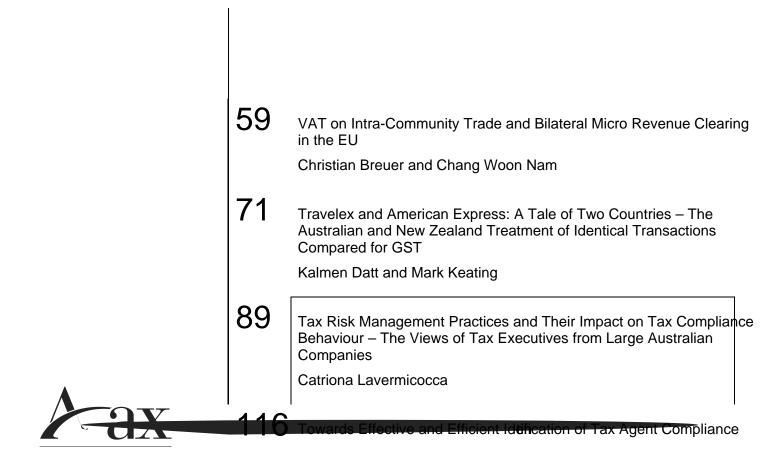
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CO h58003 Tm 6e: Australia and New Zealand – A Contrasting Yet Converging Dynamic Kalmen Datt and Adrian Sawyer



Based on the views of the tax managers interviewed, this research indicates that the management of tax risks does not in itself result in a lower level of tax risk but rather that the directors and tax decision makers are more informed about the tax risks that the organisation faces and that the tax position ultimately taken should not result in any surprises for the board of directors.

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rating approach did not have a significant impact on the approach to tax planning by large business in the UK was also supported by the HMRC's own research.<sup>18</sup>

Freeman, Loomer and Vella suggest that the risk rating approach has not been successful in altering attitudes to tax planning in the UK because of a failure of the HMRC to demonstrate that a more conservative approach to tax planning, no matter the type or size of the corporation, would result in a low risk rating and the lack of significant and clear incentives to alter tax planning behavior.<sup>19</sup> Of the respondents that did take a conservative approach to tax planning they did so, not purely as a matter of choice, but as a result of other factors such as 'the industry or line of business they are in, their particular legal structure, or their low corporate tax bill.<sup>20</sup>

#### 2.3 Changing role of tax departments

A review of tax reporting by the FTSE 350 in the UK by PricewaterhouseCoopers in 2007 identified the changing role of tax departments within a large corporation. The PricewaterhouseCoopers review suggests that information concerning a corporation's taxes is being used by a wide range of stakeholders and as a result there is a need for more information about the taxes a corporation pays.<sup>21</sup>

Whilst historically many multinational corporate groups took a decentralised approach to tax compliance the requirement for boards to take a more active interest in ensuring compliance with the tax laws has seen a move to more centralised decision making in the global tax director.<sup>22</sup> A move towards tax decision-making at a more senior level highlights a need to ensure that appropriate information is provided to tax decision makers on a timely basis.

#### **3. RESEARCH AND CONDUCT**

This qualitative research project consists of in-depth interviews with tax managers from large Australian corporations (turnover exceeding \$250 million). The purpose of this research project was to gain an understanding of the tax risk management practices and the tax manager's views as to the impact of those practices on tax decision making and tax compliance behaviour. A total of 15 in-depth interviews were carried out in which 19 open ended questions (Attachment 1) were asked relating to tax risk and tax decision making. Ultimately the results of this research will be used to inform the drafting of a subsequent large scale survey instrument to collect data on this research topic for the purposes of completion of a PhD.

Participants were recruited through a number of avenues. The Corporate Tax Association was contacted via email to determine whether any of their member companies would be interested in participating in this research. Similarly the author contacted professional accounting bodies and advisory firms in an effort to recruit participants. In addition the author ascertained potential participants based on

<sup>&</sup>lt;sup>18</sup> Research to Support the Implementation of propoisralishe Review of Links with large Business HMRC Research Report 58 (December 2007), 27

<sup>&</sup>lt;sup>19</sup> Freedman, J., Loomer, G and Vella, J. above n 15

<sup>&</sup>lt;sup>20</sup> Ibid 89

<sup>&</sup>lt;sup>21</sup> PricewaterhouseCoopers 'Tax Transparency Framework- a sugged framework for communicating your total tax contributionMay 2007 <sup>22</sup> Lambert, C. and Lucas, J. 'Managing Global Tax Complianceuly 2006 International Tax Review4

turnover and contacted the relevant tax manager via telephone or email. Each potential participant was provided with a copy of the letter of consent (Attachment 2), details of the research topic and proposed questions to be addressed during the interview. Participation was voluntary, there was no coercion and participants were advised that all individual responses would remain confidential.

Interviews were conducted face to face or via telephone depending on the participant's preference. Of the 15 participants, 12 were large public companies and 2 were large private companies each with a turnover exceeding \$250 million. In addition a tax partner with a large 'Big 4' international accounting firm was interviewed to obtain their view on tax risk management practices of large corporate clients and the impact of those practices on tax compliance behaviour. All interviews were carried out between October 2009 and June 2010 and lasted between 45 minutes and 1 hour 30 minutes. Interviews were conducted and notes taken by the author of this paper.

Due to the small scale of this research the results are not held out to be representative of all large Australian corporations. The participants were selected from a variety of

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any event, action, or inaction in tax strategy, operations, financial reporting, or compliance that adversely affects either the company's tax or business operations or results in an unanticipated or unacceptable level of monetary, financial statement or reputational exposure.<sup>26</sup>

PricewaterhouseCoopers in their publication, 'Tax Risk Management' outline seven broad categories of risk associated with taxes<sup>27</sup> including transactional, operational, compliance, financial accounting, portfolio, management and reputational risk.

Effective tax risk management by a large corporation requires a clear definition of what constitutes a tax risk. An evaluation of any tax risk management system would include an understanding of what tax risks were actually being managed. Only five of the participant companies managed tax risks based on a clear definition of what constitutes a tax risk. All five participants that had a clear definition of what constitutes a tax risk were public companies.

Participants who did not have a definition of tax risk said that the systems they have in place ensure that they consider all scenarios that give rise to uncertainty in relation to tax outcomes. Four participants who did not have a definition of tax risk noted that the criteria they used to identify a tax risk is very much based on an application of the 'smell test' or 'gut feeling' whilst one participant worked on a rough rule of thumb in establishing the existence of a tax risk where the tax consequence of a transaction was uncertain. All tax managers that were interviewed were very experienced tax professionals and a number felt that experience allowed them to be a good judge of the tax risks associated with a transaction.

Three participants expressed concern with the ATO's definition of tax risk and noted that the corporation's definition is likely to be quite different. The ATO statements concerning tax risk have focused on the risk that a tax position may not comply with the law but does not address the fact that from the company's perspective a tax risk includes not only the risk that the organisation may adopt a tax position that does not comply with the law but also the risk that they may fail to take up a concession or tax approach that does comply with the law and would result in a tax saving (eg a failure to apply for a research and development concession that the organisation would qualify for).

The view of the tax partner participant was that to a large extent large companies are concentrating on financial tax risk and really only consider other tax risks like reputation when there is a major or unusual transaction. The lack of a comprehensive evaluation of all types of tax risks suggests that there are some limitations in a corporation's ability to manage tax risks and accordingly the tax decision maker's ability to make informed decisions.

<sup>&</sup>lt;sup>26</sup> Ernst and Young above at n 12, 12

<sup>&</sup>lt;sup>27</sup> PricewaterhouseCoopers 'Tax Risk Management(2004) -This analysis is not by type of tax and they include all types of tax under tax risk management

#### 6. KEY TAX RISK DECISION MAKERS

Key tax risk decision makers identified by participants include the following;

- x Board of directors
- x Chief financial Officer/Director
- **x** Tax manager (Australia)
- **x** Tax manager(Global)
- x Risk Management Committee

Participant's responses indicate that the board of directors are usually involved in the adoption and approval of a tax risk management system but the day to day application of that system to the organisation's transactions occurred in the tax department within the corporation.

Of the 12 public company participants, 11 indicated that the board of directors were a driving force in the adoption of a tax risk management system. Where a formal tax risk management system had been adopted, typically the tax department within the organisation was responsible for its formulation and subject to approval by the board of directors. Consistent with participant responses the Ernst and Young Global Tax Risk Survey (2008) ported that 96% of large Australian company respondents have an individual with overall responsibility for managing tax risk.<sup>28</sup>

One public company participant noted that the tax risk management system that was put in place was based on a system adopted by the group internationally. In the case of the two private company participants the tax risk management systems were informal and the tax manager within the organisation was responsible for the development and application of tax risk management practices without the board of director's approval. Thirteen of 14 directors did send out a clear directive in these instances that there are to be no surprises in relation to tax.

All participants emphasised that the decisions in relation to tax risk management are based on a culture of compliance so although the directors are not involved in the day to day consideration of tax risks the tax managers know the approach to tax risks that they should take. The tax manager reports material tax issues to the Board and there are clear directives from the Board that they want to be informed concerning material tax risks. The tax managers who participated in this research emphasised that it was an important part of their role within the organisation to kept directors fully informed concerning tax risks.

Participants were asked what performance measures were used to evaluate their performance and whilst a myriad of factors where considered in evaluating the performance of the tax manager only one participant advised that it did include an evaluation of the effective tax rate for the period amongst a number of other variables. The responses concerning evaluation of performance of tax managers in large Australian corporations indicate that there is no overriding pressure on tax managers to minimise tax to maximise their remuneration.

<sup>&</sup>lt;sup>28</sup> Ernst and Young above at n 12, 9

Participants did point out however that performance measures do not necessarily want to reward a reduction in tax risk all the time as an integral part of a successful business is the taking of informed risks. Interestingly, one participant highlighted that there is such a demand for franking credits by shareholders in the relevant corporation that the tax manager is encouraged to pay more in Thirteen of the 14 corporate participants noted that there had been an increased demand by directors for information concerning tax risks and clear indications from the Board that they do not want any surprises in relation to tax. The management of tax risks was considered by participants as a means by which any potential tax risks could be identified and to ensure the ultimate tax position that is taken by the corporation is one based on informed decision making. The Ernst and Young Global Tax Risk Survey (2008)

Three participants felt that the importance of the organisation's good reputation had been a key motivator in establishing a tax risk management system. Each participant who highlighted reputational concerns said that the organisation would be most concerned if they were perceived as non-compliant with the tax laws or considered to have taken an aggressive tax position. All participants commented on the importance of the organisation's reputation and demonstrated a real concern that any negative publicity concerning tax compliance would affect the organisation's profitability.

The importance of reputation to large business and the consensus that aggressive or non-compliant tax behaviour will negatively affect that reputation and ultimately the profitability of the business, suggests that any measures by the ATO to improve large corporate tax compliance should incorporate the publication of details of taxpayers who are aggressive or non-compliant. No participant indicated that they do take an aggressive tax position but rather that they made every effort to comply and one of the motivators was the concern for the organisation's reputation.

Interestingly the participant's concerns expressed for the negative impact on reputation of a tax aggressive or non-compliant position was not demonstrated in a Pilot Study of large corporations in the UK.<sup>32</sup> Few of the respondents in the Pilot Study of large UK corporations were concerned with the public's perceptions of their tax policy and planning behaviour. The authors of the Pilot study suggest that the lack of concern for negative publicity concerning tax compliance behaviour could be du A

organisation are always pushing a variety of products and money making ventures and the existence of a tax risk management system allows tax to go back to them with concerns from a tax perspective and as a result the tax department is more likely to be listened to.

#### 7.8 Views of a Big 4 Tax Partner

Based on the tax partner participant's experience with a range of large Australian corporations, the extent to which clients were evaluating tax risk depended to a large extent on the industry in which they operate and whether they operate internationally. In addition the tax partner participant felt that the introduction of International Financial Reporting Standards (IFRS) in Australia will have a significant impact on the need to identify and manage tax risks in the future. Tax reporting of uncertain tax positions for IFRS is based on a weighted average compared to the previous FIN 48 which had limited application to Australian subsidiaries of US corporations because in many cases the Australian entity was not material and so the tax risks were not reported.

Also the tax partner participant felt that the increase in information sharing as a result of the creation of the G20 group of countries will have implications on tax risk and compliance behaviour as information exchange will provide greater certainty as to the application of the tax laws to member countries.

#### 8. FACTORS THAT AFFECT THE LEVEL OF TAX RISK

The tax risks faced by large corporate taxpayers can ultimately result in the organisation failing to comply with the tax law. It is anticipated that measures aimed at reducing the tax risks an organisation faces would result in an improvement in the level of tax compliance and is of interest to the organisation and the relevant revenue authority. This research gives an insight into the tax manager's views as to the factors that impact the level of tax risk that a large corporation faces in seeking to comply with the Australian income tax laws.

Importantly not all tax risks can be controlled by the organisation and as demonstrated in the responses of participants, tax risk management is largely about ensuring that decision makers are informed as to the tax risks that do exist, on a timely basis.

Participants were asked what, in their view, were the factors that affected the level of tax risk that the organisation faced and the responses of participants include:

- x Uncertainty/complexity of tax laws
- x Limitations of ATO staff
- x Complexity of business transactions
- x Staff turnover
- x Staff not following guidelines
- x Limited information provided to tax staff by other divisions
- x Time constraints

- x Demand for franking credits
- x Change in ATO interpretation /approach to a tax issue
- x Level of concern for reputation
- x Size of the transaction
- Х

This research does highlight that the lack of certainty as to how the laws will apply is a real concern and in a number of instances participants noted that negotiations with the ATO have resulted in acceptance of the ATO position despite the fact the participant had obtained advice to support their original alternative position.

#### 8.2 Staffing

Factors internal to the organisation that have an effect on the level of tax risk relate to staff turnover and the flow of information to the staff in the tax department. Six participants said that at times other business units of the corporation may fail to provide tax with full and complete information to determine the correct tax treatment and this is a significant limitation in the ability to manage tax risks. In addition three participants noted that the pressure from other business units of the organisation on the tax department to accept new products or arrangements limit the ability of the tax department to manage tax risks.

However by way of contrast a number of participants commented that the fact that the ATO had put tax risk management on the agenda had resulted in other sectors of the organisation listening to the issues raised by the tax department where they had not been so receptive in the past.

Staff turnover was an issue with participants that had a large tax department as well as those with a small tax department. What participants did highlight was that good systems for recording transactions would minimise the tax risk impact of this variable. Staff turnover affects the ability to manage tax risks because, although the tax risk management system ensures informed decision making, if the person who is informed concerning tax risks leaves the organisation there will be a gap in knowledge within the organisation. A number of tax managers pointed out that they enforce detailed record keeping in the tax department in an effort to limit the effect of staff turnover on tax risk management.

Time constraints is an issue for one of the private company participants who felt there was so much time consumed on tax compliance issues that tax risk management was more of an after thought. The same participant noted that, because the organisation takes a conservative approach to tax compliance and that there are very few unusual transactions, the level of tax risk was anticipated to be very low and as a result the informal approach to tax risk management was most appropriate.

By way of comparison the third party tax partner participant's view was that the extent and quality of tax risk management systems can at times be limited because of the lack of technical qualifications of the in-house tax person as their skills remain static and are quite often not up to date. The Ernst and Young Global tax Risk Survey (2008) identified that 76% of Australian respondents to that survey felt that they had insufficient resources to cover tax function activities.<sup>34</sup>

#### 8.3 Demand for Franking Credits

Interestingly four participants highlighted that the organisation may very well be reporting a taxable income more than they would if they had applied appropriate and comprehensive tax planning to their business and made use of all available

<sup>&</sup>lt;sup>34</sup> Ernst and Young above at n 12, 5

concessions. One participant said that at times the decisions the organisation makes in relation to transactions is 'crazy' and if the transactions had been done another way significantly less income tax would have been paid. The demand for franking credits, that reflect the payment of tax at the corporate level and passed on to the shareholders, suggests that in some instances the organisation will pay more tax than it should under the tax laws because of the demand from shareholders in Australia for fully franked dividends. This appeared to be most relevant for Australian ASX listed companies.

In addition it was suggested by one participant that, a corporation with significant carry forward tax losses is less likely than a corporation with a large taxable income to be concerned about tax planning and tax minimisation and accordingly the level of tax risk is likely to be inherently lower.

#### 8.4 Other factors

Other factors that affect the level of tax risk include change in ATO interpretation of the tax laws, concern for reputation, size

#### 9. CRITERIA USED TO DETERMINE THE ACCEPTABLE LEVEL OF TAX RISK

Participants identified the following criteria used to determine the acceptable level of tax risk;

- x No acceptable level of tax risk
- x Materiality
- x Disclosure requirements
- x Likely impact on reputation
- x Gut instinct, experience and judgement

Whilst directors clearly want to be informed concerning the tax risks facing an organisation all participants indicated that that would not necessarily result in a lower level of acceptable tax risk. Decision makers in a large corporation are required to take risks in making business decisions and risk management seeks to ensure that business decisions are based on knowledge of the potential risks. Participants were asked what they considered to be relevant in the determination of acceptable risk that is, what characteristics of a particular transaction or arrangement would be considered by the tax decision maker in deciding the level of tax risk that is acceptable.

Whilst seven participants indicated that no level of tax risk is acceptable, a review of the tax risk management systems and responses to this question indicate that participants recognise that there will always be some risk and the criteria they use to establish whether the risk is acceptable includes a consideration of the materiality of the transaction and any requirement to disclose the transaction under relevant reporting requirements. Four participants stressed the importance of maintaining their reputation as good corporate taxpayers and that the potential impact on a firm's reputation of any negative publicity concerning tax compliance would result in a lower level of acceptable tax risk.

Three participants had clear guidelines on the relevant variables to be considered in determining whether a transaction had an acceptable level of tax risk and these variables were given a variety of weightings and acceptable scores. Four participants noted that the overriding criteria used to ev

risks. All\_participants said that they had always adopted a low tax risk profile irrespective of the existence of a tax risk management system.

The consequences of adopting a tax risk management system identified by participants include:

- x No impact
- **x** More informed tax decision making
- x Better documented risks
- **x** Tax risks minimised
- **x** Greater range of risks being identified
- x Better managed tax risks

Six participants felt that a tax risk management system had no impact on the corporation's tax decision making as those participants believed that they had always managed tax risks and that the identification of a process or system that had always occurred informally in the past resulted in a change in form rather than substance to the management of tax risks and tax decision making.

Five participants felt that the tax risk management system had resulted in more informed tax decision making and better documented risks were also identified by five participants. Two participants identified that a comprehensive tax risk management system would ensure that tax risks would be minimised. Additional consequences including a greater range of and better managed tax risks were identified by two participants.

A number of participants felt that although they had adopted a low tax risk profile the ATO was still regularly reviewing, contacting and requesting information from them. All participants who made this observation said that they had a good relationship with

potential tax risks as well as the corporation's tax risk profile. Directors did not want surprises in relation to tax and participants felt that the impact of a tax risk management system was primarily in relation to significant improvements in documentation in relation to

# ATTACHMENT 1

### Interviewer : Catriona Lavermicocca PhD student UNSW

# Project description: In-depth interviews

This research project forms part of the data collection for the purposes of completion of a PhD in Taxation at the Australian School of Taxation (ATAX) at UNSW. The title of the PhD thesis is 'Tax risk management as a corporate governance issue in Australia and the impact on income tax compliance by large corporate taxpayers'.

Proposed questions for in-depth interviews concerning tax risk management

- 1. To what extent does your organisation consider/evaluate tax risks?
- 2. Does your organisation have clear statements/guidelines on what constitutes a tax risk?
- 3. Who (not by name but by title) in the organisation determines the acceptable level of tax risk?
- 4. Do the organisation's corporate governance guidelines require tax risks to be managed?
- 5. Does your organisation have a tax risk management system?
- 6. What systems/procedures does your organisation have in place to ensure that tax risks are managed? To what extent are those systems/procedures documented and reviewed for compliance?
- 7. Have there been any recent changes in the approach the organisation takes to tax risk management?
- 8. What criteria are used to determine the acceptable level of tax risk in your organisation?
- 9. What factors do you consider have an impact on the level of tax risk that the organisation faces?
- 10. What limitations, if any does the organisation face in managing tax risks?
- 11. What pressures do you believe have had an impact on the organisation's decision to adopt/not adopt a tax risk management system?
- 12. To what extent have the following had an impact on the organisation's decision to adopt/not adopt a tax risk management system?
  - x ATO
  - x Shareholders
  - x Customers
  - x Stock market/listing rules
  - x Directors
  - x SOX legislation

- 13. What influence have the ATO announcements had on your organisation's tax risk management practices?
- 14. Have you received any correspondence from or entered into discussions with the ATO concerning tax risk management and tax decision making practices?
- 15. Who (not by name but by title) are the key tax decision makers in your organisation? Is there any board/director involvement in tax decision making and if any, what is the level of that involvement?
- 16. What are the performance measures in respect of the key tax decision makers in your organisation?
- 17. What do you consider to be the impact of tax risk management systems on the determination of the acceptable level of tax risk?
- 18. Is the organisation more or less tax risk averse (or has there been no change) after the introduction of a tax risk management system?
- 19. To what extent does the organisation consider corporate social responsibility issues and if so does that include a consideration of the organisation's tax compliance profile?

ATTACHMENT 2

Approval No 092098

## THE UNIVERSITY OF NEW SOUTH WALES PARTICIPANT INFORMATION STATEMENT AND CONSENTFORM

# In-depth interviews concerning tax risk management as a corporate governance issue in Australia and the impact on income taxcompliance by largecorporate taxpayers

#### Participant selection and purpose of study

You are invited to participate in a study of the tax risk management practices of large Australian corporations. We hope to learn what are the tax risk management practices adopted by large Australian corporations, the motivators for the adoption of a tax risk management system and the impact of those systems on the corporation's income tax compliance behaviour. You were selected as a possible participant in this study because we understand that you are employed by a large Australian corporation (turnover in excess of \$100 million per annum) and have some knowledge of the tax risk management practices adopted by the organisation.

#### Description of study and risks

If you decide to participate, we will contact you to organise an appropriate time and place to conduct an interview. It is envisaged that the interview will be either face to face or via telephone depending on what is most appropriate determined by your preference and location. A copy of the questions that will be asked can be provided prior to the interview if requested. The interview will run for a maximum of two hours and will not be recorded althou4 Twp1omnnun

Tax Risk Mme

Tax Risk Managmeent and their Impact on Tax Compliance Behaviour

THE UNIVERSITY OF NEW SOUTH WALES