeholders for managing Tax Risk

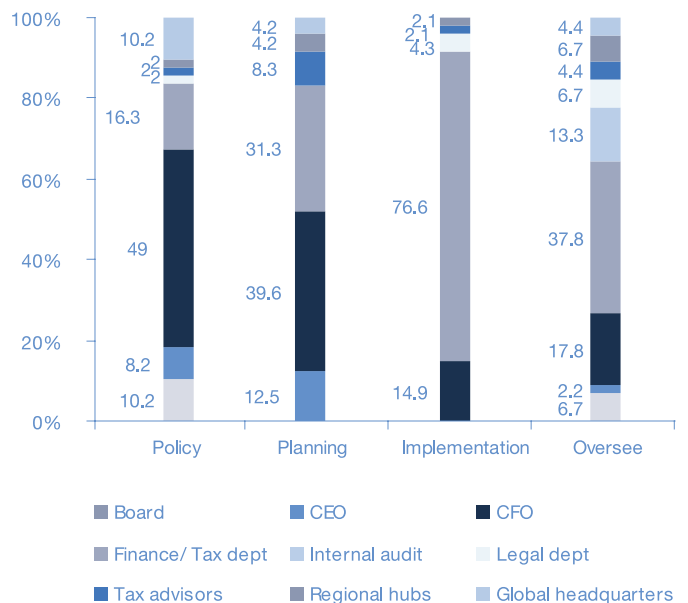
The CFO and the finance and tax departments continue to be the main stakeholders for handling tax risk. The primary responsibility for policy formulation and planning continues to lie with the CFO’s office while the finance/ tax department takes care of implementation and execution. Predominantly, the Board helps in policy formulation in consultation with the CFO.

The survey findings also indicate that three fourths of the implementation process is managed by the finance/tax departments with minimal board involvement. However, it may also be the case that the majority of the implementation process involves pure compliance work and financial reporting relevant to taxation purposes. The actual implementation of tax risk strategy laid out in the policy and planning stage may not get precedence over regular compliance (Figure 7).

In case of firms in IT / ITES (62.5%) and manufacturing (53%) sector, the level of CFO’s involvement in case of policy making is much higher as compared to other sectors. This may be due to the greater importance both sectors assign to risks because of tax as indicated by previous survey findings.

From being a subject matter that resides only at a finance department level, Tax risk management needs to reach out to the Board / CEO to gain significance and drive maturity in handling such issues in the firm.

Figure 7 - Stakeholders for managing Tax Risk



73% of those surveyed consider Income Tax as the most important tax to be managed. Service Tax comes in next with 56.7%

### Importance rating for each of the tax areas

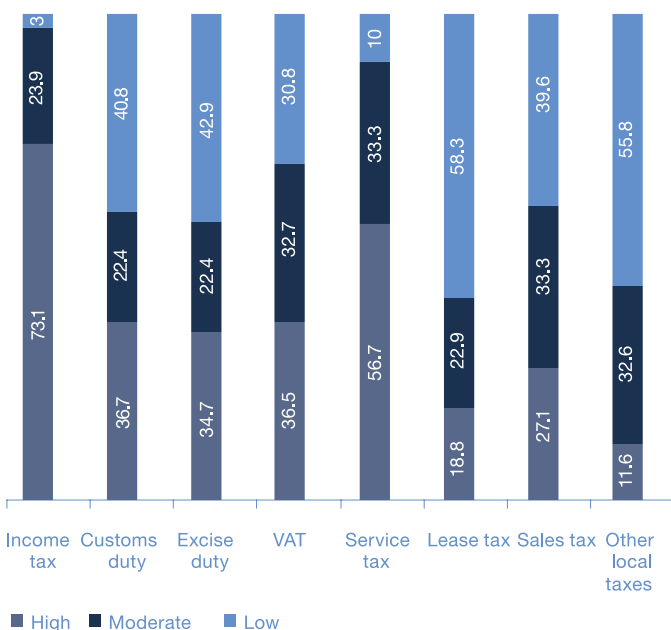
Of the various types of tax streams, direct taxes were given more importance than indirect taxes. Specifically, Income Tax was considered as the most important tax to be managed by almost three fourths (73%) of the respondents. Service Tax was considered next most important from a tax risk perspective by more than half the respondents (56.7%). Similarly, managing other local taxes, besides the one given in the graphic below, was not very high on corporate agenda. Income Tax was rated as the most important due to its direct impact on the firm, while others of an indirect nature seems to be given less importance, possibly due to the perception that it could be passed on to customers or claimed through set-offs (Figure 8).

### Where do firms want to see improvement in tax risk management?

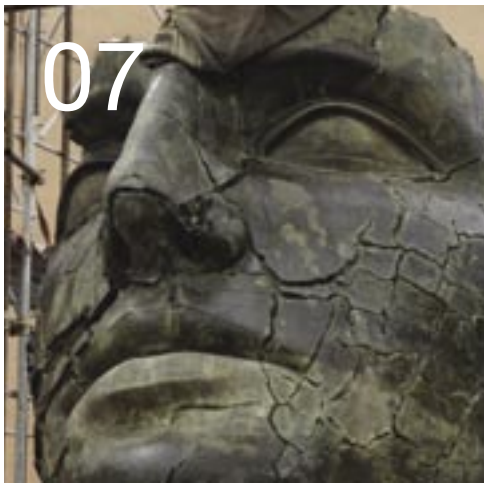
- Better understanding and management of Income Tax & Service Tax matters
- Facilitating smoother assessments / audits on Transfer Pricing issues
- Method of determination of tax liability
- Better working synergies with external tax advisors
- Operational improvements to address issue like preservation of data and records, providing training to administrator, timely circulars, guidance notes and AMC / MF specific Tax Management Risk frameworks / checklists

Firms see a gap in understanding as well as a lack of clarity in tax management processes and methods in India today. In addition, they also face challenges in facing operational aspects like documentation management and tracking regulatory changes.

Figure 8 - Importance rating for various taxes



07



# Tax Risk: Perception and Challenges

## Protecting image and retaining investor confidence were the reasons most relevant for firms to manage tax risk

### Tax Risk and its importance: Key reasons

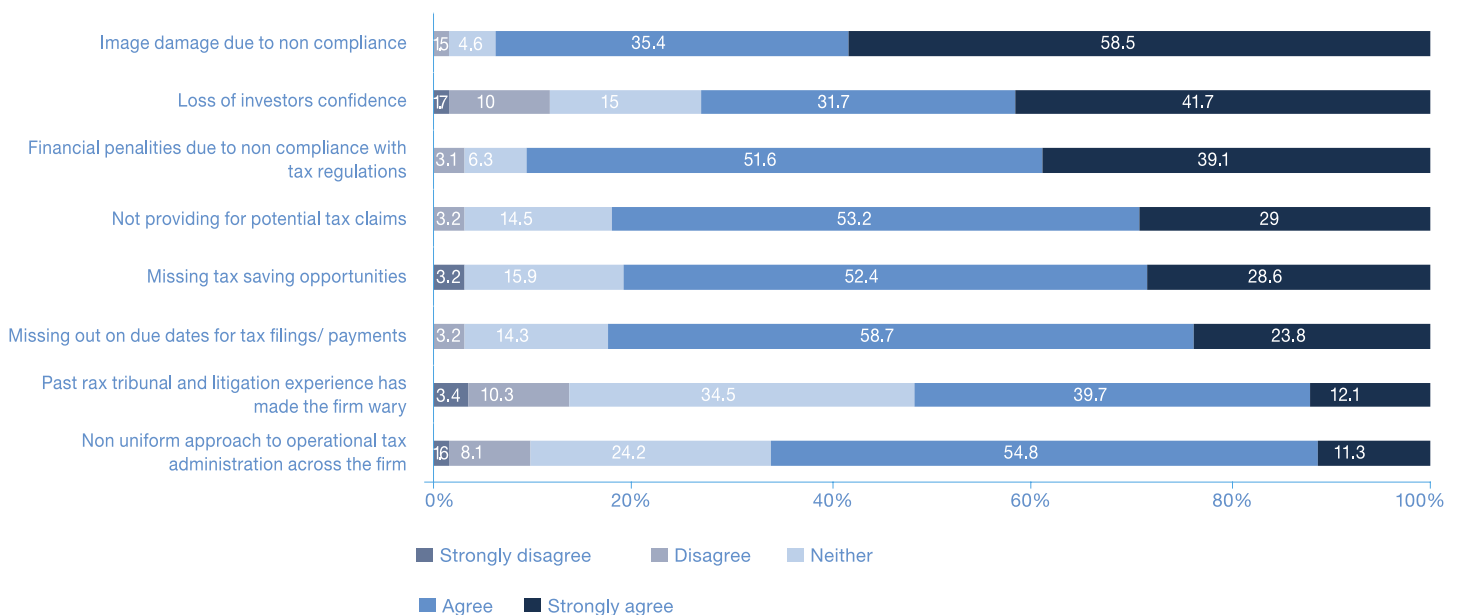
Clearly “Image Damage” and “loss of investors’ confidence” were considered as the two key major reasons for giving importance to tax risk across sectors. Maintaining credibility remains the key for both Indian (56.3%) and MNC (57.8%) companies. However, a majority of Indian companies (53.35%) also strongly agreed on managing taxes with a view to not miss out on tax saving opportunities. In comparison, a fifth (20.5%) of MNCs perceive the same. A third of Indian firms (30.8%) also strongly agreed to the importance of tax risk with a view to the non-uniform approach to operational tax administration across the firm (Figure 9).

Perceptions of image damage were higher among IT / ITES and services firms. Loss of investor confidence and not providing for potential tax claims were important reasons for most IT/ITES firms. Manufacturing and firms in BFSI sector considered

financial penalties to be very important, while missing tax saving opportunities was considered an important reason by many services firms.

Corporate India is worried most about its reputation as a fall out of the tax risks. This is ahead of opportunity to save cost and potential levies, clearly indicating that tax management is not just an opportunity but part of the image management of the company. As such, tax risk management needs to become more integrated with a firm’s overall business and growth strategy.

Figure 9 - Key Reasons for perceiving Tax Risk to be important



## Transfer pricing laws, setting up operations overseas and lack of clarity in law and uncertain rulings led to incidence of tax risk and challenges most often

### Key events leading to potential tax risks across firms

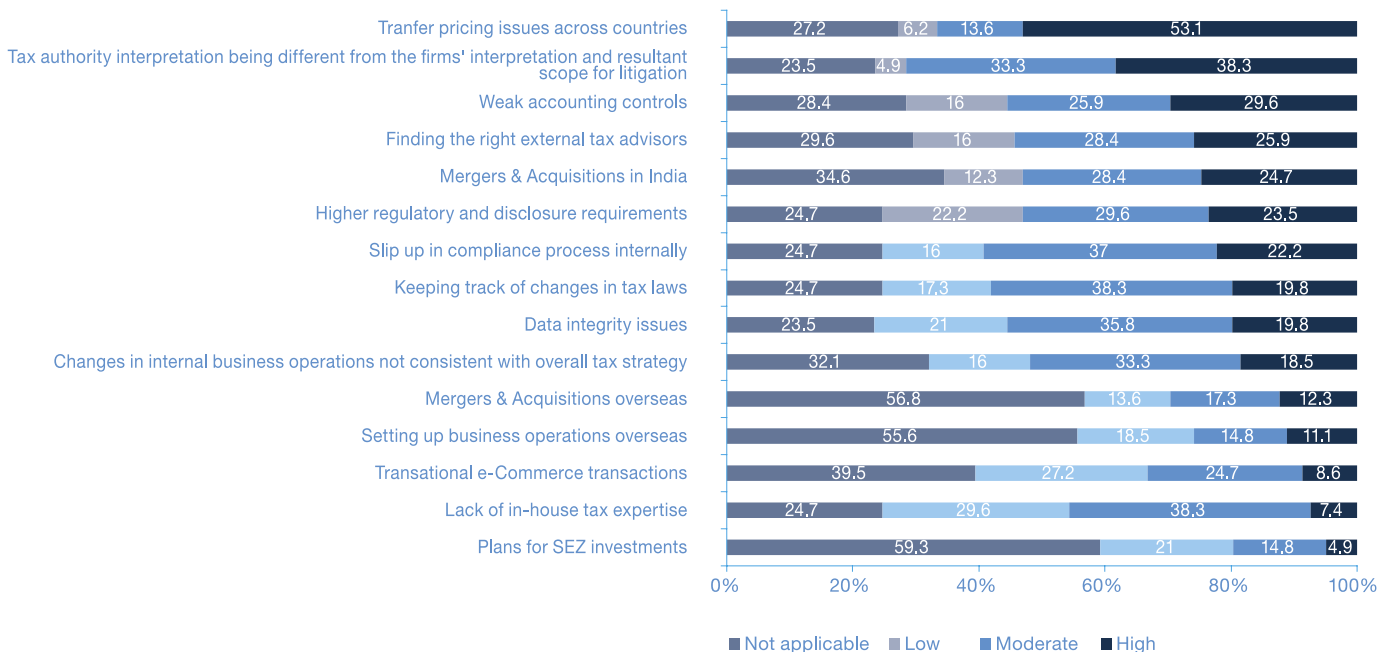
Incidence of Transfer Pricing emerged as most important reason among MNCs leading to potential tax risk situations (Figure 10).

Different interpretations of tax authorities vis-à-vis firms is also a key risk. Almost half the Indian firms (44%) felt that setting up business operations overseas could lead to such situations. More Indian companies (38.1%) felt that weak accounting controls could be high impact events as compared to MNC companies (26.8%). One fourth of MNC firms also rated data integrity as a high impact event as compared to just 4.8% of Indian companies.

Transfer Pricing issues and tax authorities' interpretation being different from the firm's interpretation emerged as the top two events across firms in BFSI, services and manufacturing sector leading to potential risks. Firms in IT / ITES also felt that mergers and acquisitions in India was a potential tax risk for them. The BFSI firms also listed higher regulatory and disclosure requirements as a potentially risky event.

Transfer pricing issues with setting up business outside India and differing interpretations of the Indian tax authorities are key instances leading to potential tax risk situations.

Figure 10 - Key events leading to potential Tax Risk



## 22 Risk Management: Approach and Practices

### Key reasons leading to incidence of Tax Risk challenges

Corporates, especially MNCs, believe that unpredictable rulings by tax administrators is the most important reason leading to Tax Risk challenges, while lack of clarity in tax laws is a major concern for Indian firms.

Lack of clarity and changes in tax laws emerged as the key reason leading to Tax Risk challenges among firms in BFSI sector. MNC banks felt more strongly on this issue. Change in interpretation of tax laws by tax authorities was also considered as equally important among firms in manufacturing and BFSI sectors (Figure 11).

Unpredictable rulings, interpretations of tax authorities and lack of clarity are the key reasons leading to tax issues for firms.

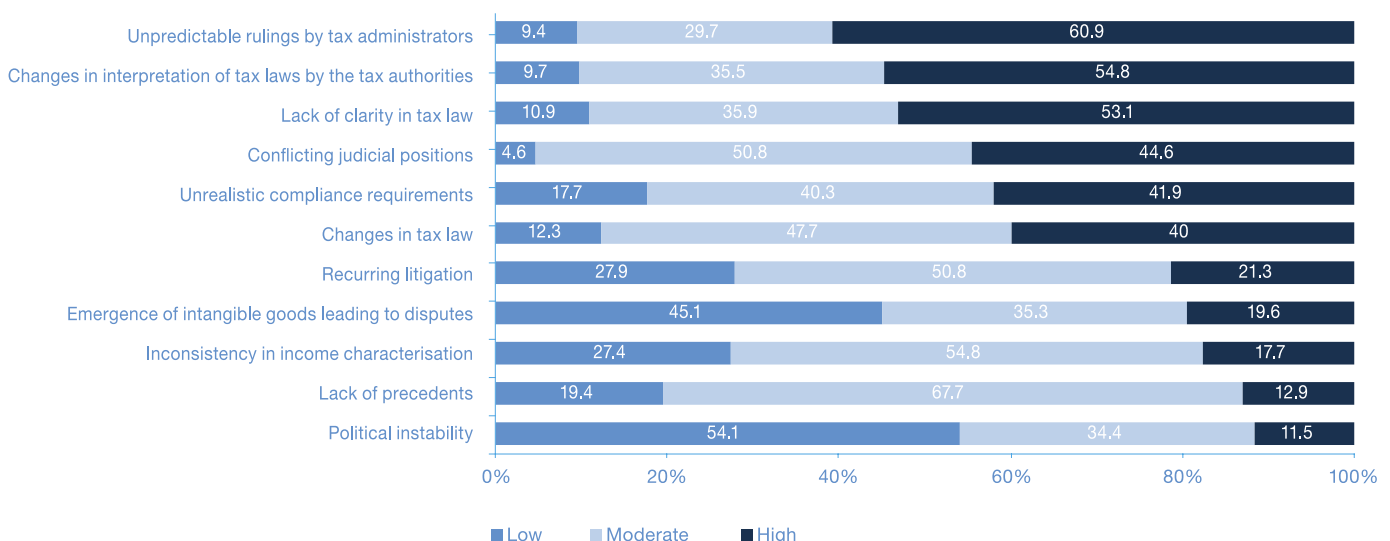
### Challenges firms need to address?

- Multiple tax holiday units and the need to comply with STPI procedures
- Inter unit pricing issues
- Incase of Mergers & Acquisitions issues with regard to emergence of intangible assets and their treatment
- Uniform implementation of agreed practices
- Interpretation issues in indirect tax laws
- Changes in tax laws and varied interpretation by tax authorities

All firms felt that there was no significant impact of establishment of the National Tax Tribunal (NTT), which was set up by the government)

Issues relating to clarity and uniform practices are the key challenges faced by corporate India in handling tax risk.

Figure 11 - Tax Risk challenges



08



# Tax Risk Management: Experiences across firms



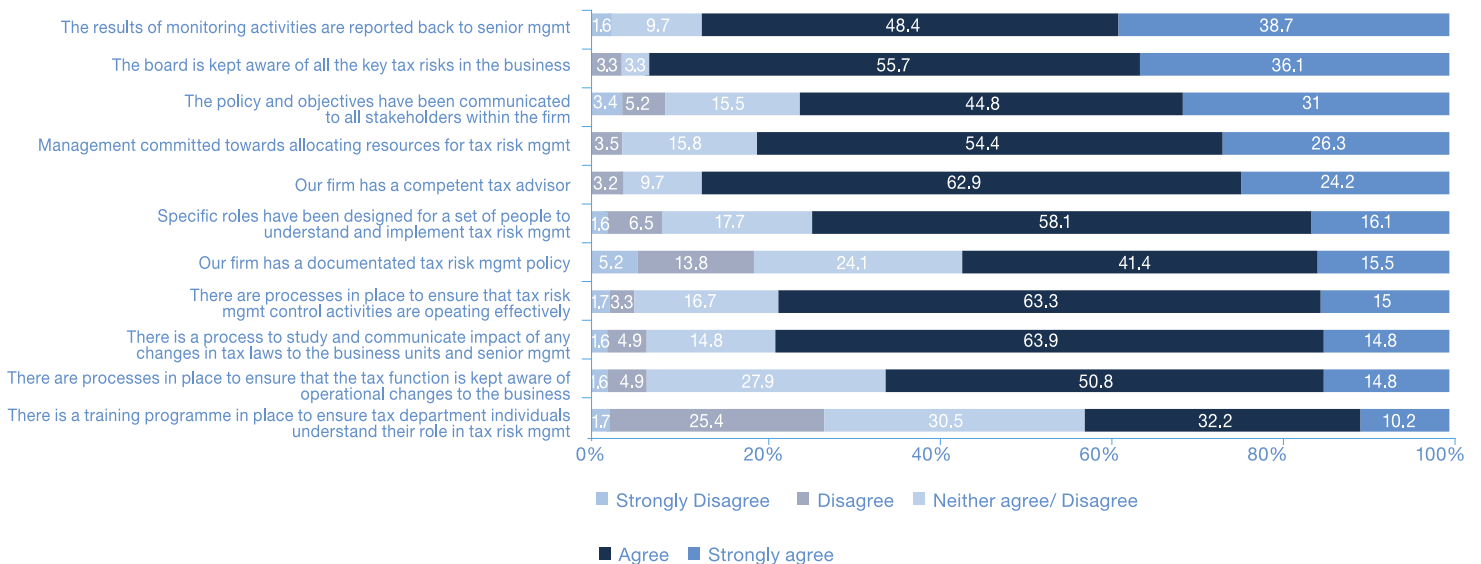
## Most companies rely on tax advisors but do not have structured policies to deal with tax risk

### Tax Risk Management across firms

Majority of firms said that they had the presence of a competent tax advisors within their firm. In most cases, the senior management was apprised of the results of the monitoring activities and the board was kept aware of the key tax risks. However, most companies seemed not have very structured internal control mechanisms or a well-documented tax risk control policy. Very few (10.2%) also placed emphasis on integrating the tax department with the overall business operations (Figure 12).

Documentation lags behind in a significant proportion of the firms. Similarly, this is the case with training programmes for individuals to understand their part in tax risk management. Apparently, the tax management needs to be more inclusive and involve all other departments and go beyond the finance / tax departments.

Figure 12 - Tax Risk Management



**Approach to Tax Risk Management**

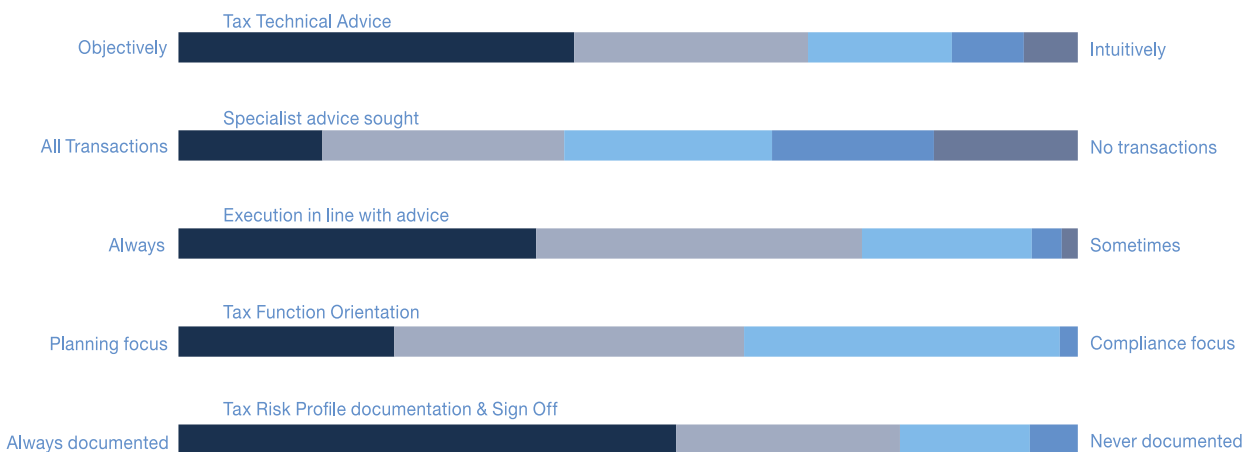
Most firms did seek specialist advice but did not act accordingly all the time. The focus of tax management strategy in most firms is still on tax compliance and not on tax planning. Ensuring proper documentation is still low on most tax risk management departments (Figure 13).

- Service industry’s approach to Tax risk management is more objective
- IT / ITeS and Services firms are more inclined towards using specialist advice for majority of transactions
- Almost 40%–50% of firms in BFSI, manufacturing and infrastructure sectors follow the advice sought
- Most corporates across sectors are neutral towards Tax function orientation; manufacturing and infrastructure segments are inclined towards compliance focus
- Only few corporates primarily in BFSI and IT / ITES segment always follow Tax Risk profile documentation procedures.

Management of tax risk is still an ad hoc process.

While most firms seem to be moving towards a systematic approach, there are some that look to addressing tax issues more intuitively and are still evolving.

**Figure 13 - Approach**



09



# Tax Risk Management: Use of external advisors

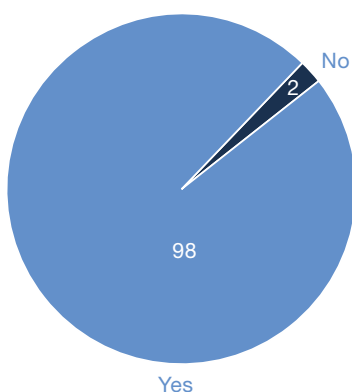
Most firms have external tax advisors. Their ability to bring in learnings from other industry sectors and keep track of latest changes in law are qualities that corporates value most

**Usage and satisfaction levels with External Advisor**

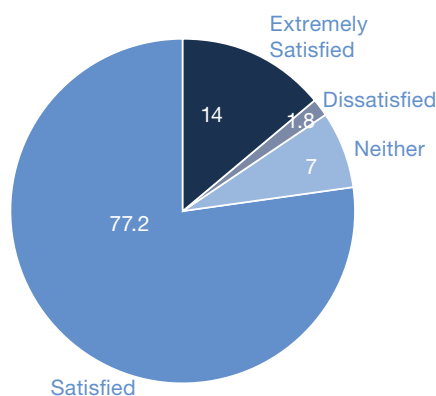
Almost all respondents confirmed using services of external advisors and more than three fourths (77.2%) seemed happy with them. However, those who were delighted or extremely satisfied formed a smaller group at 14% (Figure 14 & 15).

Constant change in tax laws and complexities associated in their application and interpretation has driven firms to hire external firms who have high level of specialisation with regard to Tax Risk Management. All MNCs use external advisors and the level of satisfaction too in their case was much higher as compared to Indian firms. However, with only 14% of firms actually 'delighted' with the present service provider, there is considerable 'headroom' for improvement.

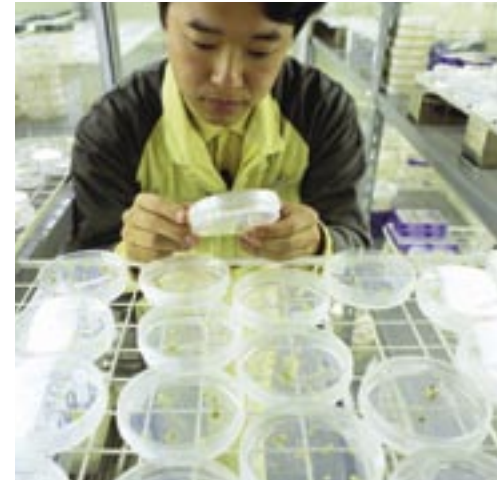
**Figure 14 - Usage of External Advisor**



**Figure 15 - Satisfaction level with external advisor**



## 28 Tax Risk Management: Use of external advisors



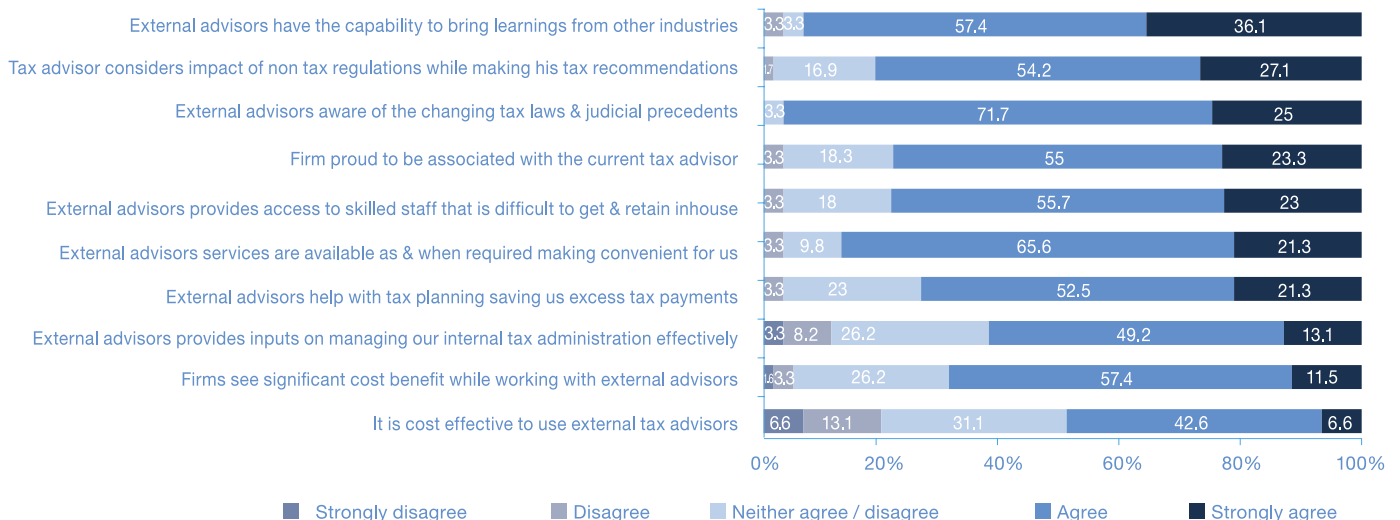
### Potential benefits arrived from external tax advisors in managing tax risk

External advisors' capability to bring learnings from other industries was perceived to be the most important benefit by all firms across sectors followed by the consideration by tax advisors of the non tax regulatory issues while making recommendations.

External advisors' contribution in terms of making clients aware of changing tax laws is perceived as the most important benefit by Indian firms, while MNCs perceived the ability of external advisors to bring learnings from other industries as a significant benefit.

Surprisingly, a majority of Indian firms (78.6%) felt that it was more cost efficient to appoint an external advisor compared to 30.2% of MNCs (Figure 16).

Figure 16 - Potential Benefits



## Contingency planning issues

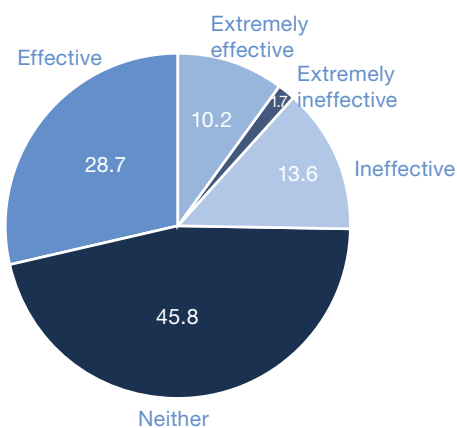
Majority of MNCs (87%) claimed to have effective contingency planning procedures in place as compared to Indian firms (69%). Most of the firms in manufacturing (70%) and services sector (86%) claim to have effective contingency planning procedures (Figure 17).

Only around 39% of the firms considered it necessary to analyse impact of tax risk. There were also companies that undertook the function rarely (15%) while some never undertook the same (Figure 18).

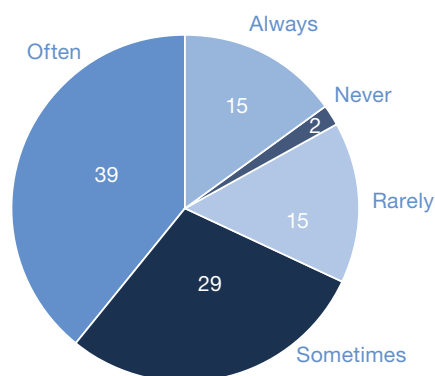
Almost half of the MNCs always carry out potential impact analysis of tax risks, as compared to only 30% in case of Indian firms.

Indian companies would do well to emulate the tax risk impact analysis practices of their global counterparts. There is also a need to bridge the gap between risk perception and its potential impact.

**Figure 17 - Effectiveness of Contingency Planning**



**Figure 18 - Likelihood of Potential Analysis**



10



# Conclusion



Increasing globalisation and changes in technology have created several opportunities and business models. With the liberalisation of its economy in the early 1990s, India has benefited considerably. However, these new opportunities have also resulted in greater business complexity and overlapping national and international regulations and taxes. Managing tax risks is now being recognised as vital to the health of a business enterprise. Not surprisingly, the tax departments and tax directors are no longer considered in isolation and are increasingly becoming strategic to a company's core risk management strategy. India is no exception to this trend.

Almost 95% of the firms operating out of India rate tax risks as very important and have identified such tax risks as among the top five risks that an organisation faces. Loss of image and damage to credibility besides loss of investor confidence seem to be the main reasons for this reaction. What is important to note here is that firms are taking note of tax risks not just because of the cost saving to company or avoiding penalties and liabilities, but also as part of sustaining its basic image and brand promise.

There is an increased focus on corporate governance and a move to keep senior management informed of tax risk. Management on their part, are increasingly allocating resources necessary for managing tax risk.

However, there still seems to be a gap between risk perception and its management, mitigation and monitoring practices. Companies tend to deal with tax risks in an ad hoc manner without adequate planning. Tax risk is still to be understood and integrated into the core risk management strategy for a business. Despite seeking specialist advice, there are companies that tend to disregard it. Similarly, the focus is still on tax compliance and not on tax planning. There also seems to be a lag in maintaining proper documentation. The policy for managing tax related risks and its review mechanisms could definitely do with greater definition and structuring.

There is also a need for broader involvement in managing tax related issues. The onus of solving and monitoring this still rests with the CFO and finance departments. A wider involvement of the board, senior management and other stakeholders is desirable.

From a business standpoint, income tax remains the most important tax for companies because of its impact on corporate bottom-line. Service tax too seems to be fast becoming a high importance tax area. Transfer Pricing (TP) regulations seem to be a problem area for most MNCs operating in India.

Companies seem frustrated with unpredictable tax rulings, changes in interpretation of law by tax authorities and the resultant scope for litigation. Most are also stumped by the lack of clarity in law regarding application and contexts.

The survey brings out some key messages: while corporates hope for greater clarity and lesser complexity, there is need for a more holistic approach to tax risk management.

# 11 Contacts

PricewaterhouseCoopers Pvt. Ltd.

## Bangalore

6th Floor, Millenia Tower D  
1&2 Murphy Road  
Ulsoor  
Bangalore 560 008  
Tel: +91 80 4079 6000  
Fax: +91 80 4070 6002

## Kolkata

Plot No. Y14, Block EP  
Sector V, Salt Lake Electronics Complex  
Bidhan Nagar  
Kolkata 700 0+91  
Tel: +91 33 2357 +9100 / 3384 / 3390  
Fax: +91 33 2357 7456 / 7207 / 3394

## Chennai

PwC Centre  
No.32, Khader Nawaz Khan Road  
Nungambakkam  
Chennai 600 006  
Tel: +91 44 4228 5000  
Fax: +91 44 4228 5100

## Mumbai

252 Veer Savarkar Marg  
Shivaji Park, Dadar  
Mumbai 400 028  
Tel: +91 22 6669 1500  
Fax: +91 22 6654 7804 / 7805

## Gurgaon

Building No. 8, Tower B  
8th Floor, DLF Cyber City  
Gurgaon 122 002  
Ph: +91 124 4620 000  
Fax: +91 124 4620 620

## New Delhi

Sucheta Bhawan  
(Gate No.2, 1st Floor)  
11-A Vishnu Digamber Marg  
New Delhi 110 002  
Tel: +91 11 4115 0000  
Fax: +91 11 2321 0594 / 96

## Hyderabad

# 8-2-293/82/A/1131A  
Jubilee Hills  
Road No. 36, Sai Square  
Hyderabad 500 344  
Tel: +91 40 6624 6600  
Fax: +91 40 6624 6300

## Pune

401 Century Arcade  
243-244, B/2 Narangi Baug Road  
Off Boat Club Road  
Pune 411 001  
Tel: +91 20 2616 9787 / 3271  
Fax: +91 20 2616 1131

PricewaterhouseCoopers has taken all reasonable steps to ensure that the information contained herein has been obtained from reliable sources and that this publication is accurate and authoritative in all respects. However, this publication is not intended to give legal, tax, accounting or other professional advice. No reader should act on the basis of any information contained in this publication without considering and, if necessary, taking appropriate advice upon their own particular circumstances. If such advice or other expert assistance is required, the services of a competent professional person should be sought.

This publication (and any extract from it) may not be copied, paraphrased, reproduced, or distributed in any manner or form, whether by photocopying, electronically, by internet, within another document or otherwise, without the prior written permission of PricewaterhouseCoopers. Further, any quotation, citation, or attribution of this publication, or any extract from it, is strictly prohibited without PricewaterhouseCoopers' prior written permission.

© 2007 PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers", a registered trademark, refers to PricewaterhouseCoopers Private Limited (a limited company in India) or, as the context requires, other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

