Contents

Introduction – Managing the TaxValueChain
By Robert van der Laan, PricewaterhouseCoopers, Netherlands

Tax and corporate responsibility
By Urs Landolf, PricewaterhouseCoopers, Switzerland

Tax strategy
By Andreas Staubli, PricewaterhouseCoopers, Switzerland

Tax-risk policy
By Tony Elgood, PricewaterhouseCoopers, UK

How to design efficient tax processes
By Tony Fulton, PricewaterhouseCoopers, Australia

Tax accounting: using cross-border losses
By Norbert Winkeljohann and Sven Fuhrmann, PricewaterhouseCoopers, Germany

Lessons learned from SOX 404
By Larry Quimby and Joseph Pearce, PricewaterhouseCoopers, US

The importance of tax reporting
By Thierry Morgant, Landwell & Associés, France

Managing global tax compliance
By Claire Lambert and Janet Lucas, PricewaterhouseCoopers, Australia

The rise of XBRL in tax
By Lindsey Domingo, PricewaterhouseCoopers, Belgium

Tax as a driver of shareholder value
By Heleen Joman-Dijkhuizen, PricewaterhouseCoopers Belastingadviseurs NV, Netherlands

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Editorial

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Customer services: +44 20 7779 8610
UK subscription hotline: +44 20 7779 8999
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International Tax Review is published 10 times a year by Euromoney Institutional Investor PLC, London.

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International Tax Review (USPS No: 005-126) is published monthly except January and August for $745 per year by Euromoney Institutional Investor PLC, c/o SmartMail, 140 58th Street, Suite 2b, Brooklyn, NY 11220-2521. Periodicals postage paid at Brooklyn, NY and additional mailing offices. Postmaster: Send address changes to International Tax Review c/o SmartMail, 140 58th Street, Suite 2b, Brooklyn, NY 11220-2521.

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Managing the Tax Value Chain

By Robert van der Laan, PricewaterhouseCoopers, Netherlands

Ever since the introduction of the new corporate governance regulations following the Enron affair, it has become clear that it is important for management to demonstrate that the company’s risks are under control. The key area that companies have been struggling to demonstrate that their internal controls are robust and operating effectively is the tax function.

Historically the main focus of the tax function is on output. This means the focus was on the corporate income tax return and other local filing requirements. This was also the case in the automotive industry before the ideas of William Deming were introduced decades ago. In the automotive industry, quality control was concentrated at the end of the production line. One took samples from the end-of-the-line products to check for defects. One soon started to realize that for things to improve, one needed to consider not only the end product, but the underlying processes. Statistical process control was the name given to this new approach.

The American William Edwards Deming (1900-1994) was the father of the new wave of industrial revolution called “integral care for the business”. Deming developed a strategy of continuous analysis of all aspects of the production process with the goal of constant quality improvement. Inspection of the end product tells us how things are going, but it does not point the way to improvement. After World War II, Deming presented his ideas to the car business in Detroit. There was no interest.

In the fifties he sold his ideas to Japan. They were very interested in his total quality management. The Union of Japanese Scientists and Engineers even introduced the Deming Prize, which was later won by companies such as Toshiba and Matsushita Electric.

In the seventies US companies started to ask the question: “Why do Americans buy Japanese products?”

Today the world’s strongest companies recognize the value of optimizing quality in the goods and services they provide. Good total quality, or process control, is now an essential and fundamental way of managing an organization. It is a way of thinking.

Modern quality improvement requires the continuing and progressive application of new processes, technology and management. It is a strategy instrument in the global war of competition. Best efforts, to be effective, require guidance to move in the right direction. The total organization has to be concentrated on quality in all aspects of the execution. The stakeholders, including customers, determine what quality is. A product or service has to meet the needs of the stakeholders.

In statistics, the realization shift from the end-of-the-line quality control to process control systems occurred many decades ago. This change in thinking, from end-of-the-line control to process control, was a revolution in itself and it took decades before Deming’s process thinking was globally adopted. Is this now happening in the tax context?
Changing the tax function

Virtually all large enterprises have defined a business control framework. However, most tax departments do not have a control framework that covers the process controls of the tax function. As a result, taxes are often regarded as the so-called “black box”. An increased focus on the tax function by different stakeholders has put pressure on tax departments to get tax out of the black box and to embed tax within the organization.

A key element in this process is to develop a tax control framework. A model for the tax control framework or the tax-value chain can be depicted as follows.

This special supplement to *International Tax Review* focuses on the various elements of the tax value chain and other relevant developments in this field such as technology and the increased attention of new external stakeholders such as investors and analysts.

Corporate strategy

In the late eighties the COSO (Committee of Sponsoring Organizations of the Treadway Commission) framework was developed as a standard for the internal control framework for organizations. One of the elements included in the COSO framework is the alignment of the control activities with business strategy.

Despite thoughtful attempts by many authors no-one has been able to come up with a single standard definition for a strategy. However, the following very useful attempt (which is very practical to work with) was written by Alfred D Chandler.

Strategy can be defined as the determination of the basis long-term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out those goals.

Often the tax position of the company is not taken into account when a strategy is designed. However, the total tax bill of a company (including income taxes, wage tax, indirect taxes and withholding taxes) accounts for more than 30% of net earnings (both below and above the line). Therefore, tax does not only have an impact on the financial performance of a company, it also has an impact on other strategic areas such as corporate responsibility and corporate governance.

Tax strategy

Because of the (potentially) large impact of taxes on a company’s business – not only in the financial statements but also on the company’s reputation – a tax strategy is critical in defining and communicating the role of the tax function within and outside the organization. A tax strategy should be in line with and embedded in the overall corporate strategy and should not, of course, be defined in isolation from the enterprise-wide business control framework.

A robust tax strategy can be used within the organization to increase awareness of tax planning and tax risks, but also for discussions with other stakeholders such as tax authorities and analysts. Recent reports from Henderson and Citigroup indicate that they are increasing their focus on the company’s tax position in the financial statements. They recognize that tax is not primarily a below-the-line item, but that income taxes may have an impact on working capital and cash flow. Other taxes, like wage taxes, value-added taxes and custom duties, can have a direct impact on the operational margin and revenue.

What a tax strategy is and what it should cover can be defined as follows:

“A tax strategy is the set of ambitions and goals related to tax over the next three to five years, having defined the scope of tax activities: it is aimed at creating value including management of tax-related risks by utilization of available recourses and creating synergies within the organization thus enabling the tax function to meet needs and expectations of the organization’s stakeholders.”

Eelco ME van der Enden

To successfully manage a tax function and create value for the organization today it is imperative to agree with senior management on the tax strategy, which includes a tax-risk policy (key actions and the resources to successfully execute these actions).

Tax-risk management

The basis for sound tax-risk management is a tax-risk policy that needs to address what the strategic, operational, financial accounting and compliance tax risks are in the business and what the response is to those tax risks, if and when they occur.
Tax-risk management is not about minimizing tax risk but about determining what level of risk is acceptable to the company, what response is required to tax risk and monitoring that such response is actually taking place. The company’s tax process design should describe what processes and procedures are in place and what are the internal controls for monitoring these identified tax risks.

When defining a tax-control framework all types of control should be included. As a result of Sarbanes-Oxley and other audit requirements there is a tendency to focus on bureaucratic controls. These controls are easy to monitor, but are time consuming and often regarded as a burden on the organization. This is a first step to be able to demonstrate that the tax department is in control of the tax function. Also it will make it easier to assign resources and budgets to the tax function without increasing the company’s tax-risk profile. However, the so-called market-mechanism controls and social-mechanism controls also need to be considered.

The most important element of the latter category is “tone at the top”. Although difficult to document, this is an important element to discuss with senior management and the audit committee. Many are struggling to find the right balance between documenting the (key) controls and creating a healthy – yet workable – control environment. The increased focus on control and the management of tax risks clearly show that it is imperative for boards to monitor and evaluate their tax control framework permanently and not to rely on end-of-the-line controls.

Tax-risk management is not only about documentation, but about making sure that your organization actively monitors tax risks and responds properly to those risks, if and when they occur. It is about people, processes and technology.

Global tax planning
Global tax planning will always be an important tool for managing the effective tax rate for the organization. However, as a result of the changing attitude of tax authorities and the introduction of new disclosure requirements, the opinion on global tax planning has changed.

Therefore it is important to keep in mind that creating value for the organization is no longer limited to the improvement of the company’s effective tax rate, but should be based on the organization’s tax strategy and tax-risk policy. There should be a balance between global tax planning and managing tax risks. The right tax-risk policy will help ensure that tax planning is effective and appropriate.

Tax accounting, reporting and compliance
Often the responsibility for tax reporting and the knowledge of US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) is not in the tax department. However, in today’s environment and in order to be able to take full responsibility over the tax line the tax department will need to increase its knowledge about tax accounting and tax reporting. The tax department should become familiar with the basics of accounting for income taxes and the disclosures required under the respective accounting rules. Another improvement towards an effective management of tax reporting and tax compliance is the use of IT tools, which play an important role in making the tax function more effective.

IT tools can be very important in effectively managing your global compliance position. A development that will support the tax function to be in control will be technology. The new business reporting language (XBRL) will enable the tax function to integrate its tax reporting and tax compliance process.

Culture change
In order to be successful it is imperative for companies to change the culture and attitude of the company towards the tax function. A key element is the development of a tax control framework, which should be aligned with the business control framework.

Our firm has developed a methodology called “Managing the TaxValueChain”. It covers all the relevant elements of a tax-control framework. In this publication the key elements of the TaxValueChain will be further discussed by specialists from the field. The right tax control framework can reassure investors and other stakeholders that the company’s tax affairs are under control and that tax risk is being taken seriously.

The objective of a tax-control framework is to achieve a tax function that delivers value-added, cost-effective solutions that meet the commercial objectives of the company. It can further improve quality, clarity and comparability on the tax provision and therefore provide for shareholder value.

Robert van der Laan

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Tax management in companies

Tax and corporate responsibility

By Urs Landolf, PricewaterhouseCoopers, Switzerland

The tax conduct of enterprises has recently been caught in the floodlight of the capital market (shareholder activists) and other corporate governance activities. Tax administrations in various countries or their organs responsible for establishing law are reacting to the tax savings potential of tax arrangement measures with increasingly severe legislative measures. Thus it is becoming necessary to look at tax planning and compliance in the enterprise under these aspects, long-term, structured and embedded in the overall concept of the enterprise’s risk management.

Over the last few years the discussion about corporate responsibility has gained substantially in importance both at the national and the international level. The subjects covered by the expression, corporate responsibility, such as corporate social responsibility (CSR), corporate governance (CG) and corporate citizenship (CC) have within a short period of time established themselves in the public discussion. The various corporate crises, suspected weaknesses in corporate management, inadequate supervision by the board of directors and the discussion about management remuneration clamour for more rules and transparency in the responsibility of the board of directors and management of listed companies.

Corporate responsibility covers in addition to an enterprise’s responsible and lasting actions (CSR) also the aspects of corporate management and control (CG) as well as its commitment as a good corporate citizen to engage actively in the local civil society or e.g. in ecological or cultural matters (CC).

Fair share of taxes

The tax attitude of an enterprise has latterly been regarded as a relevant component in corporate social responsibility. On the one hand the expression tax avoidance appears in the context of corporate responsibility. Companies’ legal tax planning practices and activities, which are geared exclusively towards the minimization of the cost factor taxation without taking account of sustainability considerations and of plausibility, are increasingly criticized.

On the other hand it is expected of companies as corporate citizens that they fulfil their duties as citizens. For example the duty to pay tax is substantiated as follows: “Tax is the price we pay for living in a civilized society and ... in a fair society we expect to pay our fair share” (Supreme Court Judge Oliver Wendell Holmes). This then raises the (contested) issue, what is the fair share.

Tax planning as a crime against the nation

Headlines like “In 1997 Daimler Chrysler, despite making considerable profits, paid neither corporate income tax nor business tax. The gatekeeper paid more taxes than the group itself” (Suddeutsche Zeitung, January 22 2004) or studies, whose assertions
Tax management in companies

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Outsourcing the headquarters of a company to offshore territories was described in the US as “taking the un-American way out”.

During the course of the Enron investigation tax planning attracted the attention of the media. Classical tax planning measures to minimize the consolidated tax charge in the US, such as locating functions in low-tax countries, relocating the headquarters of the top company to a tax favourable location were worked up during the course of the investigations.

Made public by the investigation report of the Committee on Taxation, they resulted in outrage in the media. Politicians demanded punishment of the unpatriotic conduct of such companies. In several states laws were proposed that would prohibit “corporate expatriates” from being awarded government contracts.

As a result of the public pressure the US administration saw itself compelled to intensify the regulation of groups that are listed on US stock exchanges. At the drop of a hat the Sarbanes-Oxley Act (SOX) was born. Its objectives are an improvement in corporate governance and the restoration of confidence in the capital markets. Since taxes represent part of financial reporting, in section 404(a) of the SOX the establishment and documentation of internal controls with taxation risks are required. Risks deriving from tax planning strategies should be investigated.

In the UK the Inland Revenue compared tax avoidance with “driving under the influence of alcohol” (Financial Times, November 22 2004). Statements by employees of the UK Treasury such as “Tax avoidance and the industry that drives it are increasingly an international phenomenon and it is vital that we have effective international co-operation to tackle it, as we do for tackling terrorism, organized crime, money laundering and fraud” illustrate the harder approach by the UK authorities.

In autumn 2005 the UK Inland Revenue commenced its initiative Tax on the Boardroom Agenda. The objective of the initiative is to create a better dialogue between the board of directors and the tax authorities. The tax authorities encourage the board to treat taxes as a corporate governance subject. For example, in the view of the tax authorities, the board must intervene, if tax avoidance is excessively aggressive. The initiative is being formally launched as part of the new large business service of the UK Inland Revenue in April 2006.

Australia in the role of leader

The most specific influence in this debate was exercised by Michael Carmody, Australia’s former head tax official. After a wave of reforms in corporate governance, in the last three years the Australian tax authorities have intensified their efforts to link the subject of taxation with that of Corporate Governance.

Behind this lies the intention to involve more actively board members in taxation matters. Taxation questions

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Biography

The cooperation and the exchange of information about tax shelter constructions are clearly being driven forward. Groupings such as Tax Justice Network, Citizens for Tax Justice and other non-governmental organizations (NGOs) raise lurid comparisons and report the pressure on the debate over whether companies are paying their fair share of taxes.

Thus tax avoidance is increasingly regarded as immoral. In the US tax avoidance was declared to be unpatriotic.

document that two thirds of the companies operating in the US paid no federal income taxes between 1996 and 2000, disturb the sensation of social justice.

The “indirect harm to the fellow citizen caused by the tax reduction” (Government Accountability Office report 2004) appears under today’s concept of state and society to be objectionable. The company violates the duties of the social citizen, because corporate responsibility begins in paying the normal contributions, that is its fair share, to the society, in which it is active.

In addition the tone adopted by the (tax) authorities and legislators is becoming harsher. With the signature of a Memorandum of Understanding on April 23 2004, the tax inspectors of Australia, Canada, the UK and the US determined to set up a Joint International Tax Shelter Information Center.

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should become a clear responsibility of the board members. Because in the eyes of the Australian tax authorities board members have for too long neglected the subject of taxation, the companies were in their view not compliant enough.

In a letter from Michael Carmody to board of directors, he said they must make a conscious decision as to how high their company’s risk appetite is and define the position on the tax risk spectrum and ensure adequate control. It is expected of board members that they also understand the effects of tax-planning measures and their risks, and that they do not rely only on the professional skills of experts.

According to statements by Michael Carmody the Australian tax authorities have been successful with their strategy. For example Australian companies are leaders in including the tax function in their risk management. The Australian tax authorities want to proceed even further with their approach, as they state in their Compliance Program 2005-06.

All board chairmen of companies listed on stock exchanges in Australia have received a personal letter, in which they have been assured that confidential documents, which the board of directors requires for its tax assessment, do not have to be disclosed to the tax authorities. However the tax authorities have reserved the right to be able to inspect these documents in exceptional circumstances. This expression however admits various interpretations and the companies have received anything but reliable guidance.

The linking to corporate governance and the enhanced involvement of the board of directors in the company’s tax strategy result in its becoming more sustainably geared to the longer-term corporate goals and being less aligned with short-term tax minimization.

Shareholder activism
In the environment of corporate crises, of intensified legislation and of public awareness, tax planning gained a (negative) news value. The naming and denunciation of suspected tax avoiders is increasingly becoming seen as a risk that is harmful to the reputation. Impacts on the share price can be the consequence.

The subject has also become very relevant for investors. The asset management company Henderson Global Investors in Great Britain has taken up the subject “Tax, risk and corporate governance” in a survey of 335 of the FTSE 350 companies.

In the opinion of Henderson Global Investors: “Arrangements that minimize the amount of tax paid in the short term may be detrimental in the longer term if they prejudice the company’s relationship with tax authorities and additional costs are incurred in complex dispute resolution, or if the company’s wider reputation is harmed.”

For this reason the management of tax risks should receive adequate attention. Risk management lies within the responsibility of a company’s board of directors. Henderson Global Investors wrote directly to the chairmen of each company in order to obtain information about the treatment of tax matters by the board of directors.

The results of this study were published in February 2005. The survey shows that it is increasingly expected of companies that they “demonstrate to tax authorities (and also to society) that they are complying with tax rules”. The survey also shows that there are indications of a growing involvement of the board of directors in tax issues. However it turns out that only about one third of boards have looked strategically at tax issues in the past few years and have adopted a concept or a formal tax policy for their company.

As a result of the first survey Henderson Global Investors intensified its discussions with board chairmen of those firms, who already recognized tax-risk management. Based on these discussions, in October 2005 a summary of good practice principles applied by leading companies, suggesting a self-assessment framework for responsible tax, and calling for improved reporting on tax to investors and others was published. The Henderson report recommends all companies to apply these principles and a self-assessment framework, in order that their tax management both satisfies shareholder interests and at the same time fulfils their social responsibility.

Why tax is a task for the boardroom
In view of the public sensitivity to the subject taxes, management must take sufficient account of the aspect of the fair share of taxes. However this means all taxes that a company pays must be considered and not only income taxes. The only information in the public domain is generally the information in the annual report on corporate taxes on profits. There is little information about precisely what taxes and how much tax companies pay.

But corporation tax (or its equivalent in other countries) is not the only tax that is levied on companies. Social security contributions are a feature of all developed countries’ tax systems and add significantly to business tax costs. When considering the tax burden on business we also have to look at such things as business property rates and road fuel duties. There will also be irrecoverable value-added tax for many businesses and other more specific business sector taxes such as petroleum revenue tax.

As the Hundred Group of Finance Directors discovered in a survey about companies’ tax burdens, businesses pay twice as much tax as is reported under their corporation tax disclosures. So it would be necessary for companies to draw a clearer picture of what a company contributes in taxes because taxes represent no longer only a financial risk factor, but can also develop into a reputation risk.

Earlier tax risks were understood as financial charges, which a taxpayer had not recognized in advance and for which he had not set up accruals. Now the amount of corporate tax paid by large businesses is coming under increasing scrutiny and public debate. Because the risks in tax matters has become more var-
ied, the board of directors must, within the framework of the risk management strategy for the company as a whole, concern itself with the company’s tax strategy and tax policy.

A company’s tax conduct must be managed in a structured way and proactively. Tax-risk management must be embedded in the corporate governance of an enterprise. A company’s tax planning must therefore be based on a framework that is approved by the board of directors. Such a tax strategy is to be issued taking into consideration aspects of sustainability, compatibility with business activities and tax structures, the compliance culture and the fair share of Taxes.

Based on such a tax strategy tax policies are to be issued for the individual areas of a company’s tax functions and corresponding control systems implemented. These elements will be described in detail in the following individual chapters of this report.

A long-term company tax policy, supported by implementation controls, on the one hand permits consistent positive publicity and on the other minimizes the risk of unexpected tax costs. This also enhances in the same measure the company’s credibility with the relevant tax authorities.

A broad and consistent framework

The long-term management of taxes is, especially in cross-border businesses, of great importance. It is a matter of the two aspects risk minimization and opportunity optimization. The increasing complexity of fiscal laws and court judgments in various countries, the overlaying demands on accounting for and the disclosure of tax matters, make tax-risk management a challenge.

Coordination between those responsible for accounting and reporting and those responsible for taxation in a company is essential in order to achieve the most important objectives in risk minimization: observance of the legal framework, full compliance in tax matters and no surprises in reporting.

Opportunity optimization deals with a company’s organization (legal structures) and the procedures (for example allocation of functions within the group, responsibilities and transfer prices) from a tax aspect. Here the task of the company is to minimize the cost factor, taxation. The guidelines for opportunity optimization are to be found in the legal provisions. They are, just as the entire entrepreneurial action, to be subjected to the maxim of good corporate governance.

That means that tax planning can be explained sustainably, credibly and in its entirety to relevant outsiders. That is, to the tax authorities. Artificial constructs without lasting economic justification are, even if formally they can possibly be captured by fiscal legislation, not good tax planning. The aspect of fair share of taxes is to be considered in tax planning, however in the context of the totality of a company’s tax yield (such as direct and indirect taxes, other duties, social insurance contributions and income tax on employees’ wages), and not only of corporate income taxes.

Companies should therefore have a broad and consistent framework to calculate and communicate their total tax contribution.

In this sense tax planning in a company is to be geared to sustainability and credibility within the framework of entrepreneurial corporate governance principles. Such tax management, embedded in the corporate governance framework of a company, enables tax planning and tax compliance geared to sustainability and credibility. In this way tax costs become proactively managed costs, both in respect of their amount, and also in respect of the company’s reputation in the eyes of the fiscal authorities and the interested public.

The author expresses sincere thanks to Myriam Isenring for her active support in processing the material and formulating the article.
The way a company manages its tax affairs on the world-wide basis is directly relevant to its shareholders. Both the tax charge as well as the tax risks taken have a direct impact on the accounts and therefore on the valuation of a company.

A wider awareness of corporate governance issues including tax matters, an increased complex international tax legislation environment as well as governments and tax authorities trying to protect their tax revenues by tightening rules and improving their approach to tax collection and enforcement are forcing companies to have and operate a clear tax strategy. A tax strategy shall support the objectives of the business and it should drive decision-making. Such a tax strategy has to be formally documented and be formally adopted by the board.

What is a tax strategy?
A tax strategy means an outline of what the tax function has to achieve and the plan for getting there, starting from the current position. The tax strategy is the starting point for setting objectives and priorities, and then for negotiating and allocating resources accordingly. And it is about formalizing, agreeing and communicating a tax strategy within a company.

Some of the benefits are:
• senior management including the board confirms that the tax strategy aligns with the business strategy;
• the tax framework with its goals and responsibilities is clearly defined and it helps raise the profile of tax issues and pushes tax higher up senior management’s agenda;
• it serves as a useful basis for communication with the executive, the tax function, business staff and external advisers;
• re-visiting the strategy on a regular basis provides for a progress measurement and forces management to be dynamic and responsive to changes in the tax and other relevant business environment; and
• the tax department organization and reporting lines becomes aligned to the formulated tax strategy.

The key driver behind a tax strategy and consequently its designer will always be the head of tax since he needs a map as to where he is taking the tax function. The rest of the tax team, including the overseas tax function and business tax staff, have to contribute to ensure a common understanding and for motivational reasons. The chief financial officer will usually have high level input into the strategy design and use it as a framework in making tax-related decisions and in monitoring how the tax department is performing. The discussion of the tax strategy with the board, in our experience, provides sometimes for a different view and it adds senior backing to the tax function’s approach.
Principles in developing a tax strategy

There are lots of areas that could be addressed in a tax strategy and, of course, this varies from company to company. It might include effective accounting tax rate, cash tax rate, competitor tax rates, tax risks, tax compliance, corporate structure, ethics, reputation with tax authorities and with public, key tax drivers, tax department organization, alternative investment taxation matters as well as tax accounting (US GAAP and IFRS) and SOX 404. Andreas Staubli is the author of various articles on tax matters and a frequent speaker at presentations on various tax topics.

Managing the tax charge

The main focus of senior management still is on the accounts tax charge and the impact it has on earnings per share. However, we also see increasingly interest in the cash tax rate as well as in the overall tax contribution.

Corporate income taxes are typically the core business of a tax function. Above the line taxes such as value-added tax, import and excise duties, and (increasingly) environmental levies are of course also taxes on the business. The above/below the line question is particularly pertinent when agreeing respective responsibilities between the tax function and the businesses. We are aware of a number of significant sized businesses where even very senior management is rewarded on a profit-before-tax (PBT) measurement – including, more often than expected, the head of tax. This is hardly conducive to proactive management of the tax charge.

Who shall be the owner of the tax charge? If it is the responsibility of business managers to manage the tax charge, then it is more likely that the tax function will act as a service provider to the businesses, albeit hopefully as a fairly proactive service provider. The tax function may also need to take on a role of central coordinator, ensuring consistency between these three elements.
between the various businesses and perhaps encouraging the businesses through monitoring and publicizing their respective tax performance.

If the tax function owns the tax charge then more of a leadership role will be called for, with the tax function taking responsibility for driving tax performance in all the businesses. In today’s reality, it is typically a mixture of the two. There is a trend though, in that the increasing move towards global management of businesses is reflected in a trend towards stronger head office tax function control of overseas tax affairs.

However, in companies where VAT or other indirect taxes are a significant cost these taxes are often given either to the businesses or to local tax functions. As a consequence, we often find that the management of such taxes suffer from a lack of co-ordination between different territories.

The tax charge of a company is a significant cost element. Getting senior management to focus on tax as a manageable component of shareholder value can be a powerful way to raise the profile of tax in the business. Often, the first time senior management really think deeply about the impact of tax is when they become involved in helping set the tax strategy.

Some elements of the tax charge are obviously going to be more manageable than others. Therefore, understanding the key manageable components of the tax charge, and then managing the related drivers will be key.

Managing the tax charge has also a time dimension. The tax function has to focus on negotiating prior years’ tax liabilities, computing the current year’s liability (including compliance, transfer pricing documentation, tax accounting and tax process management) as well as managing future liabilities.

Many businesses do not enough focus on the latter, that is, they are not proactively planning their tax charge.

When designing a strategy document, three to five objectives that work as focus areas for managing the tax charge should be agreed upon within the organization and with top management.

Managing tax risk
Uncontrolled or unidentified risk is clearly undesirable, but there will be occasions when a head of tax has to and even will want to take calculated risks. Entrepreneurial behaviour is about taking risks and managing tax is no different.

One can distinguish the following main tax-risk areas which are all interlinked with each other:

- **Transaction risk** – risk arising from transactions and tax planning activity (where there can be considerable opportunity). 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. In addition, improper implementation is a typical source of additional downside risks.

- **Operational risk** – risk arising from the operations of the business units and the extent to which their activities may give rise to unexpected fluctuations in the tax charge.

- **Financial accounting risk and tax process risk** - risk of materially incorrect accounts and lack of management controls over tax processes.

- **Compliance risk** – risk of additional liabilities or penalties arising through non-compliance or failures in the tax return process.

Risks can lead to surprises, restatement of accounts, material weaknesses in processes, significant additional tax charges, interest, penalties and harmed reputation. A tax function should try to minimize and optimize interlinked with the objectives in the areas of managing the tax charge and managing the costs of the tax function.

Again the tax strategy document should focus on three to five risk areas that will get high tax management attention and set objectives. Since managing tax risk is so diverse and important, a structured tax risk management approach is highly recommended and that is in line with the trend we see. What is meant by a structured tax risk management approach? The starting point is the development of a tax-risk policy and in particular the definition of the risk appetite in the various tax risk areas. Of course this has to be discussed and agreed on with senior management and the board.

In a second step, a risk assessment should be made which results in a risk map and a plan for managing the key risks.

The third step is the design or review or implementation/remediation of the internal controls over tax processes relevant for managing the key tax risks.

Next is a communication plan to ensure the appropriate knowledge and information exchange on these matters within the organization.

The fourth step is monitoring and reporting, which typically is a combined effort of internal audit and tax function.

And last, management has to regularly review the tax risk policy and the tax risk appetite.

Managing the cost of the tax function
The cost of the tax function is made up of the core tax function, the shadow tax function (staff in other departments which do direct and indirect tax work), adviser’s fees and senior management time. There is a correlation between the costs of managing tax and the ability to manage both the tax charge and the tax risks. When seeking to control the cost of managing the group’s tax affairs, it is important to distinguish between measures to improve efficiency and measures which reduce the level of service the tax function delivers.

Nobody is going to argue against improved efficiency, but the level of cost of the tax function has to be set at such level, that the set objectives for managing the tax charge and the tax risks can be achieved. Having a proper tax strategy in place will help to ensure that the tax function receives the appro-
appropriate level of resource and that the business gets value for money from the tax function.

**Tax department organization**

Another important element of a tax strategy is the organization of the tax department. This largely depends on the tax charge strategy as well as the tax risk policy. The tax function has to be aligned to the set objectives. Generally, there is a choice between a head office model and a business unit/legal entity/country model. As mentioned earlier, the trend is toward the head office model but the structure needs to fit the requirements of both the business and the key tax issues that the tax function wants to manage.

The organization should specifically include the shadow tax function staff based in other areas of the business and also external tax resources. Different businesses use very different mixes of in-house, shadow and external tax resource. It is of utmost importance that the relationship with shadow staff and procedures for engaging external resource will need to be addressed when planning the tax function structure.

Another important element is the clear guidance on the reporting lines. In most cases the tax function will be allied with the finance function, but sometimes tax sits with the legal department. Historically, tax staff in overseas subsidiaries has normally reported to their local chief financial officers, albeit with dotted line reporting to the global head of tax. However as the trend towards global management grows, direct reporting to the global head of tax is on the increase.

**Managing the tax team**

A critical success factor is the managing of the tax team. Key is to ensuring appropriate focus of the tax team aligned with the tax strategy. Individual objective settings, job descriptions and formal staff evaluation systems are a useful discipline in keeping individuals focused on the overall tax strategy. There is a need for a balance of group and local measurable objectives aligned with the tax strategy as part of the performance measurement system.

The right skill set of the members of the tax function is of course a key factor too. Strong technical skills will constitute a basic requirement, but other softer business skills will prove crucial if the tax function is to be effective in actually managing the tax charge and risks.

Tax functions have come a long way from the days when only tax technical skills were considered important. Apart from soft skills mentioned, additional technical know-how is required in new areas like accounting, reporting, business operations (value chain and transfer pricing), risk management and process management. This leads to the crucial need to maintain and develop expertise and talents in a tax function. Therefore, providing internal and external training on a regular basis for technical matters (tax, accounting, risk management, Sarbanes-Oxley 404), developing soft skills as well as job rotations for new talent development and exposure to international tax issues are important elements of any tax strategy.

**Stakeholder engagement and communication**

However strong the skills of the tax team, it is unlikely to perform effectively if it does not manage its relationships with the senior management and the business properly. This will involve regular, quality communication. Therefore part of the tax strategy should be a section addressing how the tax function will maintain effective regular communication with management, the businesses and other key stakeholders and information providers. The more effective tax teams spend a good deal of their time out of their offices ensuring regular, high quality communication.

**Appropriate attention**

In an environment where regulatory and reporting requirements are getting tighter, where “unethical” tax planning is a topic of public discussion (driven by tax authorities), where the international tax environment gets more and more complex, where non-compliance leads to financial (penalties) and damage to the company’s reputation, where the awareness for managing the tax charge to increase shareholder value has increased, where risk awareness and the need to manage the risks proactively has emerged with respect to tax in particular, having a formalized and communicated tax strategy is a must under today’s corporate governance practice.

It is best practice to formalize a tax strategy in a comprehensive way and to develop the strategy involving the different stakeholders. Discussing the areas of focus with respect to managing the tax charge, deciding on the risk appetite and managing the risks as well as aligning the tax department organization and costs to the objectives set are the key elements of a tax strategy.

On the basis of a communication plan, the tax function has to keep the tax strategy up to date, in particular through regular feedbacks to senior management and board as well as discussions with them. Tax has become a strategic issue and therefore it needs the appropriate attention.
One can imagine tax directors saying: “I know what the key tax risks are in my business. I know how we are managing these risks. Why do I need a tax risk policy?”

This is a very valid question for a tax director to ask. However it is equally valid to be asking whether the board and people out in the business (the tax-risk creators) are in agreement with the head of tax as to how tax risk should be managed and indeed as to what the key tax risks really are.

The purpose of this chapter is to address three questions:
1 Why do you need a tax risk policy?
2 What does a policy look like?
3 Who should be involved in producing it?

This chapter also sets out what is best practice in this area and concludes with a recommendation that for any large organization a properly documented tax risk policy is a must.

Why do you need a tax risk policy?

There has never been a greater focus on good corporate governance than where we are today. Additionally there has never been a greater focus on tax from not only revenue authorities but also investors and regulators. The focus of these three different constituents is leading to a much greater demand for both transparency and accountability on tax matters, and also an understanding of tax and its associated risks. We are thus seeing an increasing awareness and interest on tax in the boardroom. The tax function therefore needs to be able to demonstrate that it has proper control of both the tax affairs and, in particular, the tax risks of the organization.

Three examples will help demonstrate this growing global trend. The Australian Tax Office has been in communication with chairman and chief executives of Australian groups for a number of years, asking them to explain how they manage their tax risks.

In the UK Hendersons (an investment management group) carried out a survey of the top UK companies, looking at the board’s approach to managing tax. This survey was published in early 2005. In late 2005 they issued another report around tax and the corporate/social responsibility agenda. Additionally Citigroup have produced a report entitled An Investor’s Guide to Analysing Tax Risk. The third example comes from the US where over 20% of material weaknesses reported under section 404 of the Sarbanes Oxley Act are around how tax is controlled – and a number of US heads of tax have lost their jobs on the back of these weaknesses.

The logical conclusion is that proper risk assessment and controls need to be in place in every organization. However in order to conclude as to what is proper, an overall framework needs to be developed. That is, a properly documented tax risk policy. Without such a framework, different people in the organization will take different approaches to managing tax risk – with potentially adverse consequences.
However for those starting with a clean sheet of paper, setting out a standard format for all such policies – and the tax risk policy of a tax risk policy. Indeed some organizations will already have parts of the business.

Above six headings, should cover not only all taxes but also all groups that have included this as part of their tax-risk policy. This chapter has already mentioned the risk creators in a business and their role in tax risk management. It is important that the board put their weight and support behind whatever needs to be done. Any policy will lack traction if they sign off on a tax-risk policy. Not only should they do this, it is best practice for the head of tax to present to them, in person, at least once a year to explain the group’s tax position, the risks and how they are being managed.

Who should be involved in producing the policy?
Tax risk, and hence tax-risk management, involves a large number of people from different parts of any organization. There are the risk creators out in operations, there is the shadow tax function dealing with tax returns and the information for them, and there is the board that is responsible for managing the business as a whole. So who should be involved both in the setting of the tax risk policy and once it has been set, in its implementation?

It is the head of tax that needs to be responsible for driving the overall process. The tax function will clearly have a better understanding of the tax risks in a business and they need to have ownership of the tax risk policy. However it is important that the board put their weight and support behind whatever needs to be done. Any policy will lack traction if senior management and, in particular the board, are not supportive of it.

The board (or at very least the audit committee) needs to sign off on a tax-risk policy. Not only should they do this, it is best practice for the head of tax to present to them, in person, at least once a year to explain the group’s tax position, the risks and how they are being managed.

But it is not only the board that needs to understand and buy-in to the tax risk policy. This chapter has already mentioned the risk creators in a business and their role in tax risk management. An example might help illustrate this point.

Let us assume that the sales people want to open up a new market in a country in which you have not done business before. From a tax point of view there are two ways they can do this.
Firstly they can launch into the new country, setting up offices, creating new subsidiaries, starting to sell, all of this before talking to the tax function. Alternatively, they could mention to the tax function that they are thinking of doing all of the above and asking for advice as to how the operations should best be structured.

Table 1:

<table>
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<th>Tax risk</th>
<th>Policy</th>
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| **Transactional**                                 | All transactions must have a business purpose. The group will not undertake purely tax driven transactions. The tax function must be involved in:  
• all business or share acquisitions and disposals  
• all changes in corporate structure  
• all cross-border financing arrangements  
• all property transactions in excess of $1 million  
The tax function must be involved in not only the planning of the above transactions but also in the implementation and documentation of each transaction. |
| **Operational**                                   | Where any new cross-border trading arrangements are being set up, the tax function must be involved well in advance of any arrangements being put in place so that appropriate advice can be taken. All cross boarder transactions must be carried out in line with the group’s transfer pricing policy. |
| **Compliance**                                    | The group will comply with all tax regulations in all countries in which it operates. It will aim to submit all returns by their due dates and in line with local tax law. All positions taken in the tax returns must be supportable and, on the balance of probability, be more likely than not to be agreed by the appropriate tax authority. The tax function will proactively manage the relationship with the key tax authorities in order to minimize the risk of penalties arising when tax matters are inadvertently incorrect. The group will aim to have no adjustments to tax returns in excess of the materiality limits for adjustments to the financial accounts, which are set out below. |
| **Financial accounting**                          | The group will take a conservative/prudent position in respect of the tax charge in the accounts. A materiality limit of $0.5 million is set for the group tax charge. For the taxes charged to profit before tax — for example employee taxes, indirect taxes, sales and use taxes — the materiality limit is $0.2 million. The financial accounts are expected to be correct within these materiality limits in respect of all taxes, both at the year end and in the quarterly reporting. |
| **Management**                                    | External opinions will be taken by the tax function where the tax at issue is greater than $0.5 million. Advisers will be used where in-house resources do not have the appropriate skills or knowledge. Appropriate tax-risk-management controls will be implemented over our key tax risks and reviewed on a regular basis in conjunction with internal audit. |
| **Reputational**                                  | The group does not want its tax affairs to appear in the public domain. The group is only prepared to enter into transactions that could cause this to happen where the transaction type has become common practice. The group will manage its compliance affairs to minimize the risk of any public comment. At the same time, in its dealings with tax authorities, the group will robustly defend any tax position taken in any tax return. |
| **External**                                      | The tax function will monitor changes in relevant tax practice and law in order to assess any consequences for the group, with the aim of minimizing any adverse impact. The tax function will participate in any tax authority formal consultation process where it is expected that the matter under consultation will have a material impact on the group’s tax liability (see Financial accounting above for materiality levels), or where a significant change in practice is being proposed that will impact the group’s management of its tax compliance. |
In the first alternative there is a high chance that the structure will not be tax optimized, in the second it is much more likely that it will be.

The tax-risk policy needs to set out what they should so in such circumstances and this tax policy needs to be communicated to these risk creators. The policy therefore needs to be practical and not a hindrance to the people driving the business forward. It is therefore important that they have some involvement in helping draft up the policy.

An exercise tax advisers can carry out with our clients is to look at who the stakeholders are for a tax risk policy, with a view to deciding which of the stakeholders need to be involved in producing the policy and which of them need to understand the policy once it has been prepared. In each case a proper communication plan is important to get appropriate buy-in and acceptance of what needs to be done. These stakeholders can include both people within the organization and those outside, such as advisers and, in some cases, even revenue authorities.

### Implementing the policy

There are three types of policy. Firstly there is poor policy and poor implementation, and thirdly there is a good policy and good implementation. It is beyond the scope of this chapter to go into the implementation of the policy. Suffice it to say that the real value of a good policy is only when it is implemented.

**Best practice**

It is best practice, particularly in the present corporate governance environment, to have a properly documented tax-risk policy. This policy should be signed off by the board. There are a number of different formats for a tax-risk policy; we believe the most effective is one which focuses on the individual types of tax risk. Finally there are a number of different parties both within and outside an organization that are stakeholders and appropriate communication with each of these stakeholders needs to be thought through.
One of the impacts of the focus on risk management, compliance and internal controls has been a push for companies to review, reassess and seek to optimise their processes across all aspects of the business, including the management of tax.

A number of corporate governance developments in different territories are driving a climate of business change and increased expectations regarding risk management and internal controls. Also, the unrelenting pressure on costs is pushing companies to extract efficiencies in business processes. The tax function has not been immune to this pressure, with increased focus on the tax processes and how they relate to other business processes.

Of all the corporate governance developments, the US Sarbanes-Oxley legislation has had the most profound impact in tax, and is leading to similar legislative responses in many other jurisdictions. The focus of the Sarbanes-Oxley legislation, principally through Section 404, is on the operation of internal controls in relation to financial reporting, including reporting of tax results. Tax has particularly come into focus, given it was among the most common weaknesses identified during the first two years of reporting under the new code. For companies registered with the US Securities and Exchange Commission (SEC), remediation of potential weaknesses might result in the need to review the effectiveness of existing tax processes or to design new tax processes.

The trend towards tax process design
Unlike many other business processes, tax processes have traditionally been manual in nature, with limited automation, checks and controls. Tax controls often rely heavily on the skill and experience of the individuals who own the process, and there tends to be limited monitoring. A recurring theme is that individuals with the right skills, experience and application tend to compensate for poor processes and systems. Issues arise where there is a frequent turnover of staff or an inappropriate mix of available resources to ensure quality outcomes.

For many organizations tax processes and controls are not within the scope of internal audit and risk management review processes. However it is becoming more commonplace for companies, often driven by the board audit committee or risk committee, to require that tax processes and internal controls be reviewed to ensure compliance with the company’s tax obligations.

A company might wish to look at the design of tax processes for a number of reasons. These include a desire to improve risk management, cost and time efficiencies, or the need for new or changing tax functions to establish appropriate processes and controls for the first time. Benefits can be realized in all these areas if the right approach is taken to the design and improvement of tax processes.
What tax processes do you need?
Tax processes typically cover a range of different responsibilities of the tax function, from strategic tax advisory processes through to tax effect accounting for external reporting and tax compliance. A summary of the typical tax processes is outlined in Table 1.

Tax processes should play a big role in managing tax risk, which could relate to the identification of tax risks and issues, the appropriateness of tax technical positions adopted or the operating integrity of tax compliance or tax reporting systems and processes.

A framework for process improvement
Having identified the need to improve existing tax processes or develop new processes, the question is then how to proceed. Overall success requires the right structure around the design and implementation project. The project should be focussed on producing the desired outcomes for the company and its stakeholders, and the main stakeholders themselves must buy-in to the project and the proposed solutions.

The objectives of the process improvement project need to be determined on a case-by-case basis relative to the desired outcomes, and typically involve establishing business processes with the following elements:

- efficient and effective in delivering the desired outcome;
- inbuilt controls that are able to be measured and tested;
- facilitate the organization’s risk management objectives;
- documented (process mapped) and easily communicated; and
- monitored for operational effectiveness.

Various published process improvement methodologies can be applied for tax process design. At the most robust end of methodologies is the Six Sigma continuous improvement methodology. Six Sigma was institutionalized by global corporates Motorola and GE in the 1980s and 1990s, and has been integrated into operational risk management by a number of other corporates recently. Six Sigma drives continuous improvement by focussing on the outcomes of processes in terms of minimizing variations or defect rates, and is strongly grounded in statistical measurement of the performance of business processes.

For the design of tax processes much can be learned from Six Sigma. It provides sophisticated methodologies both for process improvement and process creation aimed at improving overall performance of a business process, a company function or the organization as a whole.

The process
A process design and improvement framework can be applied that shares many of the elements of Six Sigma (see Table 2). The main objective of the framework is to realize and manage the various benefits that are achievable through process design and improvement.

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<th>Table 1: Types of tax processes</th>
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<td>Roles of the tax function</td>
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<td>Strategic</td>
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Tony has worked with numerous significant corporate groups to establish effective tax-risk management programmes and tax processes. Tony also advises a number of Australian corporate groups on the implementation of global compliance arrangements, tax-risk frameworks and compliance with Sarbanes-Oxley requirements for internal controls.

Tony’s broad experience in a range of domestic and international tax issues has been established over a number of years advising Australian and multinational corporations, including two years working with PricewaterhouseCoopers’ mergers & acquisitions tax group in London.
Assess the tax function needs and the as is environment

The starting point for improving existing processes and developing new processes is properly understanding the current operating environment of the tax function, in other words the as is position.

At this point the organization defines its business needs in terms of new processes, or identifies areas where there are improvement opportunities. In assessing the as is position, look at the benefits sought from developing new tax processes or improving existing processes, and how the various stakeholders are impacted.

It is valuable to define the benefits in terms of the usual process dimensions of time, cost and quality, as well as other considerations, such as risk management through better controls and ensuring compliance with all laws and regulations.

Some of the questions to be considered at this stage are:

• What are the roles of the tax function and required outputs?
• How effective are current processes?
• Which process work well and which don’t?
• What are the current constraints from process change in terms of people, processes and technology?
• Who are the stakeholders in the outputs of the process, and what are their respective business needs?
• What are the symptoms of problems – level of errors, time/cost inefficiencies?
• Can the real cause of the process problems be determined?

Designing the environment

Some of the thinking around the perceived constraints can be challenged and companies should establish a vision of what the ideal solution would look like. Some constraints, such as current systems, people and the structure of the finance function might be more easily dealt with than expected.

From a picture of the ideal solution, one can start to design the elements of the to be environment. The question to ask is: How do you achieve as many of the benefits of the ideal solution within the real constraints?

For design, best practice can provide inspiration. Some of the elements of best practice in tax processes include the following:

Diagram 2:

Applied in the context of tax process design, the framework is broadly as follows:

1) Assess the tax function needs and the as is environment.
2) Design the to be environment.
3) Develop the process, technology and organization changes required to achieve the desired outcomes.
4) Implement the changes and a programme of continuous improvement.

One large multinational company estimated that over 50% of its time was being spent on tax compliance; consuming resources to meet basic tax obligations. Despite the time spent on compliance, there was a concern that potentially material issues could arise in submitted tax returns. Determining the real causes of the problems required the processes to be broken down to their individual steps to understand where the time was being spent and to assess where there was inadequate risk management built into the process.

Case study

One large multinational company estimated that over 50% of its time was being spent on tax compliance; consuming resources to meet basic tax obligations. Despite the time spent on compliance, there was a concern that potentially material issues could arise in submitted tax returns. Determining the real causes of the problems required the processes to be broken down to their individual steps to understand where the time was being spent and to assess where there was inadequate risk management built into the process.

The ideal environment

The ideal environment for a company trying to improve tax compliance processes was a reconstructed tax compliance process based on risk management principles, with the right mix of internal and external resources. In terms of the internal work on compliance, the company believed that they could reduce the time spent on analysis of data by placing greater reliance on the accounting data, provided it developed some new sub-processes aimed at improving the quality of the data at its source; for example general ledger coding of tax-sensitive data.
and, lastly, selecting the preferred design. In a complex environment the preferred solution is unlikely to be obvious and will not be perfect. So continuous improvement is important. **Develop the solution**

Developing the solution is the most critical phase in the process. This is where the detailed elements of the tax process design are developed, and this includes changes to existing systems or development of new systems, people’s roles and responsibilities, the organizational structure, and the processes around these areas. Compromises must not be introduced into the design at this stage without proper consideration.

The development of the solution should cover such aspects as what:

- new resources or changes to people’s roles need to be implemented;
- changes to systems or new systems are required;
- communications are required internally regarding the change project; and
- other functions or processes are potentially impacted by the solution.

The main output from this stage is an implementation plan that contains all of the changes to be implemented: roles and responsibilities, the timetable and process documentation.

Process documentation, including process mapping both of the *as is* process and the new process play an important role in the implementation, training and ongoing review of the processes.

A level of project management around the implementation is necessary to ensure the success of the project. Ideally a project manager should be appointed to oversee the implementation, and ideally someone separate from the business process owner for the processes being developed or changed.

Lastly, a company cannot proceed to implementation without the full support of the various stakeholders, particularly the process owners and those dependent on the process. **Implement the solution and operate**

The fourth phase involves carrying out the process changes, including any new systems or modifications to existing systems, internal and possibly external rollout and re-training for staff.

The implementation of the solution should bring to life the best-practice elements set out above to deal with the problems identified in the *as is* environment. After operations begin under the new processes, it is critical that there is ongoing review and measurement of the performance of the processes to facilitate a programme of continuous improvement.

**Making process change an ongoing process**

Having identified the need for change to tax processes, and implementing that change, the difficult next step is building continuous review and improvement into the process. No processes will be perfect, given the best fit for the time they are created, and the constantly moving information needs. Beware of *change fatigue*, which has become a particular problem in many countries with constant tax law changes and the adoption of new accounting standards under IFRS.

Ongoing monitoring of performance against the defined outcomes and benefits agreed at stage one will help to ensure that the benefits of the new or changed processes are being realized and that processes don’t slowly morph back to where they were.
Tax accounting: using cross-border losses

By Norbert Winkeljohann and Sven Fuhrmann, PricewaterhouseCoopers Germany

In today’s environment companies have to understand the difficulties surrounding tax accounting and related disclosure responsibilities. International Accounting Standard (IAS) 12 deals, among others, with the recognition of deferred tax assets arising from unused tax losses. This article discusses the possible impact of decisions of the European Court of Justice (ECJ) on the accounting of tax losses under IAS 12.

In the long-awaited Marks & Spencer decision of December 13 2005 (C-446/03) the ECJ decided that the UK’s restricting group relief to losses incurred by UK resident subsidiaries infringes the EC Treaty freedom of establishment if such losses cannot be used either by carry back, current year relief against other local profits or carry forward either by the EU (non-UK) subsidiary or another legal person. The judgment is tailor-made to the specific case of Marks & Spencer and does not, as such, open the door to multinational enterprises to off-set losses generally against the highest tax rate profits within the EU.

Facing the ECJ jurisprudence in Marks & Spencer, some member states reconsidered their cross-border loss utilization rules. In anticipation of the ECJ ruling, Austria, for example, amended its Corporate Income Tax Act to permit cross-border loss utilization under a new group tax regime in 2004. Multinational enterprises should analyze whether it is possible to optimize the total income tax position comprising the current tax position and the deferred tax position either by applying national tax law of the member states (for example, Austria) or by applying the ECJ jurisprudence.

In the following, a simplified example is depicted illustrating tax planning activities of an EU-based corporate group by cross-border loss utilization. By analyzing the current and deferred tax implications of the restructuring for the companies involved it will be demonstrated that cross-border loss utilization might lead to an increase of the reporting entity’s income tax position as a whole.

Simplified case study

A corporation D resident in Germany (D-Corporation) is the 100% shareholder of corporation P resident in Poland (P-Corporation) as well as of corporation A resident in Austria (A-Corporation). A-Corporation is in a significant taxpaying position.

P-Corporation will incur losses in the next three years due to costs for broadening its business. The costs can neither be capitalized nor offset against profits for statutory as well as for tax purposes and will, as a consequence, give rise to a loss carry-forward in Poland. In the fourth year, P-Corporation will become profitable and generate taxable income so that the loss carry-forward can be set off against profits to the extent the provisions of the Polish Corporate Income Tax Act (CITA) are fulfilled.

German resident D-Corporation is considering the contribution of its entire shareholding in P-Corporation into A-Corporation according to section 23 paragraph 4 German Reorganization Tax Act (RTA). The German Finance Ministry published a
Bill on Tax Measures re the Societas Europaea and on other tax changes on June 9 2006 that leads to a complete amendment of the German Reconstruction Tax Act including section 23 paragraph 4 German RTA. As the announced amendments continue to provide for a tax neutral share-for-share exchange between companies that are resident in a Member State and, hence, will not have any impact on the underlying case study, they will not be dealt with for purposes of this analysis. The share-for-share-exchange is envisaged to offset the loss carry-forward of P-Corporation against the higher tax rate profits of A-Corporation in Austria (in the following: the restructuring).

The corporate income tax rates of the involved companies are as follows:

- **D-Corporation (Germany): 40%**
- **A-Corporation (Austria): 25%**
- **P-Corporation (Poland): 19%**

In the following, the implications of the restructuring shall be reviewed by analyzing the current tax position and the deferred tax position of A-Corporation in Austria and of P-Corporation in Poland as follows:

- income tax position before restructuring; and
- improvement of income tax position by cross-border loss utilization.

### Income tax position before restructuring

#### Restriction of loss carry-forward on the level of P-Corporation

Losses may be carried forward for five years according to section 7 paragraph 5 Polish CITA. Up to 50% of a loss may be set off in each year. For purposes of this analysis it shall be assumed that the prerequisites of the recognition of a loss-carry-forward are fulfilled on the level of P-Corporation.

#### Capitalization of a deferred tax asset on the level of P-Corporation

An entity may recognize a deferred tax asset arising from unused tax losses to the extent it is probable that a future taxable profit will be available against which the unused losses may be offset according to IAS 12.34. However, the entity should recognize the deferred tax asset only to the extent that it has sufficient taxable temporary differences or where there is persuasive evidence that sufficient taxable profit will be available (IAS 12.36(a)-(b)).

In the case at hand, it shall be assumed that the prerequisites for the accounting of a deferred tax asset of P-Corporation in the meaning of IAS 12.36 are fulfilled.

### Improvement of income tax position by cross-border loss utilization?

#### Establishment of an Austrian tax group

The German tax group relief system in the meaning of sections 14 to 19 German CITTA (Organschaft) does not provide any regulations for cross-border loss utilization. Current developments in German tax law do not contain any amendments of the German group relief regulations in this regard either. The Bill on Tax Measures re the Societas Europaea and on other tax changes of June 9 2006 does not contain any regulations with respect to the Organschaft.

Thus, in this case, a reduction of the current tax liability by a cross-border loss offset could solely be achieved by establishing an Austrian tax group whereas A-Corporation serves as parent company and P-Corporation as subsidiary.

#### Decrease of current tax position on the level of A-Corporation

In principle, the Austrian group tax regime provides an immediate cross-border loss offset under the following cumulative conditions: (i) the respective EU subsidiary is comparable to an Austrian corporation (ii) the EU subsidiary...
is held directly by an Austrian corporation and (iii) the EU subsidiary could not utilize its losses by itself immediately. Given the conditions of section 9 paragraph 6 Austrian CITa, the losses of the EU subsidiary can be deducted from the Austrian parent’s company tax base in proportion to its shareholding in the EU subsidiary.

However, the Austrian group tax regime contains a loss recapture rule. As a consequence, current tax benefits generated by deducting foreign losses from the Austrian parent’s company tax base are recaptured in the year when the respective EU subsidiary could set off its loss carry-forwards against its own profits or the EU subsidiary exits, even by insolvency or liquidation, the tax group. As the Austrian group tax regime was enacted before the ECJ decision in *Marks & Spencer* it does not reflect the latter. However, the ruling in *Marks & Spencer* has revealed some weaknesses in the Austrian regime.

In the contemplated case, it shall be assumed that the prerequisites of a cross-border loss offset in the meaning of section 9 paragraph 6 Austrian CITa are fulfilled.

A-Corporation could reduce its current tax position by deducting the losses incurred on P-Corporation’s level. In the amount of losses incurred by P-Corporation and utilized by A-Corporation the latter has to set up a “noted recapture item” according to the recapture rule of the Austrian Group Tax Regime to assure its taxation.

**Recognition of a deferred tax liability on the level of A-Corporation**

In the following, the treatment of the “noted recapture item” under International Financial Reporting Standards (IFRS) will be described.

Setting up a contingent liability for the “noted recapture item” pursuant to IAS 37 could be considered. IAS 37 is, however, only applicable provided that there is no specific rule of the standard. For income tax accounting purposes, IAS 37.5(b) refers expressly to IAS 12. As the recapture item is a tax related item, it has to be accounted for applying IAS 12 only.

The objective of IAS 12 is to prescribe the accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax consequences of (i) the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity’s balance sheet and (ii) transactions and other events of the current period that are recognised in an entity’s financial statements.

IAS 12 requires the concept of temporary differences to be adopted stating that it is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. The reporting entity has to consider whether the recovery or settlement of that carrying amount is probable and will result in future tax payments larger (or smaller) than they would be if such recovery or settlement had no tax consequences. If it is probable that such larger or smaller tax payment will arise, in principle, IAS 12 requires that the reporting entity recognizes a deferred tax liability (or deferred tax asset).

The standard gives further guidance concerning the recognition of deferred tax assets arising from unused tax losses and unused tax credits (IAS 12.34-12.36). It should be noted that unused tax losses are neither recognized as such in a reporting entity’s financial statements as an asset or liability nor could they be regarded as transactions and other events of the current period that are recognized in a reporting entity’s financial statements. According to the concept of IAS 12, however, unused losses have to be recognized in the determination of a reporting entity’s deferred tax position, as they will have an impact on the taxes payable in future periods.

With respect to the “noted recapture item” it could be argued that the standard does not give any guidance for the accounting of the “noted recapture item” by interpreting IAS 12 closely. Hence, any potential tax obligation has to be recognized in the year of occurrence only and will, as a consequence, solely affect the respective current tax position.

This interpretation, however, may not reflect the concept of IAS 12, as otherwise any potential tax obligation based on the deferral taxation of the “noted recapture item” would not be recognized in the reporting entity’s financial statements. In omitting a deferred tax liability, the reporting entity might not present the net worth, financial position and results cor-
rectly. At the time IAS 12 was promulgated, the standard setter was not aware of the ECJ decision in Marks & Spencer and could not anticipate that EU member states would permit a cross-border loss utilization under tight conditions. Bearing this in mind, IAS 12 should be applied analogously in the case at hand by setting up a deferred tax liability for the “noted recapture item”.

IAS 12.74 states that deferred tax assets and liabilities may not be offset, among other things, to the extent that the deferred tax assets and liabilities concerned relate to income taxes that are raised on different taxable entities or that are imposed by different tax authorities.

In a recent statement concerning the implementation of the EU’s Lisbon Programme on April 5 2006, the European Commission outlined that a Commission-led expert working group on the Common Consolidated Corporate Tax Base (CCCTB) has made “encouraging process” to “enable companies to follow the same rules for calculating the tax base for all their EU-wide activities, thereby removing many of the tax obstacles to companies operating across the Internal Market”. However, the European Commission has no intention to link the CCCTB with any proposal to harmonize tax rates.

Due to the different tax rates applicable in Poland and Austria the reporting entity is facing the situation in its consolidated financial statements that the deferred tax liability to be set up for the “noted recapture item” in Austria is exceeding the deferred tax asset to be capitalized for the unused losses in Poland. Hence, it could be concluded that it is conceivable that the deferred tax position increases by the implementation of a cross-border utilization model provided the applicable tax rates of the involved jurisdictions are different. It might also be the case that the difference in tax rates is in favour of the reporting entity.

**Court’s influence**

The simplified case study depicts that even IAS 12 is affected by the jurisprudence of the ECJ. It would be appreciated if the IASB Board would give further guidance whether a deferred tax liability would have to be set up for a “noted recapture item”. Depending on the IASB Board’s conclusion it is possible that the European Commission might reconsider its decision not to harmonize corporate income tax rates within the EU as the problem could be easily solved by a harmonization of tax rates.
It has been nearly four years since the legislation was first introduced in the US and businesses and individuals around the globe are still feeling the impact of the Sarbanes-Oxley (SOX) Act of 2002. Most have been particularly impacted by section 404 of the Act, which requires an annual report by management regarding internal controls and procedures for financial reporting and an attestation as to the accuracy of that report by the company’s auditors.

Arguably, no one has felt the sting of SOX 404 more acutely than the tax departments. Tax departments globally are feeling the pressure as tax, for the second year in a row, holds the dubious distinction of being one of the most common areas of internal control failure (material weakness) cited in the adverse opinions filed in 2005 (Year 2).

Before SOX, perhaps due to the many complexities and unusual rules, accounting for income taxes more often than not was handled somewhat differently than the other financial statement accounts as there seemed to be less formalized processes. Often, the tax entries were the responsibility of one individual who kept much of the knowledge in their head rather than in clearly documented schedules and reports. Calculations were manual, complex and to a large degree reliant upon information gleaned from informal conversations with other departments, business units and, potentially, countries. Taxes were a “mystery”, often deemed more of an art than a science and a chief financial officer’s comfort over these accounts was probably gained more through dialogue than through review.

SOX 404 has thrown the spotlight on accounting for income taxes and the results have highlighted issues at many companies both large and small. A lack of understanding of US Generally Accepted Accounting Principles (GAAP) tax accounting rules, formalized processes, internal controls and documentation continued to be problem areas in Year 2. Year 2 has shown that much work is still left to do in the area of income taxes.

**Tax trends and issues**

PricewaterhouseCoopers, along with many others, has been tracking public disclosures of confirmed and potential material weaknesses discussed in Form 10-Ks, earnings releases and Form 8-Ks since 2004.

**Year 1**

The following is a brief list of the areas of failure cited most often in Year 1 which in certain instances also led to restatement:

- lack of documentation of processes, controls and evidence of controls;
- lack of process and controls over foreign tax provisions;
- lack of understanding of tax risk and where it impacts reporting – “tax contingencies”;
- lack of understanding of US GAAP as applied to income tax accounting; and
The overall number of adverse opinions has decreased from Year 1 to Year 2. Unfortunately, tax has continued to be one of the leading areas of “material weakness” disclosures.

Most companies that have been through Year 2 have cleared the documentation hurdle. They have, in large part, identified those internal controls that are key and rationalized the documentation needed to evidence the existence and operation of the control. Having said this, as noted above, there were still material weaknesses in the tax function.

Year 2 results included certain of the same material weaknesses in the tax area as those reported in Year 1. The following issues were once again reported as issues in Year 2 reporting:

• lack of controls around foreign tax provisions;
• lack of understanding of US GAAP accounting for income taxes; and
• lack of communication/application of changes in US GAAP and tax law to the accounting for income taxes.

There were instances where there were material weaknesses in Year 2 at companies where there had been no material weakness in the prior year. While we have not done an in-depth study of these situations, the following observations are offered as probably explanations.

In Year 1 there was significant focus on the internal controls and remediation of deficiencies before year end. In some cases it would appear that the remediation, while addressing the immediate issue, was insufficient to address fully the underlying issues in the tax process. In other words, a certain control may have operated effectively in Year 1 due to the remediation steps taken in Year 1; however, those steps were never truly ingrained as a permanent improvement in the process and as a result, did not operate effectively in Year 2.

Another explanation might be that there were certain issues that were uncovered in Year 2 that may not have been highlighted in Year 1 for whatever reason. For example, if a company did not have any acquisitions in Year 1, it would not necessarily be evident that a company’s controls around recording deferred taxes as part of purchase accounting did not operate effectively.

Finally, businesses change. They change their systems, the people change positions and in some cases the business itself expands into new markets and/or products. Each of these changes impact the internal controls applied to the accounting for income taxes. Failure to recognize the impact of these changes may lead to deficiencies that did not exist in the prior year.

It is no secret that management, audit committees and boards of directors have become more active and more

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Larry serves as the national lead for the initiative addressing the application of Sarbanes Oxley Act section 404 (SO 404) to the tax function. His responsibilities include developing tools and training materials related to SO 404.

Prior to his present role, Larry was in the BPO line of service and served as CFO of that line of service from June 2001 to January 2003. He also participated as a member of contract negotiation team and process transition team for multinational outsourcing clients.

Before joining the BPO line of service, Larry had 23 years of experience providing services to clients, including 5 years as an auditor and 18 years providing tax services. Larry’s current clients include: IKON, Hercules, Campbell Soup, Exide, VF Corporation and Kulicke & Soffa.

- communication and controls breakdown between tax and units within the organization.

Initially when the deficiencies outlined above were noted there was an attempt to rationalize and attribute the deficiency to the informal manner in which the tax computation and review were documented. In many cases, tax managers suggested that they indeed had solid processes and internal controls, however, those processes and controls simply were not adequately documented. There was resistance to expand documentation especially in areas that might be considered sensitive.

However, many of those observations proved unfounded when company’s remediation of gaps in internal controls uncovered various errors in the tax accounts. In some cases the discovery of the error led to a restatement of the financial statements. In fact, most of the companies that disclosed a material weakness in the tax area in the first year of SOX 404 also had a restatement.

Also in Year 1 were those tax departments who took SOX 404 as an opportunity to highlight their efforts and resource needs in the area of income tax accounting. These companies set forth to enhance the documentation around existing processes and controls, as well as, implement new processes and controls in an effort to ensure SOX compliance in Year 1. In some cases these efforts led to documentation to almost the desk level which was much more than required to docu-
engaged in the financial reporting process and the internal controls around those processes. SOX 404 is not viewed as a periodic compliance exercise to the company stakeholders, rather it is an ongoing process and a mindset.

It is also apparent that although great strides have been made in addressing gaps in controls when comparing Year 1 to Year 2 the results indicate that, tax still has room for improvement.

So, what issues still need to be addressed and what does the future look like for tax departments?

**Specific issues – what still needs to be addressed?**

Material weaknesses can be isolated and specific gaps in internal controls can be remediated, but a micro approach may only result in a temporary solution. One cannot assume that controls that have operated effectively in the past will operate effectively in the future.

A major challenge for many tax departments will be the need to embrace the discipline of maintaining, executing and documenting “controls” as part of the day to day activities. The truly effective tax department of the future will identify those key activities that can provide value and insure that they leverage those activities to the fullest extent.

In the future, the success of the tax department may hinge on vigilance and a holistic approach to internal controls and tax risk. Rather than documenting a multitude of control activities and adopting a compliance mentality, (individuals focusing on sign-off on checklists) tax departments must focus on those controls that provide the reasonable assurance that there are no significant errors. Having said this, many organizations may find that a well designed checklist that challenges the preparer to consider and document their activities can be a valuable tool. From a SOX 404 perspective, the objective is to provide reasonable assurance that no significant errors go undetected in the identification, computation and financial statement reporting of the tax accounts.

The concepts of this holistic approach may be captured by a series of questions. The persons responsible for tax controls should be able to identify, document and test the responses to the following questions:

- How do I know that changes in tax laws, regulations and/or judicial decisions have been identified and the implications to the tax accounts accurately evaluated on a timely basis?
- How do I know that the tax implications of changes in accounting pronouncements (including those not directly applicable to the tax accounts) have been identified and the implications to the tax accounts accurately evaluated on a timely basis?
- How do I know that the data/information that is being provided and utilized in the tax computation is complete, accurate and received on a timely basis?
- How do I know that the tax laws/regulations and the tax accounting principles have been applied properly to the information received?

- How do I know that the computations are accurate (including consideration of systems and spreadsheets used in the computation)?
- How do I know that the tax amounts computed are recorded properly in the general ledger?
- How do I know that the disclosures included in the financial statements are complete and accurate?

Each organization must review their processes and procedures to determine how they address these questions. For a decentralized organization, this may involve numerous individuals throughout the organization, many of whom may not be in the tax department. In these situations, there may be a series of control activities that build on each other to provide the reasonable assurance. In an organization that is highly centralized, one might see fewer overall control activities. In these organizations the issue may become one of identification of redundant controls given the potential implications of a deficiency in a single area.

One other significant hurdle as companies move forward will be the identification and training of resources. This includes resources that not only understand tax technical issues and the related tax accounting but also understand the concepts of internal control.

**Different 404 attitudes**

At the macro level, SOX 404 may equate to enhanced corporate responsibility, enhanced financial disclosure, and a means to prevent corporate and accounting fraud. At the micro level, from the perspective of a vice-president of tax and a tax department, SOX 404 may be seen as a blessing or a curse.

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Joe is a tax director in the Philadelphia office of PricewaterhouseCoopers and works in the Industry Services Group where he focuses on providing tax consulting and planning services to multinational corporations. Joe has over eight years of public accounting experience and has served clients in a variety of industries, including technology, manufacturing, pharmaceutical and financial services.

Joe earned his Masters of Business Administration with a concentration in taxation from Drexel University and is member of the AICPA and PICPA.
For those unprepared or unwilling to comply, SOX 404 will mean increased administration, pressure, scrutiny and anxiety. These are the individuals resistant to change who believe that nothing of value can come from SOX 404.

For those ready to meet the challenge, SOX 404 will mean process improvement, efficiency, best practices and a direct line management. SOX 404 can be the tool to improve communications, responsiveness and the position of the tax department in the hierarchy of the company.

Those that realize that SOX 404 is not merely a project but a behavioural shift in thinking and actions will be better positioned to take advantage of SOX 404 and elevate their departments to the next level. Those who think of SOX 404 as a "pass/fail" exercise will most likely continue to struggle and feel the increased pressure of poor performance.
The tax function in most groups has changed significantly over the last few years because of regulations and the overall financial environment. Even before regulators started to emphasize internal control requirements and put significant pressure on internal functions to document and explain the entire financial information, a large number of tax directors have seen their job description change to include or increase their responsibility for strange concepts such as effective tax rates, deferred tax and fiscal effects reflected directly in the net equity of the consolidated financial statements.

Implementation of International Financial Reporting Standards (IFRS) has entailed a final change in the usual organization of most European groups whereby the tax director is responsible now for the financial disclosures on income taxes included in the published financial statements or, for the luckiest, co-responsible only with the head of the accounting/consolidation department.

Having said this, income taxes do not create more information to publish than any other line of the income statement and balance sheet. It is also not very complicated to determine a taxable income and to assess a corporate income tax payable in one particular jurisdiction. Therefore, the information to be published on income taxes should not be a major issue for groups.

However, income taxes have been identified as the primary source of material weaknesses by the SEC for US listed groups. Income taxes also are a significant source of discussion with the legal auditors at year end and a source of headaches for many in the organization of large groups.

There are reasons for that. And these reasons justify taking particular steps to reduce the burdens associated with income taxes accounting. The main action may well be the implementation of a system of tax reporting that will organize and simplify the collection of information on income taxes. However, implementing a new system will not in itself be the ultimate solution, nor will it reduce the management’s expectations of tax-efficient planning. There should thus probably be more to tax reporting than pure accounting and financial disclosure.

What makes tax a complex matter when it comes to accounting for income taxes?

A brief overview of the accounting standards applicable to income taxes is sufficient to convince anyone that the calculation and anticipation of income taxes in consolidated financial statements is a complex activity.

The main issues faced by international groups are the need for mixed technical skills in the central tax function and the size of their perimeter.

Requirement for mixed accounting and fiscal technical skills

Among many other difficulties, one notes the need for an understanding of local juris-
In general terms, accounting standards require that you are able to provide a reconciliation of differences between local tax positions and consolidated positions on every line of the balance sheet. The nature of such differences, temporary or permanent, will determine the calculation of a deferred tax or the creation of a reconciliation item in the consolidated tax accounts. The basic situation is that at some stage been a requirement to explain the net change in an opening liability of 100, an income statement expense effect of 20 and a closing position of 120. A common experience for anybody in a tax function has at some stage been a requirement to explain the net change in the balance sheet deferred tax accounts. The basic situation is an opening liability of 100, an income statement expense effect of 20 and a closing position of 120.

Such a situation is an easy one. And also a totally unrealistic one because there will be currency translation adjustments coming through, because there will be a need to account for newly consolidated operations and because acquisitions of the period create direct net equity entries. All of these adjustments are easy to understand and easy to demonstrate on a limited group of entities. But they are really impossible to document manually without the assistance of a consolidation system on a decent number of entities. A central function then only can rely upon information provided by local entities and are in a passive role with all the consequences that has for efficiency.

Using an integrated reporting system for income taxes will allow a tax function to deal with these individually minor but consolidated critical items automatically and organize them in an efficient way.

Effective tax rate reconciliation
Other elements should be looked at in detail to improve efficiency. Reconciling the group’s effective tax rate for instance is a tremendous exercise when it has to be done manually at central level. Significant items or events of the period are well known by central functions. But the devil is
in the detail such as local adjustments to the taxable base, effects of prior year adjustments, withholding taxes, local tax credits or incentives.

A vast number of effects, either on the consolidated net income before tax or on the tax charge, must be considered to reconcile the effective tax rate fully. And most people agree that it is more a systematic exercise than a complicated one. Then a machine can do it and let tax teams spend time on in-depth investigations rather than collection of information and running after explanations in some countries of the consolidated perimeter.

Management of local tax group effects

This is another key example of improved efficiency obtained from dedicated tax reporting.

Many jurisdictions have consolidated tax regimes in their legislations. These tax regimes generally apply to legal entities that are held under a common parent, whether in the same jurisdiction or not, depending on the tax rules.

In many groups the consolidated financial statements are dealt with by a business activity rather than by legal entity. Therefore, it is highly difficult to obtain a consolidated net income before tax for the perimeter of a particular tax group and to have the effects of the tax group declared and reflected properly at central level. It is however very interesting to determine an effective tax rate at the level of local tax groups and to be in a position to assess the performance of local tax functions on the financial statements for instance.

For these objectives to be met, there is a basic requirement that must be observed.

Tax reporting as part of financial reporting

Ideally, a tax reporting must be integrated in the reporting for the financial statements, that is to say as part of the consolidation package every entity must report centrally at closing periods.

Without integration, numbers in the tax reporting are unlikely to agree with the financial statements and will require a significant amount of work before being used, which will take a tax executive a couple of steps back.

It is also important to acknowledge that local teams and individuals who are in charge of the financial reporting package will prepare the information. It will therefore be much easier for them to do so using the same integrated system rather than duplicating their work in two different software or solutions.

Finally, since the tax reporting will be aimed at explaining and documenting accounts of the financial reporting package, it makes sense to have the information in the same package and to ensure that all critical accounts are reconciled automatically. In this respect, it will most often be possible to retrieve the information automatically from consolidation eliminations to have them included in the tax reporting section and to ensure that they will all be dealt with according to the group’s principles.

Having gone through the main advantages of an integrated tax reporting approach, the organization of such information and the various uses that can be made of tax reporting need to be discussed.

General structure of tax reporting

Income taxes for accounting purposes are made of three different items:

- local tax adjustments contribute to almost all of current tax effects and some of deferred tax effects;
- accounting adjustments between local GAAP and group GAAP may contribute to current tax accounts and definitely contribute to deferred tax accounts; and
- consolidation adjustments are essential to the understanding of the effective tax rate.

Therefore, understanding the details of these three steps is necessary to obtain useful information and the collection of such information should follow a similar construction. This will also help identify the individual who can explain a particular number.

Another requirement is to obtain a clear understanding and forecast of the deferred tax effects, which will reverse with a cash effect (deferred taxes from local tax adjustments) and those to be reversed with accounting effects only (deferred taxes from GAAP adjustments).

Finally, collecting the income tax base through an integrated detailed format strongly facilitates the documentation process. Only where you provide for tax adjustments separately can you reconcile these to a local tax return. Only where you provide for GAAP adjustments separately can you reconcile these to the published financial statements and to the locally audited financial statements under local GAAP (in countries where statutory accounting remains compulsory).

Such a reporting structure will thus help everyone within the organization and will give the central tax function the information it needs to achieve its objectives.

As previously discussed, tax reporting should not limit itself to the documentation of the published tax information included in the financial statements and should include more specific information for the tax management of the group.

Instrument for the general tax management

Collecting and organizing critical detailed information

In addition to the recently added obligation to validate all tax information included in the financial statements, one of the main objectives of tax departments remains to optimize the overall tax position of the group. Studies demonstrate that effective tax rate improvement has a direct impact on a company’s earnings per share and the market value of such shares.

Assuming that all tax planning and strategies will affect the effective tax rate or the net debt position of the group ultimately, a tax function is essential to financial improvement and performance.

This being said, multi-million euro optimization is unavailable and not obvious on a daily basis. Even groups
with a low sensitivity to tax risk and a high appetite for aggressive tax schemes may not identify or implement such strategies regularly.

One way to ensure that the overall tax position is managed appropriately is to verify regularly a number of individually minor accounts that may be of higher benefit globally. In all groups, entities or countries exist where, for example, fiscal losses are not activated and where tax depreciation leads to creating tax losses to be unrecognized or forgiven because of expiry dates.

Identifying and following up such matters regularly will allow you, even if not definitely reducing the effective tax rate, to ensure that there are no easy wins left for the group’s tax strategies. This definitely matters in a tax management process.

Most of the information needed to optimize the global tax position is available through the requirements of accounting standards but need to be reorganized or provided in greater detail so it can be used quickly at central level. Therefore, tax reporting may typically be made up of two sections, one for financial purposes and one for pure tax purposes.

Depending on the central tax team objectives, specific areas can indeed be emphasized, such as:
- follow-up and forecast of cash positions on income taxes;
- identification of recurring permanent differences;
- management of tax contingencies and associated additional costs vs savings;
- management of internal tax costs associated with financial flows; and
- identification of cash traps within chains of holdings for payments of dividends.

All of this information is needed, one way or another, to understand the financial statements when it comes to income taxes but is rarely disclosed to be efficiently managed by the tax function. It can be prepared on a case-by-case basis only, depending on the focus that has been decided by management.

A case-by-case basis is necessary to avoid requiring information that will not be used at central level. And there are many places from where no specific information is necessary because of historic knowledge, great efficiency of local teams or communication on a regular basis.

Against that, for those locations where the tax situation is complex or needs further investigation, it is preferable to having organized flows of information to avoid spending hours on e-mails and phone conversations. E-mails and phone calls will still be necessary but will be based on already shared information, reconciled with the financial statements and directly useful to the central tax function.

Ultimately, a carefully developed tax reporting system may be used as a very useful element of the group’s tax strategy. Such a strategy should therefore be considered upfront when designing the tax reporting system.

**Usual drawbacks associated with tax reporting may ultimately improve the overall tax process**

This takes us to the main issues faced in the implementation and management of an integrated tax reporting system. Ignoring the system itself, the implementation and management of an integrated tax reporting system will only depend on the quality of the information reported into it.

It will of course improve the confidence in the collected information and calculation process; it will include controls and warnings to ensure a certain level of consistency on a global basis. But it will not trace all human errors or mistakes in the assessment of income taxes.

Training of local teams in the broad concepts of income taxes accounting remains essential and is necessary more than ever to explain how things should work and be disclosed.

This may be viewed as a consequence of a tax-reporting project but really is not in fact. Quality of the resources and of the training proposed for all individuals within the organization has always been and will remain for a long time a key element of a good performance. Tax reporting will just emphasize any issue a little more in this area.

In a similar area, increasing the detail of the financial reporting increases the level of work required from local and central team. That is true, and is also not.

Under IFRS and US GAAP, the standard calculation methods for assessing income taxes are similar and based on balance sheet reconciliation, as already discussed. Formalized tax reporting is of course not requested but should logically be prepared anyhow for assessment of the accounting figures reported in the consolidated financial statement. Hence, a tax reporting process only replaces various different local methods and processes, with a group approved and controlled methodology.

This can be viewed as more complex, but is more efficient and secure too.

**Tax reporting advantages**

Tax reporting tools may therefore benefit large international groups hugely and are thus being looked at by many companies in Europe. This is especially true in countries where accounting was not historically part of the tax function or in situations where the management of accounting positions on income taxes becomes too time consuming and is viewed as an obstacle to tax optimization or rationalization.

Implementing a tax reporting system will typically generate several benefits for management and key users of the tax information. The most appreciated consequences of a decision to implement one would definitely include improved quality and knowledge of the tax information, with benefits for financial publications and optimization of the tax charge, emphasis on local teams interests and competencies on tax matters and, for the lucky ones, identification of previously unrecognized deferred tax assets, with a direct impact on net income.
This chapter discusses the impact the changing face of the corporate governance environment has had on multinational corporations’ attitude to the management of worldwide tax compliance obligations.

Organizations around the world continue to struggle with the ongoing tide of corporate governance developments, which require the capacity to demonstrate adequate risk management and control of all facets of the business. The management of tax and associated compliance obligations is not immune from scrutiny, and the pressure to deliver higher degrees of confidence. For tax directors of multinational organizations, demonstrating appropriate management and control of tax in all jurisdictions can be a confronting task, given the varying types of levies and imposts, legislative complexities, and differing revenue authority approaches.

Historically, many multinational groups have taken a decentralized approach to tax compliance, delegating the management of tax compliance obligations to local in-country finance teams. With boards taking a more active interest in ensuring that tax compliance is being managed on a timely and effective basis by the global tax team, it is however, the global tax director who the questions are directed at. How does the global tax director obtain the degree of confidence needed to respond to enquiries, while proactively advising the board, of where the management of responsibilities has been delegated?

Lately there has been an increasing trend in corporates adopting a more centralized compliance approach, with global tax directors and their teams taking on a proactive role in ensuring the company’s tax compliance obligations around the globe are being captured and met.

This chapter focuses on the key challenges that global tax functions face in managing tax compliance. It canvasses options for responding to those challenges in developing a strategy for managing compliance, as well as tips on how successful organizations are responding to some of the barriers that typically present on implementation of any change in approach.

**Key challenges**

In an ideal world, the global tax team of a multinational corporate would:

- know the status of all group tax returns around the world by country, timing of lodgements, pending audits, areas of revenue authority focus, and relevant legislative developments;
- have confidence that a consistent approach to risk management was applied around the world, tax returns and filings are accurate and materially correct, and that planning opportunities are readily identified, and reflected in returns and filings; and
- have ready access to quality information for planning purposes, such as net operating losses, tax credits, tax costs, and copies of relevant advices and filings.
In the ideal world the global tax director and his/her team would be able to confidently demonstrate to the board that tax compliance is under control and being proactively managed, demonstrating a valuable business contribution.

However in reality, the tax functions find it difficult to obtain compliance nirvana, when constantly faced with challenges such as:

- complex rules and regulations which are subject to ongoing change;
- limited quality resources;
- lack of a coordinated service, managing multiple service providers;
- difficulty accessing consistent reliable information, from around the globe;
- uncertain costs, and
- shrinking timeframes.

Organizations must nonetheless respond to these challenges in order to ensure that the risk of financial loss through lodgement failure, error or misrepresentation, legal disputes and reputational damage is kept within tolerable thresholds.

**Global compliance strategy**

There are a number of key components to developing an effective global compliance strategy. These include:

- establishing clear risk management objectives and guidelines for the management of the organizations tax compliance – the guardrails for day-to-day operational activities;
- project management – ensuring compliance activities are monitored and stay on track;
- coordination of local teams – ensuring somebody close to the business and the country, who understands the environment co-ordinates activities;
- easy, real time access to reliable, relevant information;
- communication and escalation protocols – ensuring that sensitivities are alerted to and responded to having regard to risk management guidelines;
- standardization of compliance processes as appropriate, and
- appropriate local territory resourcing.

These key components are delivered through designing a global compliance arrangement that is based on the right combination of the following: people, process and technology.

**People**

As with most business functions, the core component of a tax function is its people (both external and internal team members). Critical to the success of any global tax compliance strategy is having the right people, with the right skills, focused on the right issues at global, regional and local levels.

People will carry the responsibility for risk management strategy, process design, project management and operation.

**Global**

At a global level, there is a trend towards allocating the day-to-day management of global compliance to one person at head office. This role is likely to involve the supervision of local in-house teams, liaison with external service providers or a mixture of both. It is at this level that risk-management standards and protocols should be established through liaison with relevant stakeholders within the business, such as representatives from risk and strategy, internal audit, and finance.

Where the role involves the supervision of local in-house finance teams, to ensure that the tax team can influence the local teams, there is a trend to the implementation of dotted reporting lines from local finance teams to the central tax team in respect of tax matters.

**Regional**

Companies with a large global footprint often have regional tax teams located in strategic locations – for example a London-based team with responsibilities for Europe. It is important to have these teams play an active role assisting the global tax team with the coordination and project management aspects of managing tax compliance.

**Local**

It is at a local level that identifying the right people to prepare and review tax returns and filings can be most challenging and is worthy of extended comment. Most multinationals do not have dedicated tax specialist resources in all locations around the world as the relative size of some individual country operations does not justify a full-time tax resource. With in-house
tax expertise often restricted to global and regional levels, local country tax returns are either prepared in-house by the finance team or external service providers and it is here that we see the most variation in approach.

Assessing what is the right resource combination is a risk-assessment exercise. Some simple questions to assist in deliberations are:

• Is there sufficient resource in-house to ensure the timely and accurate preparation of the tax returns/filings?
• Does the person reviewing and approving the returns/filings have sufficient expertise and knowledge of both the entity in question and local tax laws? Are they capable of effectively working with the compliance tools in place and understanding the risk management protocols?
• Is an alternative resource available (with the required knowledge) if the present internal compliance preparer(s) leaves the organization?
• Can the internal team deliver the relevant information that the global tax team require on a timely basis? Do they have the necessary project management skills and expertise?

If the answer to any of the above questions is no, then it is imperative to consider what alternative resources are available, or what additional controls might be put in place to alleviate any exposure. A key option for consideration here is the use of an external service provider to fulfil the local compliance obligations in either a preparation or review capacity.

Whatever the right combination in the circumstances, it is recommended that for each country an individual is identified to take ownership of compliance, whether this is the supervision of the in-house preparers or liaison with the external service provider. The successful management of compliance in that country should be built into their performance metrics or key performance indicators.

Process

Once you have an understanding of capabilities and the resources available to implement and manage the strategy, the processes that will be followed need to be considered, agreed and documented and the resources attached thereto.

Design of the process gives life to risk management protocols and controls. Many organizations will standardize compliance processes at a local level before then overlaying with appropriate management processes for co-ordination and project management. At both levels it is important to address the role of the tools that will be used and the people who are to use them.

Process design will generally be managed through a combination of global resources in setting guidelines and standards, as well as global reporting needs. Local level resources will be involved in managing matters that are specific to the local territory.

This chapter focuses on the processes around the management of compliance at a global level and the coordination role that the global and regional tax teams will play, and how that might be structured.

The following table breaks down some of the key management activities that need to be identified and addressed in designing and implementing a coordinated compliance tax strategy.

In practice, the allocation of these activities will vary between two extremes:

• an all-encompassing role whereby the global and regional tax teams have a large part to play in the management of overseas compliance or a high level oversight role and all of the activities identified above rest therewith, or
• using a single service compliance provider globally, relying on them to take on the bulk of the coordination and control of the local compliance processes.

Most organizations fall somewhere in the middle, and what is best once again becomes a question of matching the people to the role, and working within budgetary and resource availability constraints.

One factor that does particularly come into play here is individual preferences, as some tax directors prefer to have a more hands-on role than others. Further, in practice, where a single service provider is engaged globally to manage local territory delivery, it generally makes sense to outsource the coordination role.

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Technology can add a great deal of value to the management of global compliance and the sophistication of the tools being employed is ever-increasing.

The key uses of technology in supporting an organization’s global compliance strategy, which support all elements of strategy from risk management through to delivery, are as follows:

- **Status tracking reporting tools** – what is the compliance status in various countries around the world? What is outstanding?
- **Data repository** – storing of key documents and data – for example tax returns and tax payments, and providing real time access to key information.
- **Monitoring** – monitoring revenue authority review and or tax audit status.
- **Computation or calculation** – either local territory specific or more extensive – for example global tax reporting or accounting tools.

Technology can be a great enabler, reducing time spent and improving the quality of information available in managing global compliance. In the short term, companies must however commit to the investment of time to guarantee the successful implementation and ongoing use of technology.

Important things to address include ensuring:

- project management of technology, development, information and rollout;
- appropriate user participation in development of the technology;
- definition of clear procedures for technology updates, usage, and access controls;
- provision of training, and
- ongoing training, monitoring and testing.

In particular when using technology as a communication platform, it is important to ensure that there is a commitment from both local and global teams to the use of the tool and updating of information it contains. This is best managed through incorporation of responsibilities into performance metrics.

To sum up on global compliance strategy, designing a strategy that delivers to the key compliance components identified, requires a combination of people, process and technology.

What is the right combination will vary from organization to organization, depending on their risk-management objectives, the territorial dimensions, business complexity and revenue authority attitude. Incorporating the capacity to vary the approach to developing the right combination to respond in different territories, without compromising quality and risk-management standards, is crucial to the design of the global compliance strategy.

**Barriers to change**
Most global tax teams see the benefits for their organization of implementing a global compliance strategy and getting their arms around compliance. They like the idea of no surprises. However, many find the task daunting. This is understandable considering the challenge of dealing with multiple countries, differing tax compliance requirements, as well as language and cultural barriers.

Reasons offered for reluctance vary but include:

- “I don’t want to upset the local finance teams, they have been working with their local service provider for years;”
- “It will involve too much change;”
- “I don’t have time to consider it at the moment;”
- “It will be too painful to undertake the transition;” and
- “If we change providers, we will lose knowledge and data in respect of historical issues.”

In today’s environment companies are realizing that they need to overcome these barriers in order to gain long-term benefits. Successful organizations work through these barriers with minimal pain through careful upfront planning and attention to change management. Some of the common elements of successful strategies include:

- Drafting and agreeing a project plan with target milestones and deadlines.
- A clear communications programme and commitment to ensuring the buy-in of all stakeholders at key times of process development. This ensures understanding of organizational objectives and country level needs.
• A commitment to a transition programme that involves education and training on all aspects of the process, key actions, individual roles, and use of tools, and collection of required historical data.
• Transition champions – ideally these individuals should have the necessary language skills and should be readily accessible taking into account international time zones. These individuals are ideally suited to ongoing regional coordination roles.
• Appropriate use of external resources – third parties can be used in many ways, such as providing additional resources, broad experience, ideas and support.

**Looking forward**

In responding to globalization and corporate governance pressures in the area of tax compliance, organizations are trending towards centralization of the management of tax compliance and reporting.

Increasingly, global tax directors are reaching the conclusion that they need adopt a formal tax compliance strategy and communication plan to gain greater control over the compliance process. In-house resource constraints are also leading them to consider alternative resourcing options, including outsourcing, particularly core service provider arrangements.

Through careful planning, stakeholder management and sensitivity to organizational needs at a local as well as global level, it is possible to design a strategy for management of compliance that delivers the right combination of resources to achieve organizational objectives. Key to the success of the ongoing strategy will be the design and implementation of the role of the central coordinator.

As the corporate governance environment continues to evolve, so will the coordination and management of global tax compliance as leading organizations respond to the challenge.
Corporate reporting continues to be in the spotlight. Companies are already overburdened by the multiple reporting requirements of investors, creditors, tax and other regulators and other stakeholders, and there is no indication that such demands will slow down. It is quite the opposite.

This often now requires reporting departments to re-use and inefficiently re-key or reformat the same data in order to produce different reports in different formats to meet their myriad of reporting requirements.

Regulators in every sector face the challenges of collecting, processing and reporting information more efficiently, accurately and cost effectively. New rules, such as International Financial Reporting Standards (IFRS), Basel II and the Sarbanes Oxley Act for the US Securities and Exchange Commission registrants, only exacerbate the challenge. As regulators’ responsibilities evolve over time to changing issues and mandates, they must improve the value of the information that they collect and report, while controlling the cost of compliance for companies.

Standards-based reporting on the basis of a digital reporting language could provide a solution to these issues, by facilitating how businesses provide information to investors, markets and regulators. Developing and encouraging the adoption of a common digital business reporting language – for the broader class of business reporting information including tax information – is the goal of eXtensible Business Reporting Language (XBRL). It is a global, collaborative effort joined by tax administrations around the world.

What is XBRL?

XBRL is an open information standard for representing business reporting. The underlying concept is fairly straightforward. Instead of treating the information in a report as a block of text, as in a standard webpage or printed document, XBRL provides an identifying tag (comparable to a barcode) for each individual item of data (revenue for example) and can also be applied to a specific block of text (a business description for example). These tags can be read directly by a computer, hence reducing the need for manual re-keying and interpretation, and automating the validation and processing of this information.

Derived from XML (extensible markup language), recommended by the worldwide web consortium (W3C), XBRL is available worldwide under a royalty-free licence from XBRL International, an independent and collaborative consortium of over 450 organizations representing all areas of the business reporting supply chain. The consortium is focused on the development of the XBRL specification (defined later), and other materials to promote the adoption of XBRL.

XBRL International is comprised of local jurisdictions, typically representing a country or business reporting regime (International Financial Reporting Standards for example).

XBRL applications include, but are not limited to:
How does XBRL work?
The XBRL specification defines the use of XML for the purpose of business reporting; it is the technology platform for transporting information contained within business reports seamlessly from one application to another. It governs how to build taxonomies and instance documents.

An XBRL taxonomy is a standard description and classification system, or dictionary, for the contents of business reports, and addresses specific reporting requirements (Belgian GAAP or IFRS for example). Many accounting and reporting software products today can already automatically use taxonomy elements to tag an XBRL document, or users can do this manually using publishing applications such as Microsoft Office.

An instance document is an electronic report in XBRL format containing elements from one or more taxonomies, and associated values originating from source systems (accounting systems for example). It could represent, for example, an annual financial statement, a company earnings release or a number of ledger entries. It can be rendered in different formats using rendering tools, as illustrated above.

There are two main areas of focus using XBRL to develop agreement on business reports. One of these concentrates on printed reports and forms, such as financial statements or tax returns. This area, known as XBRL for financial reporting (FR), is being adopted today by many countries to improve their electronic filing (e-filing) programmes and reduce the regulatory burden while increasing the efficiencies of collecting, preparing, and sharing reporting data.

The second area of XBRL is XBRL GL, the standardized global ledger. The global ledger is a single, generic, extensible and modular taxonomy framework for standardizing information from transaction through end reporting – essentially all of the information found in a typical accounting system. XBRL GL was designed to facilitate the simultaneous capture and representation of information for both books and tax purposes, capturing permanent and timing differences, tax-specific accounts and entries, and information needed for both direct and indirect taxation.

One key issue is the availability of appropriate agreed-upon taxonomies. A number of those are now available or under development, covering requirements such as:
- IFRS general purpose taxonomy;
- IFRS banking (extension);
- local GAAP taxonomies in UK, Germany, Netherlands, and Belgium;
- US GAAP taxonomy framework;
- extensions for Commercial & Industrial, Banking & Savings, Insurance, and Investment Management; and
- credit risk taxonomy.

Drivers increasing the relevance of XBRL
Historically, many tax departments have had relatively manual processes and relied upon spreadsheets to support compliance and other decision-making processes. Some of their tax returns can represent as many as 60,000 printed pages. While spreadsheets may be appropriate for low-volume, non-complex data management issues of a one-off nature, they have inherent limitations in terms of audit trail, integrity and reliability, and are leading organizations to look to more robust systems for managing compliance.

The US experience with Sarbanes Oxley has demonstrated that companies that did not have adequate focus on controls in relation to tax reporting and tax compliance were likely to report significant control deficiencies or material weaknesses in the tax area.
These tax departments are also under increasing pressure to do more, with less help from their auditor. They are being forced to increase the efficiency of their processes, and are also looking at centralization and outsourcing, as well as enabling technologies, amongst other solutions, to provide the answers.

Some of the features that these technologies need to deliver include:

- shared data access by internal and external resources and applications;
- greater emphasis on controls and data quality (audit trails, access controls, edit and validation checks for example);
- ability to efficiently use data from general ledger systems for tax reporting purposes (for example automatic pre-population of working papers);
- ability to extract timely information from different geographical locations or business units for compliance or other decision-making; and
- integration of tax reporting for financial purposes and for compliance with tax authorities.

Furthermore, tax administrations, as we will describe later, are themselves starting to allow or mandate XBRL for filing purposes.

**The benefits of XBRL**

XBRL offers many advantages over traditional business reporting formats to both reporting companies and regulators, stemming from the fact that information produced once and represented in XBRL format can be efficiently re-used many times. Computer applications are able to treat XBRL data more intelligently: they can be designed to recognize the information in an XBRL instance document, select it, analyze it, store it, exchange it with other applications and display it automatically in a variety of formats for users.

XBRL thus greatly increases the efficiency of processing data, reduces the risk of error and enhances automated validation capabilities.

More specifically XBRL provides the following:

- Key benefits for regulators and governments in general are electronic filing (e-filing), reduced reporting burden, improved timeliness of data, improved accuracy of data, and enhanced analytics leading to a more effective overall regulatory environment.
- Tax administrations will be able to reduce compliance burden, the cost of handling paperwork and error rates; increase self-service and value-added services and communication with all parties – taxpayers, tax preparers, tax filers and other government entities, as well as moving toward that standardized e-audit tool with the potential for a more real-time audit environment.
- Tax preparers will be able to service their clients more efficiently, more often, and with greater transparency into current and historical data.
- The flexibility of XBRL facilitates prompt compliance with additional disclosure requirements and new reporting standards. For instance, XBRL can help financial institutions meet the Basel II disclosure requirements by easing the collection and analysis of required information from different sources.
- XBRL can help credit institutions streamline their credit assessment processes, by automating the input of credit data (annual reports for example) for immediate process-
Supporters of XBRL among the tax community

Many of the world’s tax administrations are working together to leverage the standards environment, influence existing market efforts, and support efforts relevant to their needs. These groups have different goals and different constituents, but share an acute interest in XBRL. They all recognize the value of a single, global standard for representing everything necessary along with audit information supply chain and facilitating the reestablishment of the seamless audit trail.

XBRL, and in particular XBRL GL, have received support from OASIS (Organization for the Advancement of Structured Information Standards) Tax XML, a group dedicated to promoting XML-based standards and interoperability concentrating on tax administrations and those with whom they exchange information, and the OECD Taxpayer Services Subgroup, representing tax administrations from leading nations. Their support was published in the OASIS Tax XML position paper, now in its second edition, which was provided to OECD Taxpayer Services and received their recommendation. It is also available at the Tax XML website.

The Tax XML position paper points to two other OASIS efforts as important to tax administrations: universal business language (UBL, developing standards to represent trade documents) and customer information quality (CIQ, developing standards for names and addresses).

Under OASIS Tax XML there is a subgroup called the Tax XBRL Liaison SC. This working group was begun to offer resources to support XBRL, encourage Tax XML values by XBRL and to promote use of XBRL by tax administrations. The group has also been working to understand and influence standards organizations relevant to the audit trail to facilitate the reestablishment of the seamless audit trail.

Another task group under the OECD, the Tax e-Audit Task Group, is working on compiling and publishing the requirements for “Standard Audit Files,” to encourage business software developers to provide more standardized data exports for tax audit uses. The OECD Tax e-Audit Task Group has published a simple XML representation of that set of requirements; they also indicated that an audit file is fully realized when it is standardized and holistic, with full realization in a format like XBRL GL.

Representatives from both OASIS Tax XML and OECD Tax e-Audit are involved in making sure XBRL GL properly represents the content required by the Standard Audit File and by member organizations.

Who is adopting XBRL

The Australian Prudential Regulation Authority was the first organization worldwide to adopt and deploy XBRL in live operation back in 2002. Many other regulators have since followed suite including:

- the Federal Financial Institutions Examination Council and the Securities and Exchange Commission in the US;
- the Tokyo, KOSDAQ (Korean equivalent of NASDAQ), Shanghai, Shenzhen and Toronto exchanges;
- the Belgian Finance and Insurance Commission, which mandated XBRL as filing format for the quarterly filing of IFRS financial statements for financial institutions as from 2006;
- the National Bank of Belgium will expect annual accounts to be filed in an XBRL format as from January 2007;
- the Bank of Spain is using XBRL as filing format for the financial institutions under its supervision; and
- the Committee of European Banking Supervisors (CEBS) strongly recommends the use of XBRL by its members (European banking regulators) for capital adequacy reporting as from 2007.

With such increasing international support for XBRL, it is not surprising that some of the tax administrations have already begun to allow or mandate XBRL for e-filing and planning the drill down to the XBRL GL level.

One of the best-known success stories is the Netherlands Taxonomy Project. The Dutch tax office, working with many other governmental agencies including statistics and national accounts filing, collaborated to find overlapping requests for information and simplify the request of information from taxpayers. This work resulted in an incredible decrease from 180,000 reporting data elements to 4,000, resulting in an expected decreased in compliance burden recently quoted at €900 million ($1,130 million) annually.

The Australian tax office is also already accepting XBRL filing and the Japanese Tax Office and New Zealand Inland Revenue are planning to implement a similar model to the Dutch one.

UK’s HMRC (Her Majesty’s Revenue and Customs) has also been developing XBRL taxonomies to work in conjunction with the UK financial reporting taxonomy. HMRC recently announced: “All companies should be required to file their company tax returns online, using XBRL, and make payments electronically, for returns due after 31 March 2010.”

Numerous other countries are actively involved in exploring the relevance of XBRL to their administrations, including the IRS in the US.
Why this has not happened sooner
Progress has perhaps been slower than expected. The implement-
ment of XBRL has been hampered by the following:

- Change is rarely easy, especially in a voluntary collaborative
  environment relying upon win-win-win solutions and cons-
sensus among all parties.
- Taxpayers have not moved to implement XBRL on their
  own waiting for software developers. The companies
  themselves often lack the internal tax systems knowledge
  and have relied on the past on their auditors. This might
  change with the new requirements that auditors cannot be
  relied upon for tax guidance and with increased focus on
  XBRL encouraging the software developers to act.
- XBRL, and especially XBRL GL, provides a holistic
  approach to the company’s problems and is therefore not
  just a tax or finance issue; its adoption is not a simple,
  quick fix, but needs to be driven by the need for real effi-
ciency.
- There has been some confusion and competition in the
  standards marketplace, both generally, related to e-filing
  and related to e-audit. The support of tax administrations
  in their position papers from Tax XML and the public suc-
cesses of XBRL in the tax environment may help here.
- The XBRL specification had to reach a sufficiently mature
  and stable level as a basis for building taxonomies. Soft-
  ware tools were initially not sufficiently mature. Devel-
  opers had to wait for end users to tell them what
  they wanted, while end users were waiting for software
  developers to deliver solutions. In addition, software
  developers are hesitating to be the first to incorporate stan-
dards into their product for fear that users will take the
  standard data from their systems and move to other appli-
cations. End-user demand coming from regulator require-
ments and benefits may help in this area.
- Companies may hesitate due to fear of too much trans-
pparency; but collaboration and benefits that regulators may
  offer for sharing information may help them overcome
  those objections – especially if companies and regulators
  can collaborate to make sure that sensitive information
  stays sensitive.
- Areas such as providing assurance or certification over
  XBRL documents, and ensuring the security of XBRL doc-
  uments, still need further development.

A new set of tools
The tax community will be significantly impacted by XBRL
and stands to benefit from its application. Tax executives are
encouraged monitor and to participate in XBRL develop-
ments and to provide feedback to standards organizations and
tax administrations.

With XBRL tax professionals have a set of tools to improve
their internal reporting environment; with XBRL GL, the
standardized global ledger, in particular, they can be laying
down a framework to improve the health of the organization
and markedly improve the tax information environment.
XBRL should therefore be addressed as a key element of their
requirements when contemplating re-engineering their tax
reporting processes or deploying new software.
Tax as a driver of shareholder value

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Until now the main stakeholders interested in the tax position of a company seemed to be the tax director of the company, its tax consultant and the tax authorities. This is in the process of changing; the number of stakeholders interested in the tax position and tax strategy will be growing and may also include analysts and investors. As Henderson Global Investors mentions in their report: “The way a company manages its tax affairs is directly relevant to shareholders, influencing important figures in the accounts and thus company valuations and investment decisions.”

Shareholder value is a well-established measure of corporate performance; but how important is tax and the tax department’s contribution to creating shareholder value?

It seems that tax has not yet been treated with the same focus as other items of equivalent size in the profit and loss account influencing shareholder value or as an item which could influence an investment decision. As indicated by Citigroup, they are concerned that the market generally struggles with or ignores tax risk.

This chapter discusses why tax is difficult to understand and why it is important to gain an understanding of tax risks and tax position of a company. It analyzes two subjects that can provide information on the tax position of companies and suggest the kind of questions which are and could be raised by analysts and investors in the future.

What the research says
Profitable companies in general contribute around 25% to 40% of their net earnings to corporate income taxes. The total tax bill, including withholding taxes, (unrecoverable) indirect taxes and payroll taxes, is substantially higher than just one third of the net earnings.

The UK Hundred Group calls this the “total tax contribution framework”. Tax is therefore an important number in the accounts of companies. As shown by a PricewaterhouseCoopers study in 2004, an important driver of shareholder value is cash tax paid. The analysis in this report shows that the impact of effective tax management on shareholder value can be significant.

Tax is more and more headline news and therefore increasingly recognized as a major risk by companies. Research has indicated that companies that reported no internal-control weaknesses in 2004 or 2005 showed an average share-price gain of 27.7% between March 31 2004 and March 31 2006. Companies that did report internal-control deficiencies in both 2004 and 2005 saw an average share price decline of 5.7%. A substantial part of all internal-control weaknesses reported were related to tax and therefore seem to influence the share price of a company.

Further, according to a survey of Institutional Shareholder Services (ISS), corporate governance is becoming increasingly important to European investors. Jean-
Tax management in companies

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Heleen has graduated with honours from the University of Groningen with a degree in civil law and a degree in tax law. She later completed the post-graduate program, European Tax Studies at the University of Rotterdam. She is now doing the post-graduate Tax Assurance Academy at the University of Nyenrode. She has spent two years on a secondment to the International Tax Services group of PricewaterhouseCoopers in Boston. Heleen spent her career within PricewaterhouseCoopers in the international tax practice advising large multinational clients. Currently she is fully focussing on tax assurance; designing, developing and implementing a tax control framework on the basis of the TaxValueChain®. This includes designing, facilitating and refining of Tax Strategies and Tax Risk Policies.

Nicolas Caprasse, managing director of ISS, said: “Although to date, continental European investors have lagged behind their counterparts in North America and the UK in terms of the priority they place on corporate governance, this study shows that attitudes are clearly changing.”

Already in 2004 Nick Bradley noted in Corporate Governance: an International Review: “the good news is the discovery of an increasing amount of new evidence suggesting that these links [between performance/return and governance] do exist.”

Eisenhofer and Levin concluded recently in Corporate Accountability Report that based on a review of various researches carried out that: “Simply put, good corporate governance does, in fact, pay.

A 2005 ISS report also comments: “Companies with better corporate governance have lower risk, better profitability and higher valuation.”

Henderson Global Investors indicates in its FTSE350 survey report that they will continue its ongoing dialogue with companies and take part in the wider debate on tax, risk, governance and corporate responsibility and will be an important stakeholder to take into account analyzing the tax position of a company. Other parties such as The Tax Justice Network are part of a debate over concerns in Accountancy Age in February 2006 on “greater demand for disclosure from companies of how they meet their tax responsibilities” and that tax is part of good corporate governance and that there is an ethical side to tax (Het financiele dagblad, April 1 2006).

Why is tax difficult to understand?

In general tax issues are complex and are dealt with by specialists as it requires an understanding of specific terminology (such as fiscal unity, participation exemption, loss-relief rules and phantom taxable profits on intra group transactions). Especially in the international context as it also requires an understanding that in every country different tax rules are applicable.

In order to understand and to be able to analyze tax, certain principles should therefore be understood. For example, accounting profits are subject to significant adjustments in order to calculate profits chargeable to taxation (for example dealing with tax rather than commercial depreciation rates).

Numerous adjustments are made to the accounting numbers based on local taxation rules. These adjustments can, for example, be based on the fact that dividends between two group companies may be exempt from taxation or based on different depreciation rates.

Tax rules are often unclear. Jokingly, one can say often it is a grey area. It is almost never black or white. There are few predictable numbers but there are a lot of uncertainties with many, frequent changes in tax law, sometimes even with retrospective effect.

Therefore, questions on tax from analysts rarely provide for a detailed response as tax and tax risk are generally not well understood or found difficult. For example when a question was raised about a specific tax item during the publication of the quarter-one results by a Dutch multinational company, the chief financial officer responded that tax was too difficult and he could not explain. The question is whether analysts will be satisfied with such an answer in the future or will require further explanations on tax risks and the tax position in the annual accounts.

There is reluctance to provide too much detail on tax risks and tax planning. However, under the International Financial Reporting Standards (IFRS) and most other generally agreed accounting principles (GAAPs) and due to recent legislative changes, such as Sarbanes Oxley, certain disclosures on the tax position are required. And as indicated by the Securities and Exchange Commission chairman, Christopher Cox, recently, there is a discussion on the possibility of requiring additional tax disclosures (Associated Press, May 1 2006).

Why it is important

Tax risk is a key risk facing companies and therefore worthy of analysis. The significant tax risks companies are facing that
can influence shareholder value are (among others):

- **Reputation risk** - the risk of becoming headline news;
- **Cash flow risk** - also described as tax audit risk – cash payable relating to previous years; and
- **Regime risk** – influence on future cash flows due to, for example, a change in attitude to tax planning, or the tendency in Europe to lower corporate income tax rates. Most investor rating services already include an assessment of the control environment as part of their overall evaluation of the company. These can have a significant impact on investor decisions and the company’s cost of capital. In these risk and control assessments tax will be an increasingly new but important factor to take into account.

A PricewaterhouseCoopers study entitled *Global Retail & Consumer Tax Benchmarking Survey 2004* shows that a reduction of the cash tax rate of companies has a huge impact on shareholder value. The impact of a 1% reduction in cash tax rate on shareholder value should not be underestimated.

The study shows that the effect of a single percentage point reduction in cash tax rates can be the equivalent of the company generating a 12% to 15% increase in its sales over a 10-year period. Tax saving is essentially pure profit. This is confirmed by research of Citigroup and is called the “tax lever”. The report says that small tax rate reductions can have the profit equivalent of significant increases in revenues. Therefore changes in the tax rate can influence shareholder value and the share price of a company.

To successfully manage the tax charge, companies should therefore formulate a clear tax strategy. In particular corporate tax departments should ensure they have an integral role in business planning and finance teams should be appraised on post-tax results. According to the PricewaterhouseCoopers study in 2004, there is a strong correlation between a company’s tax strategy and its effective tax rate; a company’s attitude to tax management, and to some extent risk, is very important in influencing the tax charge.

As two examples show, a company’s tax position may influence the perspective of analysts and investors and therefore may influence the share price of a company. For example in the case of Sligro, a Dutch company, a tax benefit raised its share price and analysts raised the share price target based on a slightly lower future tax rate. The search-engine company Google blamed tax for missing analysts’ expectations on their fourth quarter 2005 net-earnings per share and had a significant drop in their share price after publication of the results. According to Scott Kessler, an analyst for Standard & Poor’s who, at that time, had a sell rating on Google, the matter is: “indicative of the company’s ability to effectively plan and evaluate”.

In addition, the Henderson report, *Responsible Tax*, says: “understanding the principles and policies framing tax management also helps investors assess companies’ ability to achieve their business and financial objectives.”

### How to analyze a company’s tax position

The section below analyzes the tax position of a company on basis of:

- effective tax rate (ETR) calculation and reconciliation; and
- tax loss utilization in the accounts.

#### ETR calculation and reconciliation

First of all, a calculation and review of the effective tax rate can be done. International Accounting Standard (IAS) 12 paragraph 86 provides: “The average effective tax rate is the tax expense (income) divided by the accounting profit”.

ETR is often used by the board or audit committee to measure the performance of the tax department. Also ETR is and can be used to benchmark the performance of a company in comparison with its peers. A substantially lower ETR than competitors may indicate a high-risk profile. For example as mentioned in the Citigroup report: “X seems to be prime example of a company whose tax rate is remarkably low, and the geographical distribution of whose profits seems eccentric given its distribution of sales. One possible explanation is aggressive use of transfer pricing, which opens up the question of sustainability.”

ETR alone does not provide for sufficient information and includes distortions due to, for example, exceptional one-off non-taxable or non-deductible items or goodwill amortization.

Therefore, further information can be obtained in the disclosure to the accounts. One of the disclosures based on IFRS, and most other GAAPs is the: “explanation of the relationship between tax expense (income) and accounting profit”. This is also referred to as the effective tax rate reconciliation.

The purpose of the ETR reconciliation is to explain the relationship between tax expense (income) and accounting profit is unusual and to understand the significant factors that could affect that relationship in the future.

The ETR is calculated in either or both of the following forms:

- a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
- a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

The disclosure required by IAS 12 paragraph 81(c) should enable users of financial statements to understand whether the relationship between tax expense (income) and accounting profit is unusual and may be affected by factors such as:

- revenue that is exempt from taxation;
- expenses that are not deductible in determining taxable profit (tax loss); and
- the effect of tax losses; and
- the effect of foreign tax rates.

Information included in the ETR calculation and other items of the tax disclosures can be used to determine risk factor.
Once ETR reconciliation is made a comparison can be made with the cash tax rate. Low tax payments indicate a divergence between tax and accounting profits and so have potential informational value for stakeholders. In case of a big difference between ETR and cash rate this is in general due to deferred taxation or loss utilization.

**Tax loss utilization – recognition and valuation-deferred tax assets**

Deferred tax assets and loss carry-forward disclosures can be highly relevant in determining the value of a company. Under IFRS a deferred tax asset should be recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized.

For a deferred tax asset convincing evidence should be available that there will be sufficient taxable profit in the future against which the unused tax losses or unused tax credits can be utilized. If losses are not accounted for as they are unlikely to be recovered in the foreseeable future they must however be disclosed.

The disclosure on existence of unused tax losses could be evidence that future taxable profit may not be available. Is a company running out of losses? That could indicate an increasing tax expense. There is a significant possibility for tax shielding future earnings and existing tax losses can therefore offer hidden value in mergers and acquisitions.

An example is the merger between Alcatel and Lucent. After the merger, the combined company is expected to use the projected US earnings of Alcatel and likely savings from the merger against the net-operating losses of Lucent and according to a money manager "they are not going to be a US tax payer for the next 10 years at least.”

**What analysts are asking**
The Tax Council Policy Institute conducted a survey among tax directors at Fortune 500 companies and reported its findings in February 2006. The survey asked the question: “Have Wall Street Analysts inquired about an item at your organization in the past two years?” The results were that 81% had received a question on ongoing effective tax rate, 52% on impact of tax legislation and 26% on ongoing cash tax rate.

Based on recent developments and the understanding that tax and tax risks may influence shareholder value, questions which may be expected from analysts and investors are as follows:

- Your ETR is substantially lower than the median of your competitors. Can you explain the risks involved? Or alternatively the other way, your ETR is substantially higher than the median ETR for your competitors, can you explain?
- Under corporate governance rules the Audit Committee must review the company’s tax-planning policies. Can you briefly outline your tax strategy?
- In your annual accounts you mention that the company is exposed to a number of different tax risks which could have a significant impact on the local tax results. Could you specify what you mean by significant?
- In your annual accounts no mention is made in your risk report on tax risks. Does this mean there are no tax risks?
- There is divergence between the tax charge of, for example, 35% and the cash tax rate of, for example, 15%. Can you explain the difference? Can you provide for a forecast of your expectation of the cash tax rate for the next year?
- Could you specify in which countries the majority of the operational losses are located? I am asking this question to calculate a potential tax risk of losses carried forward in case of a reduction of the local corporate income tax rate.
- The risks described in your statements seem all corporate-tax related. Is that assumption correct? Does this imply that no tax exposures exist with respect to sales and/or other indirect taxes and wage taxes?
- In setting your strategic approach to tax, what consideration have you given to implications for the company’s reputation with the government (tax authorities), employees and the public at large, and the relationship between tax strategy and the company’s position on corporate social responsibility?

Further, credit rating agencies are also beginning to include in their credit evaluations a company’s ability to enumerate its tax related. Is that assumption correct? Does this imply that no tax exposures exist with respect to sales and/or other indirect taxes and wage taxes?

It is also stated by Henderson in their report *Responsible Tax*: “Simply reporting figures for tax provided or paid does not allow a rounded understanding. It is essential to provide contextual information on principles and policies, and their practical implications, so that readers can gauge whether reported tax payments appear ‘appropriate’.”

**A valuable opportunity**

Tax only is not a sufficient item for an (des) investment decision but seems certainly relevant. Analysts and investors will therefore become more educated on tax and more sophisticated in the kind of questions they will raise and they will no longer be satisfied with a way to explain.

It is likely that greater understanding and consistency will begin to emerge over time as analysts and investors see and respond. In the meantime, companies may need to look at how to enhance explanation, market education and intelligibility of the financial statements. Companies need to be able to anticipate and respond to analysts, investors and other key stakeholders’ rapidly increasing appetite for information.

While there is naturally a risk in openness, companies to fail to meet analyst expectations may face the greater risk of undervaluation and higher cost of capital.

Tax strategy can offer a valuable opportunity to enhance investor understanding and improve relationships with key stakeholders such as analysts and investors. Improving quality, clarity and comparability on the tax position, which is
often regarded as too difficult to understand, can provide for shareholder value.

Companies should review their tax function, determine the key objectives, attitude to risk and appropriate methods to implement and valuate these objectives; the objective is to operate a tax function that delivers value-added, cost-effective solutions that meet the commercial requirements of the company. Effective tax management is vital to any organization, not only because of the impact on an organization’s bottom line, but because of future shareholder value, reputation and directors’ liabilities.
Transform your business overnight. Get the tax wrong.*

Tax is a high profile issue in these days of heightened shareholder and regulatory scrutiny. Getting it wrong can have a severe impact on your reputation as much as on your profits. At PricewaterhouseCoopers we can help you formulate and document a suitable tax risk policy, evaluate your current position and identify immediate risks of which you might not be aware. We’ll recommend tax management controls to help ensure you’re compliant and that your tax planning is effective and appropriate in all circumstances. Most importantly, we’ll help you bring your approach to tax risk into line with your overall business risk strategy. For more information contact Robert van der Laan on +31 40 224 48 60 for continental Europe, Angus Johnston on +44 20 7804 2722 for the UK, or your PricewaterhouseCoopers relationship partner.

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