Rethinking the risk management process for tax

Emerging markets flex their tax muscles

The tax function welcomes a new role: Head of Controversy

Closing the gap

Why tax risks are becoming an issue for the boardroom
Facing up to tax risk

Dear Reader

Tax risk and controversy have never been higher on the corporate agenda. As governments around the world battle to restore public finances to health, they are doing all they can to raise tax revenues, close loopholes and share information that will lead to better compliance. As prominent taxpayers, companies are firmly in their sights. Tax legislation is becoming more stringent and many administrations are subjecting companies to more frequent and aggressive audits – sometimes jointly with one or more overseas tax administrations.

The public mood toward corporate tax has darkened. In the current environment, barely a day goes by without another multinational company being vilified in the media for taking an overly aggressive approach to tax planning. Campaign groups are also becoming increasingly vocal in their accusations. This negative attention can have serious reputational damage, even if the tax strategies that companies have adopted are completely within the law. With the economic recovery still highly fragile, few companies can afford the negative publicity that these campaigns and media coverage bring.

In some markets, companies also have to contend with a highly uncertain and unpredictable tax environment. Legislation can change quickly, and sometimes in unexpected ways. Companies may find that a structure that was perfectly legal and uncontroversial when they first set it up subsequently proves to be problematic when rules are changed, sometimes even retrospectively. This is particularly true in rapid-growth markets, where the tax system is less mature and where legislation may be more dynamic and fast moving. Dealing with such an uncertain environment creates major headaches for tax and finance departments, and also means that companies can lack the certainty they need to make long-term investments.

The severity of the risk environment means that tax must now be a topic for frequent board discussion. Companies must ensure that their tax strategies are appropriate and suit their risk appetite. They must also be aware of the tax risks associated with any new investment, particularly in unfamiliar markets. This calls for frequent communication between tax directors and the senior executive team, as well as a platform for discussing the implications of tax risk issues at board level. It may even call for new roles to be created – such as a head of tax controversy – who has a specific mandate to take a proactive approach to identifying and managing tax risks. Without these mechanisms in place, companies are running the risk not only of penalties and fines, but also of severe reputational damage.

In this 10th issue of T Magazine, we explore how tax risk and controversy have changed since the financial crisis. We look at emerging risk areas and explore how the relationship between companies and their external stakeholders, including the media, tax administrations and campaign groups, is evolving. Perhaps most crucially, we examine how companies are identifying and managing these risks.

We hope you find the publication valuable and stimulating.
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1 China
October 2012
China’s regulations on capital contribution with equity of a Chinese company including a foreign investment enterprise (FIE) took effect during October 2012. According to the new rules, a Chinese or foreign shareholder could bring its equity of a Chinese company in another company as capital contribution for the purposes of either: establishing a new FIE; converting a domestic enterprise into an FIE; or increasing the capital to change the equity of an existing FIE. At least 30% of the registered capital of the invested company must be maintained as cash, leaving the equity capital contribution (along with other non-cash contributions) as no more than 70%.

2 Australia
October 2012
The Australian Treasurer Wayne Swan released the Government’s 2012-13 Mid-Year Economic and Fiscal Outlook (MYEFO), stating that the fundamentals of the Australian economy remain strong, with the budget returning to surplus this financial year as scheduled, despite worsening global conditions cutting almost AUD22b from tax receipts.

3 OECD
November 2012
The OECD’s Centre for Tax Policy and Administration released a revised version of the public discussion draft (2012 Permanent Establishment Discussion Draft) on proposed changes to the OECD Model Tax Convention (OECD Model), as well as a revised version of the public discussion draft on beneficial ownership (2012 Beneficial Ownership Discussion Draft). Comments have been invited on the revisions.

4 India
November 2012
The Accounting Standards Committee established by the Indian Central Board of Direct Taxes submitted its final report that recommends tax accounting standards (TAS) for calculating taxable income. The Committee examined the accounting standards issued by the Institute of Chartered Accountants of India meant for maintaining books of accounts, and recommended separate accounting standards for computing taxable income on various issues. The final report is available on the Finance Ministry website and is open for public comments.

5 United Kingdom
October 2012
The United Kingdom will not adopt the proposed EU financial transactions tax. He confirmed that the UK will not be joining other EU Member States that are willing to participate through enhanced cooperation.

6 United States
November 2012
The US Treasury Department announced that it is engaged with more than 50 countries and jurisdictions to facilitate the implementation of the Foreign Account Tax Compliance Act (FATCA), with the aim of improving international tax compliance. The Treasury Department concluded a bilateral agreement with the United Kingdom during November 2012, and announced at the time that it aimed to have finalized intergovernmental agreements with a further 16 jurisdictions by early 2013.

Cover

“For most large corporates in the UK, and for many mid-sized ones, tax is now firmly on the boardroom agenda.”

Dave Hartnett CB, the recently retired Permanent Secretary for Tax at the UK’s HM Revenue and Customs (see page 16).
Tax risk rising

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A century of tax anti-avoidance rules

1915

Australia and New Zealand pass joint anti-av avoidance provision. The regulations have been overhauled several times but remain in force today.

1960

The Netherlands introduces first European anti-av avoidance initiative, with rules directed at transactions that “would not be undertaken except to make the future levy of taxes wholly or partly impossible”.

1970

Switzerland issues Ani Abuse Decree, which tackles avoidance by domestic taxpayers but also includes an international element to tackle avoidance using countries with which it has tax treaties.

1980

Germany’s first attempt at a GAAR places the burden on taxpayers to prove that their affairs have not been arranged in order to benefit from tax advantages that the law did not intend to provide.

Upon whom is the burden of proof?

Who is responsible for proving a transaction does not fall foul of GAAR?

Source: Ernst & Young 2011-12 Tax Risk and Controversy Survey

Upon whom is the burden of proof?

Who is responsible for proving a transaction does not fall foul of GAAR?

Source: GAAR in Hong, Ernst & Young, 2012

US$ 385bn

The amount in US$ expected to be recovered by FATCA over 10 years. The cost of FATCA compliance for some large firms is estimated at between US$70m and US$100m.

207

The number of GAAR cases concluded in 2011 and reported by the Chinese tax authority, which resulted in around US$24bn in taxes being collected.

200%

The maximum penalty, as a percentage of tax underpaid, that Italy has the power to levy on companies falling foul of anti-avoidance legislation.

Australia

Despite having been the first country, along with New Zealand, to introduce general anti-avoidance rules, first issued in 1915 (see timeline), Australia continues to update and refine its rules. Under Treasurer Wayne Swan, it is consulting on draft reforms, which may broaden the circumstances in which such rules can apply, in order to reduce the scope for potential loopholes.

Coming up:

The OECD will publish the results of its investigation into base erosion and profit sharing in January amid mounting controversy over the extent to which multinational companies are shifting profits between jurisdictions in order to minimise their tax bills. The OECD’s strategies aim to address:

- The minimisation of taxation in a foreign operating or source country;
- Low or no taxation at the level of the recipient;
- Low or no withholding tax at source;
- No current taxation of the low taxed profits (achieved via the first three steps) at the level of the ultimate parent.

1988-1990

As the pace of globalisation increases, tax avoidance begins to move up the agenda in many countries. Brazil, Canada, Singapore, Ireland and South Korea all introduce their own versions of anti-av avoidance rules.

2004

France adopts a GAAR following similar principles to other countries, empowering its tax authorities to reassess companies where management decisions are considered contrary to the interests of the business.

2006

South Africa introduces a GAAR that enables its tax authorities to take a much stricter line on tax avoidance, introducing, for example, objective tests whether a transaction has been conducted primarily for tax reasons.

2008

China’s Corporate Income Tax Law introduces a raft of specific rules and a GAAR granting a number of sweeping new powers to the country’s tax authorities.

2013

Some 16 years after the 1997 Budget first proposed a GAAR, the United Kingdom is due to implement one in 2013. India also plans a new regime, in both countries, final details are still being finalised.
The G20 tax turnaround

Sustained government pressure on tax compliance means tax risk is now an issue for corporate boards, not just tax directors. The desire to minimize tax bills must be balanced against risks such as reputational damage.

By David Prosser

 Held just one day before the US Presidential election amid continuing turmoil in the Eurozone, one might have expected November’s meeting of G20 finance ministers in Mexico to prioritize progress on macro issues such as the global economy. In fact, the summit’s most tangible result was a joint commitment on a separate, albeit related matter: tax avoidance by multinational companies.

Following the G20 Leaders initial announcement from Los Cabos in June 2012, George Osborne and Wolfgang Schäuble, the finance ministers respectively of the UK and Germany, have lead the G20’s promise to back an OECD initiative aimed at closing loopholes in international tax practices that some believe have enabled multinationals to pay less tax than they should. The OECD is due to make firm proposals in February.

The G20 summit’s focus on corporate tax would have been unthinkable as recently as five years ago, when the overriding priority of both developed and developing economies was to promote free trade and international competitiveness. Then came a financial crisis and the resulting global economic downturn. Ever since, the priority for many governments has been to reduce their large budget deficits. Given

François Gadel — The Senior Vice-President for Tax at the luxury goods business LVMH, François Gadel is widely regarded as one of Europe’s experts on transfer pricing.
Governments have given corporations attractive tax regimes – now they want to see compliance

considering new rules. The BRIC nations, and especially India, have been increasingly aggressive on tax. Even Finland, a small and wealthy nation long regarded as one of the most competitive places in the world to do business, has passed new tax avoidance legislation.

Jeffrey Owens, the Senior Tax Policy Advisor to the Vice Chair of Tax at Ernst & Young, says that many governments see this as payback time. Owens, who spent 20 years as Director of the Centre for Tax Policy and Administration at the Organisation for Economic Co-operation and Development and companies to expect this trend to continue.

“Governments have given corporations attractive tax regimes - corporate income tax rates have fallen by 20% to 30% over the past two decades - and they want to see people complying with the rules,” he argues. “That’s why you are now getting this balance. On the one hand, rates are going down but, on the other, compliance is being reinforced and corporations that have been following more aggressive strategies will have to stand back and consider their positions.”

Companies under the spotlight

Corporate tax directors are becoming accustomed to ever closer scrutiny from the tax authorities. “What we’ve noticed since the crisis in 2008 is a big step up in the level of audit activity around the world,” says Bartlett, Head of Tax at BP, one of the world’s leading international oil and gas companies. “The world I would use is persistent. These audits take a lot of time and effort to complete. And, in each one, the authorities are looking for a larger slice of the cake,” says Gadel.

Tax risk becomes a board issue

In this context, companies must think harder about how they manage their tax affairs. Administrations think that might once have been routine may now attract the sort of attention companies would prefer to avoid, even if the arrangements remain perfectly legal. “Companies must be clear about their tax planning strategies and ensure that any scheme has substance behind it and a commercial rationale,” says Owens. “In particular, they need to review where they have their holding companies and financial structures, and determine whether they are structured in jurisdictions perceived as tax havens.”

This potentially requires companies to undertake a significant amount of work. Of course, it will not be solely the responsibility of the company tax director. As tax has moved center stage - particularly given heightened public scrutiny on tax and by the media, for corporate tax practices - so it has become an issue for the company’s most senior executives.

“Tax has moved up into the boardroom,” says Owens. “CEOs and CFOs have been more aware of the financial and reputational risks. Some may decide they are happy to continue taking them, but many are arrepenting. They just can’t afford for publicity to have a negative impact on their clients and their staff.”

Tax directors are increasingly expected to have an understanding of the company’s strategy

This means that tax directors are increasingly expected to have an understanding of the company’s strategy and values to ensure that tax practices are aligned with them. “From an executive’s point of view, tax is just another area of risk – hence the need to bring it into the boardroom,” says Bartlett. “That is an efficient and critical and can really tarnish your image so it’s vital that the company is clear about its strategy.”

For the company’s Reijo Salo, says the tax director, he now spends more time talking to his chief executive about the strategic direction of the company than ever before. “Tax is now so crucial that, if I’m going to be able to offer good advice, I’ve got to really understand where we are going in the future,” he says.

Working in tandem with tax directors, the board and senior executives are now required to ask difficult questions about their tax practices and ensure that they are striking an appropriate balance between managing risks appropriately and fulfilling their responsibilities to shareholders. It can be challenging to find the middle ground. Taking a cautious approach will reduce risk but, at the same time, most investors will not thank a company if they think that it is paying more tax than it should.

The need for clarity

With company tax practices under the media spotlight, these discussions now take on particular importance. But there is an added complexity. The complaints of campaigners who have focused attention on the tax affairs of large corporates are not always fair or even well founded. Companies therefore have two choices. They can decide to reorganize their tax planning out of fear of being attacked, someone we see so often in the case of executives, by activists who have a poor understanding of

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__How big is the tax gap? The truth is no one really knows - if every taxpayer, corporate and individual, made an honest declaration of their finances, or the tax authorities had perfect information, assessing the difference between total tax due and total tax paid would be simple. But then there probably wouldn’t be a tax gap to speak of at all.

Still, Benjamin Franklin’s oft-quoted warning that nothing in life is certain but death and taxes could do with updating. It’s just as certain, wherever in the world you look, that not everyone pays all the tax they should.

In the UK, the latest estimate of the tax gap is that HM Revenue & Customs ( HMRC) collected £323 billion less tax last year than it was owed. In the US, the IRS’s most recent figure is $350 billion. Across the Eurozone as a whole, the current estimate is that the tax gap could be as high as €1.5 trillion. In each case, the gap comprises two distinct elements: there is tax lost to evasion - clearly illegal behavior - and there is tax lost to avoidance - tax planning strategies that stay on the right side of the law with each step of a transaction, but overall nevertheless deprive authorities of revenues they had been expecting to collect. In an ideal world, the tax authorities would seek to narrow the gap by targeting both evasion and avoidance. But the crackdown on corporate tax avoidance that is so marked around the world suggests the focus has been more targeted.

This is an odd strategy given the breakdown of the tax gap figures. For one thing, far more tax revenue is lost to evasion than avoidance - that €160bn Eurozone tax gap, for example, may well be 85% evasion. For another, corporate tax avoidance is often a tiny part of the total. In the UK, for instance, HMRC puts the amount lost to tax avoidance strategies at large companies at less than 3% of the total tax gap. In almost all economies, indirect taxes and direct taxes on individuals account for far greater sums.

The figures suggest, in other words, that multinational companies may not offer the richest pickings for authorities in closing the tax gap, even if they are the easiest political target. Not that the figures should be taken entirely at face value. Even the statisticians who compile tax gap data concede that they are, at best, well-informed “guesstimates”.

Most recently, she has reform their approach to bolster their budgets and countries should act to how, and how quickly, forefront of the debate on Fund has been at the International Monetary will have major implications increases. Such decisions measures and tax adopting tougher austerity cautioned countries on uncertain future.

The new-found focus of governments on corporate tax may complicate strategic decisions at the same time, they have to remain very good technicians, even if technical skills are no longer enough."

LVHM’s François Gadel says that the key is for tax directors to be able to defend their company’s practices - and to equip other executives to do the same. “We have to be more careful and we need stronger arguments than ever to explain our policies,” he argues. “That doesn’t mean paying more than we need to pay, but the optimization of our tax charge is very clearly linked to the fact that we must also protect our reputation.”

A deterrent to investment? The biggest fear of all many companies is that the new-found zeal of governments for corporate tax will make it difficult for companies to make strategic, long-term decisions about where and how to invest. Without good visibility into basic tax structures, those decisions, so crucial to large multinationals, become more finely balanced. The worst-case scenario is that governments not only change tax regimes at short notice but seek to apply the amendments retrospectively. Telecoms giant Vodafone, for example, continues to challenge a US$2.2b tax charge it claims has only arisen because of a retrospective change in the law by the country’s government.

BP’s John Bartlett says this is exactly the sort of dispute that unnerves multinationals and their shareholders. “If you’re investing for the long term - and as a natural resources company, we operate projects over 30 years or more – tax reform is often spoken about and it does worry investors,” he says. “We’re not suggesting nothing can change, or even that taxes can’t rise, but you need a consistent approach, as well as thorough consultation in the event of reform.”

Financial institutions are still trying to work out how to comply with the US legislation FATCA. Without that consultation, companies often find themselves dealing with the unintended consequences of tax legislation. Financial institutions across Europe and Asia, for example, are still trying to work out how to comply with the US’s Foreign Account Tax Compliance Act (FATCA), which effectively requires them to ensure US taxpayers with accounts overseas pay tax back home - or face severe changes on their own assets.

Are governments and tax authorities aware of the risk that overly aggressive reform might damage corporations - and their ability to produce the sort of economic growth that will ultimately eliminate the deficits about which they are so worried? Jeffrey Owens thinks they are. “Politicians realize that, if you want growth, that requires investment and it’s the large corporations who are the big investors,” he says. “So yes, you do want better compliance, but that can be consistent with having a business-friendly tax environment.”

In Finland, Reijo Salo is not so sure. “Politicians are willing to listen but whether it will have any effect is another matter,” he says. “We’ve explained about the need for certainty with our investments but, when something is taken up by the newspapers, governments want to be seen to be taking it seriously.”

It’s not all bad news, says Owens. As tax authorities dedicate more resources to scrutinizing corporates, both sides are getting to know each other much better - and not necessarily in a confrontational manner. “As we move down the road of more anti-abuse provisions, a number of tax authorities are also saying ’let’s change the dynamic of the dialogue we have with companies and build an enhanced relationship’, Owens explains. “For corporations, that can be attractive because developing that sort of relationship is how you minimize hassle and get certainty and predictability.”

This is a positive step but it is only one part of the puzzle. Bartlett believes that, even if governments do try to remain pro-business during this period of focus on compliance, much will depend on how sensible and practical the tax authorities are prepared to be. “Any policy is worthless without a good administrator to apply it,” he says. “What corporations need is stability and, in many countries around the world right now, it feels like there is a great deal of instability.”

When might that instability moderate? With governments under pressure to pay down debt without damaging growth - and to improve tax compliance and increase the collection of tax - don’t expect the pressure to ease any time soon.

Christopher Agnew

Christine Lagarde

The Head of the International Monetary Fund has been at the forefront of the debate on how, and how quickly, countries should act to bolster their budgets and reform their approach to tax. Most recently, she has cautioned countries on adopting tougher austerity measures and tax increases. Such decisions will have major implications for corporate tax directors trying to plan for an uncertain future.
Closing the gap

The information below shows the level of tax authority activity on tax audits. As the results below show, even if all the tax associated with the open cases were to be collected by the tax authorities, it is not going to pay off the public debt. There remains work to be done.

Sources: OECD 2011, IMF 2012 - Note: all figures relate to 2009, unless specified / Graphic: Bernadette Schenker

**Value of unsettled tax cases as % of public debt**

**All associated tax amounts represented in millions unless otherwise stated**
Setting the parameters of tax

Dave Hartnett CB, the Permanent Secretary for Tax at HM Revenue and Customs (HMRC) until his retirement in July 2012, speaks to T Magazine about the key shifts in UK tax policy over the past decade. *Interview by Fergal Byrne*

**T Magazine:** Looking back over the past decade, what would you say have been the most important changes in tax policy?

**Dave Hartnett:** I think the introduction of tax disclosure rules in the UK in 2004 has proved to be a very significant change. This was the beginning of the end of marketed corporate tax avoidance, particularly for large corporates; of course, bespoke avoidance for corporates still exists. These rules were designed to operate with “non-judgmental transparency” - that is, to put the tax administration in the same place as the tax advisor in terms of openness and transparency for the first time. I think it’s fair to say that the new tax disclosure rules enabled HMRC to stop tax avoidance schemes and arrangements involving billions of pounds.

The introduction of the senior accounting officer (SAO) rules was another significant change. These rules make the SAO in a large company responsible for its tax computations. I think many professionals felt these rules were very oppressive when they were introduced. But today, I would say that there are very few tax directors in business who don’t have a good word to say about them. The SAO rules have been instrumental in getting senior management in large corporates to pay more attention to their tax liabilities. These rules have had a very good effect on tax compliance with big corporates.

The reform of the controlled foreign companies (CFC) legislation has also been an important change in tax policy. This legislation, and, to an extent, the way HMRC applied it, was a real disincentive to some multinational businesses; they felt, in effect, that the UK was seeking to tax profit that had very little to do with the UK. Over the past year or so, the changes in the CFC legislation have given companies confidence that the UK is serious about being competitive. In my last year at HMRC, we regularly saw multinationals either wanting to return to the UK, or return their headquarters to the UK, or indeed to come here for the first time. This is to some extent a testimony to the impact of the new legislation.

Finally, I think the decision to reduce the top personal tax rate to 45% was an important one. The introduction of the 50% rate was a huge disincentive to some individuals and many left the country as a result. The lower rate will encourage many wealth creators who have left the UK to return.

**Summary**

Enabling a competitive business environment and a more efficient tax administration are two of the broad themes playing out within HMRC, along with a more international approach to revenue collection.

**Feature / Dave Hartnett**

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Since first joining HMRC in 1976, Hartnett has held a diverse range of tax positions. In 2004, he became HMRC’s Director General for Customer Contact and Compliance Strategy and then Director General for Business. Most recently, he was the Permanent Secretary for Tax, and served as a member of HRMC’s formal governing board from its creation in 2005 until his retirement.
I have to say I've always been a fan of tax gap measurement because it gives an insight, not only into the performance of the tax administration, but also into how it can focus resources to be more effective. But it's important to bear in mind that there is not a lot of precision here. Certainly, some of the wilder estimates in tax gaps that have been put out there are clearly just not right. But I don't think the UK tax administration, nor indeed the US tax administration, which has been measuring the gap for a lot longer than the UK, could say what is the right number with precision.

Increasingly, tax administrations are using risk management to manage and prioritize their casework. How well would you say the UK has performed on this front? The tax administration in the UK is much more focused on larger tax risks. If you look at what the Large Business Service has managed to do, and particularly in the past year or two, it has reduced by a very significant degree the number of small enquiries it has with big business and concentrated its resources on the important stuff that really matters. In the past, that was a big issue for many companies.

Since the UK tax administration started to adopt a risk-based compliance regime for medium and large-size companies, and started to exchange risk assessments with these firms, we discovered they were almost identical. In fact, I have never seen a corporate tax risk assessment and a tax administration's assessment of risk for that corporate with more than a 20% difference. This means that the corporate and the tax administration have a pretty good shared understanding of what the big risks are - and can then focus on dealing with these big risks.

We are seeing fairly substantial growth in alternative dispute resolution processes around the world. What would you say has been the main impact of this development? Running a dispute through the courts is hugely expensive, so having an option where an independent arbitrator can play a role in resolving, or at least assessing, the two sides of a dispute is a really significant development. Personally, I'm a big fan of early neutral evaluation. This is a form of alternative dispute resolution where the tax administration and the corporate agree that, after a period of time, say 9 months, someone completely independent will come in and look at both sides' arguments. The arbitrator can then assess what the likely result would be if these arguments were presented in court at that time. In my experience, that can have the effect of persuading one side to reconsider their position. I see considerable scope for this in transfer pricing.

In a recent interview, Jeffrey Owens (the former Director of the Center for Tax Policy and Administration at the OECD) noted that tax commissioners are talking about moving from cooperation to coordination. How well do you think tax authorities are doing in terms of cooperation and coordination? There is a huge benefit in tax administrations cooperating with each other. We have already seen this with the taxation of high net worth individuals, on some aspects of banking, and the transfer pricing study led by the UK, which was really a cooperative effort of about 16 nations. Coordination between tax administrations is much more in its infancy. The OECD study on joint audits viewed them as a really effective compliance tool. The UK and Dutch revenue authorities, for example, have done some joint audits where the two tax administrations worked very closely together, in some cases with one authority effectively carrying out the work for both with the full involvement of the corporate. That saves time and money for the corporate and for the tax administrations as well. When I reviewed this with the Dutch Tax Commissioner four or five months ago, we were both hugely satisfied with that approach to coordination.

Over recent years, tax has clearly become a more important boardroom question, as boards and audit committees have taken a firmer oversight of tax issues. Have you felt this transition happening within HMRC? For most large corporates in the UK, and for many mid-sized ones, tax is now firmly on the boardroom agenda. No board today - they want to know about the big tax risks. The days when the tax director got to visit the board for two minutes once a year, usually at Christmas, are long gone. The tax director is now expected to know a great deal more about the business: how it's run; how it makes profit; and the role of tax in all this. And the tax director and the CFO are expected to be able to brief the board on major tax issues. In many corporates today, the CFO knows that, if there is a big tax surprise, they may not become as secure in their job as perhaps they once thought.

The role of the non-executive director has also been an interesting development. Over the past 10 years, non-executive directors have become more professional. Some sit on several boards and take their tax learning from one board to another. Of course, the best thing if they don't fully understand taxation, but what is important is that, where non-executives are engaged and know something about tax, they are a powerful force for good.

More than 20 multinationals have recently announced plans to move their regional or global headquarters to the UK over the next year. How would you assess the competitiveness of the UK's tax regime? Clearly, there are tax policy factors that have helped to improve the UK's competitiveness, such as reducing the headline rate of corporate tax or the changes to the CFC rules. Companies want a tax administration that can be quite commercial in its outlook and that focuses on the things that really matter, rather than the trivial issues. I think that the UK tax administration scores a lot higher on this now. But there are other important developments that have nothing to do with tax at all. The British legal system, for example, is clearly prized by many corporates.

The fact that companies can engage with the UK tax administration is another strength. I don't mean that companies get a soft touch, but rather that they can talk through important tax issues. This means that both the tax administration and the corporate can put their cards on the table about issues that are likely to be either impacting on current taxation or will impact on taxation in the future. This also means that large corporates can build sufficient trust with the tax administration to be willing to share their strategic thinking as to where the company is going.

Looking forward, what other important developments do you see internationally in terms of tax policy and administration? I think one of the biggest changes we will see is how we address risks posed by low tax and secrecy jurisdictions. The UK was the first country to approach Switzerland to see whether it could negotiate an agreement and, in 2011, the Swiss Government agreed to tax undeclared Swiss bank accounts by British taxpayers. Now, there are three agreements and a number of others under consideration. I think the approach is working, but countries more likely to work together. So, instead of one country doing it on its own, we will perhaps see five countries working together. I think this will be an important development.
Setting new policies on tax is an exercise fraught with difficulty, with unexpected outcomes cropping up all too often. Understanding this is the first step toward reducing the frequency and impact of any such issues.

In science, the “observer effect” describes how the very act of measuring something has an impact on what is being measured. For example, an ammeter, by being wired into an electric circuit in order to measure its current, reduces that very current. A similar phenomenon has long been visible with tax policy. The act of measuring economic activity or assets, and then using that information to decide tax policy, has an inevitable impact on the things being taxed.

Sometimes, this is the actual goal: tax breaks in numerous countries promote individual retirement saving, for example. Often, though, given the complexity of modern, globalized economies and their tax codes, the results of poorly thought-through policy changes can be unfortunate, with various unintended consequences.

In November 2012, Denmark abandoned the fat tax it had pioneered the year before, after realizing it had resulted in higher costs for businesses and simply prompted Danes to buy such products in cheaper neighbouring countries instead. The country’s tax ministry also cancelled a proposed tax on sugar.

The proposed price increase, per kilogram of saturated fat in a product, which was due to be added to all food products, from milk and cheese through to prepared pizzas in Denmark.

Summary
Setting new policies on tax is an exercise fraught with difficulty, with unexpected outcomes cropping up all too often. Understanding this is the first step toward reducing the frequency and impact of any such issues.

Unintended consequences
Setting tax policy is fraught with challenges, with many well-intentioned ideas leading to unexpected outcomes. Unfortunately, there are few easy solutions to address this somewhat inevitable problem.

By Dr. Paul Kielstra

Credit: Keystone / Heritage Images
At one extreme, raising certain taxes can increase criminality. For example, different American states have sought to plug revenue gaps, some have turned to higher levies on cigarettes. American authorities report that the growing disparity in such tax rates is leading to significantly higher levels of interstate smuggling, including by organized crime groups (see chart). A more dramatic example of the same effect involved the recent discovery of a 700 meter long secret tunnel, with the open market, the conversion triggered substantial tax. At the end of the year, the company reported a deferred tax liability of €134m, while its gross operating profit was just €18m. Similar cases led to the law being repealed in 2005.

Multiplier effects

The study of these unintended consequences goes back decades. As early as 1936, American sociologist Robert K. Merton identified a series of possible reasons for unexpected results of actions in any social sphere. These included four that remain of relevance to tax policy-making.

Unexpected outcomes cannot be completely eliminated from tax policy

The proportion of executives participating in a survey during an Ernst & Young webinar in October 2012 that predicted that more countries would introduce GAARs.


Correcting unintended consequences

Of course, correcting unintended outcomes can never be completely eliminated from tax policy. Nevertheless, the underlying drivers for this policy failure mean that authorities can take in order to reduce their frequency and impact. The most obvious is to address the issues of lack of knowledge and error. This begins with government departments devoting the necessary time to considering what they are doing. Sanger notes that there are “some examples where policies have been delivered exclusively because of a political mandate rather than a true economic analysis.” As Tom Daniels, a Partner with Ernst & Young Tax Advisors in the Netherlands, and a Professor of Tax Law at Nyenrode Business University, adds, that, too often, not enough time is taken in the legislative process to consider complex issues that require clarification. "Therefore, the economic consequences of actions taken by governments need to be considered, and the government needs to be able to do policy U-turns when the need becomes clear." If a policy is politically difficult in undertaking some tax reforms," he explains, “because doing so seems to accept that what was once right no longer is. Being able to accept that policies will need to be reformed - and that tax is not a fire and forget activity - is critical."

Of course, trying to strip out the underlying politics from any tax decision is a tall order, but governments at least can develop processes to scrutinize legislation in the drafting of legislation or regulations. Such consultation can take various forms. The Australian State of Victoria, for example, has a State Taxes Consultative Council – made up of senior members of the State Revenue Office, professional bodies and industry executives - which meets quarterly to provide input into policies and procedures. The UK takes a different approach: since 2011, under its Tax Consultation Framework, the Treasury has conducted multiple, ad hoc consultations on specific issues. Whatever their form, however, making such initiatives effective requires effort on both sides. Sanger finds that often businesses are willing to “engage on policy only once they see the legislation in place.” That may be too late to make meaningful revisions. And the actual process of consultation has to be carefully considered too. Daniels notes that consultation “is important but can have a negative impact if it delays the legislative process because it can create uncertainty. You need a balance.”

Tackling complexity

Beyond these tactics, a number of strategic considerations can also help reduce the number and frequency of unintended consequences. The first is eliminating complexity across the system. The OECD’s 2006 Policy Framework for Investment: A Review of Good Practices puts the problem well in discussing tax exemptions designed to stimulate investment: “Tax incentive relief, even when targeted… will always be

sought by businesses outside the target group.” Tax-planning strategies can be expected that will deplete tax revenues from actions that government was not willing to prevent or that provide authorities with a way to override the tax benefits of transactions or arrangements typically on the grounds that they are not allowable. Often, when tax authorities make such a claim, the burden of proof switches to the taxpayer to demonstrate the necessary economic substance, rather than the authorities needing to prove there is no such substance.

Guarding GAARs

But GAARs also bring their own dangers, and indeed their own unintended consequences. In particular, they create uncertainty around the tax base for transactions, and the provisions can be used to override a host of transactions. A resulting drop in business confidence and investment, especially in the case of a badly planned GAAR, might damage the economy far more than the government would benefit from increased revenues.

Overall, there is less that can go wrong,” as he puts it. The easiest way to prevent unintended consequences, however, focuses instead on the taxpayer. General anti-avoidance rules (GAARs) are a key example. These are a cornerstone of general principles based rules within a country’s tax code designed to counteract the perceived avoidance of tax. Instead of a set of rules, they provide authorities with a way to override the tax benefits of transactions or arrangements typically on the grounds that they are not allowable. Often, when tax authorities make such a claim, the burden of proof switches to the taxpayer to demonstrate the necessary economic substance, rather than the authorities needing to prove there is no such substance.

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Giles Parsons

At Caterpillar, the construction equipment and diesel engine manufacturer, Parsons’s responsibilities range from direct and indirect tax in Europe to global strategy for indirect taxes and customs duties. At the core of his role is risk management: avoiding problems before they occur.

Risk in the shadows

Tax is increasingly about risk management. But many of these risks arise from failing to implement proper processes and working relationships between tax and the rest of the business.

Summary

Businesses run serious non-compliance tax risks unless they have clearly identified who the process owners are. It is important to have excellent communication across the whole of the ‘shadow’ tax team and not just the core.

By Andrew Sawers

Caterpillar realized its potential exposure when Parsons noticed that the company was incurring additional taxes, duties and penalties, and was in dispute with tax authorities in a number of jurisdictions including the UK, Russia and Mexico.

"We had a lot of processes that had evolved over a considerable period of time and, because nobody globally actually owned those processes, they developed in their own way to address local issues," he explains. "When that person moves on, their successor doesn’t necessarily understand what they were doing and why, so you then get ingrained practices that are not necessarily the best."

Today, a global set of requirements has been put in place for all Caterpillar facilities to follow:

- A very clear framework of what the local processes need to deliver
- Identify the global process owner for each major area, and the local process owner
- Set up guidelines for what the processes actually have to deliver

Credit: Muir Vidler
100% of unpaid taxes across jurisdictions, tax authorities are becoming increasingly keen to protect their revenue and enforce their laws. They are also, as Michael Nelson at PwC says, "becoming increasingly skilled." Through training, the recruitment of experts from the private sector and the growing use of drill-down technology, tax authorities are raising their game. Accordingly, the type of relationship that companies have with them is more critical than ever.

"We certainly contest issues on their merits but we'll reach reasonable resolutions and we try to provide high-quality information on a timely basis so that auditors can do their jobs properly," he says. "Quite simply, it is not helpful to have tax litigation or arguments dragging on for ages, instead, resolving such disputes helps to contribute some certainty for the company. "And that certainty is a contributor to risk management," notes Nelson. At Caterpillar, Giles Parsons thinks that having better-trained tax agencies is good for the business. "I would far rather have the inspector understand what our business is and ask sensible questions, rather than having endless correspondence with them about something that they don't understand," he says. "They can sometimes get too far embedded in their questioning and won't take no for an answer. They think they're onto something and they're not." But there remains a question of how far to take this relationship with the authorities. In his view, Parsons advises caution about entering into formal relationships, such as contemporaneous audits with the US authorities. "You may have to commit to doing a lot of things to get systems up to date, you may have to commit to telling them absolutely everything, and you may have to commit to making significant disclosures to them, which can be commercially sensitive," Parsons says. "The arrangement we have in the UK, and in some other European countries, is far more of a professional relationship between two parties, where they are both disclosing a reasonable amount of information to each other, to allow them to focus on the most important issues and make sure both more efficient."
As businesses seek to increase the volume of trade they conduct within rapid growth markets, new tax hurdles await. Rapid growth markets not only bring potential, but also increased complexities and exposure to different tax risks. This is especially true as local policies and enforcement get stricter. So how can firms cope?

Emerging markets flex their (tax) muscles

Rapid growth markets not only bring potential, but also increased complexities and exposure to different tax risks. This is especially true as local policies and enforcement get stricter. So how can firms cope?
From a tax perspective, doing business in emerging markets can be a considerable challenge. Many local tax authorities have few established regimes and protocols to deal with taxpayers and limited resources overall. There is often a lack of available guidance, case law and precedent, which can leave foreign businesses in the dark about how to navigate these markets. This can be particularly complex in Asia. In South America, the enforcement landscape is also becoming stricter – and more global in nature. In Brazil, the specialized tax offices in São Paulo and Rio de Janeiro that look after large corporate taxpayers, have taken a tougher approach when auditing large companies, targeting issues such as tax planning and corporate restructuring. Transfer pricing, controlled foreign corporation (CFC) rules and international tax.

Challenging OECD standards
Many of these policy and enforcement trends are in line with standard OECD approaches. But increasingly, as these markets become more confident and sophisticated in their approach, they are challenging commonly applied international tax standards. This has proven particularly true in transactions involving foreign-based companies. Here, some markets are levying taxes on events that may previously have failed to trigger taxation, such as indirect capital gains and transfer pricing. Indeed, in Ernst & Young’s 2011-12 Tax Risk and Controversy Survey, tax executives, policy-makers and tax administrators identified transfer pricing as a leading risk. Although OECD transfer pricing guidelines have long been accepted as the “international standard” in most markets, these can still be hugely challenging. This is largely due to a lack of comparable transactions between unrelated parties to show that companies’ pricing of intercompany transactions in consistent, which is key to the arm’s length principle. With an increased focus on transfer pricing, the OECD is considering changes to its transfer pricing guidelines for multinational enterprises – particularly in the area of intellectual property rights. Quoted in the Financial Times, Pascal Saint Amans, the OECD’s top tax official revealed that “intangibles are clearly a key area of concern where transfer pricing rules must be clarified to avoid abuses and localisation (of) intellectual property in low tax jurisdictions.” Such changes in the approach of the OECD also have implications for local tax administrations. The Indian Government has, for example, recently condemned the use of the OECD Transfer Pricing Guidelines by the UN, proposing instead the UN develop an alternative that benefits developing countries. However, the UN protocols are more complex, which introduces additional challenges for companies. Furthermore, varying local requirements on transfer pricing often means that standard documentation won’t work, raising further complications. All told, there are clear opportunities to pursue across many Asian markets, but a range of challenges is inherent within these too. 

Focus on Asia
The regionalization challenge

Foreign investment into Asia has continued to substantially from outside multinationals. Traditionally, companies have set up their operations in Asia on a stand-alone local country operations basis. That is now changing. More companies are now looking to regionalize their supply chains to capitalize on market opportunities, streamline costs and simplify their operations in response to greater competition and tougher macro economic conditions. “Companies find it makes a lot of sense to work in a centralized and harmonized way – coordinating supply chains and procurement, taking advantage of tax efficiencies – even if specific countries have their own tax-specific hurdles,” says Edvard Rinck, a Partner in Tax Effective Supply Chain Management (TESC) at Ernst & Young China. “Coordination may be harder to achieve because of local logistics challenges and the limited resources of tax administrators to respond to taxpayers’ issues.” Effective treasury strategies deliver cash to fund regionalized growth, but are limited by the foreign exchange control regulations in many Asian countries. “Companies are asking themselves how they can practically manage the regional treasury functions due to these regulations,” says Matthew Andrew, Ernst & Young’s Asia Pacific Tax Effective Supply Chain Management Leader. “In this way, treasury considerations are driving to greater competition and tougher macro economic conditions.

Transfer pricing is another key problem area for companies in Asia. “Even though they may broadly follow OECD guidance on transfer pricing, some tax authorities in Asia are taking varying approaches to practically applying and auditing such matters,” says Andrew. “Other practical challenges of regionalizing a supply chain include non-resident VAT/GST registration, where even registering an offshore Principal for VAT/GST in some ASEAN countries will create a taxable presence for corporate income tax purposes.” Many Asian countries are adopting transfer pricing approaches from other markets. Exit charges, where local tax authorities try and secure arm’s-length compensation from companies for moving functions and responsibilities to other countries, is one example that has recently emerged. At the same time, there is growing pressure from some Asian markets to challenge commonly applied international standards when it comes to transfer pricing. The Indian Government has, for example, recently condemned the use of the OECD Transfer Pricing Guidelines by the UN, proposing instead the UN develop an alternative that benefits developing countries. However, the UN protocols are more complex, which introduces additional challenges for companies. Furthermore, varying local requirements on transfer pricing often means that standard documentation won’t work, raising further complications. All told, there are clear opportunities to pursue across many Asian markets, but a range of challenges is inherent within these too. 

73% of respondents feel that entering into or operating in emerging markets significantly increases their levels of tax and tax controversy risk.

92% of China-based companies confirm that they have experienced a rise in the volume or aggressiveness of tax audits in the last three years.

85% of India-based companies and 88% of China-based companies have experienced growth in disclosure and transparency requirements in the last two years.

Focus / Toughening up /
Information exchange among tax administrations is now the norm, which means that the era of tax secrecy is well and truly over.

principles. For one, the risk of double taxation and the need to enter mutual agreement procedures is reduced. For Russia, this uncertainty had real practical impact as it sought to introduce enhanced tax systems. The ever-longer arm of the law.

Focus

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approach pursued by countries in the region can be different even on the same tax issue. Even the arguments in the different markets. “The approach pursued by countries in the region can be different even on the same tax issue. Even the arguments in the different markets. “

Despite the challenges, there is no doubt that tax administrations in fast-growing markets are becoming more skilled. The OECD is playing a part in this too, its “Tax Inspectors Without Borders” program, for example, seeks to match “demand” from countries wanting outside help with complex international tax audits with the “supply” of international experts.

Nonetheless, the transformation from “emerging” to “developed” market, at least when it comes to tax policy, legislation, administration and culture, is not a quick one.

The way forward

Despite this development, companies still need to address the distinctive approaches to tax that individual countries have adopted. Across Asia, says Andrew, tax directors can face a wide range of arguments in the different markets. “The approach pursued by countries in the region can be different even on the same tax issue. Even the arguments in the different markets. “

So what can companies do? First and foremost, companies need to improve their knowledge of local tax administration processes and approaches for each market - which vary across markets and within markets as well. This includes strong local knowledge of risk rating processes in each country, including key focus areas and potential audit triggers. Crucially, they need to get a good understanding of how tax law is being applied in practice, to grasp the rationale for the decisions and approaches being taken.

“Companies that want to have a meaningful presence in the emerging markets need to know what the legislature and the tax authority of each nation are planning, and closely monitor the tax policy actions of countries that have already dealt with such issues,” explains Becky Lai, Tax Policy and Controversy Leader at Ernst & Young in China. “Companies that constantly build their levels of intelligence around the approach and processes used by local tax administrations can better manage their tax risks and controversies.” Senior management also needs to take concrete steps to improve local tax authority relationships.

Communication and education has a key role to play, notes Escobar. “In my experience, many cases and litigation are the result of a lack of effective communication between the business and the tax authority; that is something that companies need to work on, so that the tax authority can increase their understanding of the business,” he says.

From dispute to debate

Organizations also need to show a willingness to engage with policymakers and administrators to improve policy. Too often, this only happens when problems arise. “Most companies are too reactive,” says Escobar. “Companies need to be willing to reach out to engage in advance. They need to begin to communicate with technical advisors and politicians, to explain, for example, they cannot make their tax system work if they are missing certain enablers.”

Experts suggest that companies should also seek to understand, and make better use of, any dispute resolution processes that are available. Does a local market support so-called “enhanced dispute resolution”, as one example? Are there as many opportunities for dispute resolution? In China, a taxpayer that disagrees with an act or decision of a tax authority has a right to seek an administrative review. Although this process requires considerable procedures and paperwork, it is nevertheless regarded as a less time-consuming means of dispute resolution than litigation.

Regarding transfer pricing, Andrew recommends that companies explore the possibility of advanced pricing arrangements, or APAs, where possible. These allow taxpayers to set an appropriate transfer pricing position in advance of a return being filed. “In the short term, I think companies should explore using the bilateral or unilateral APA, for upfront agreement on the transfer pricing position for complex and high value transactions. Certainty on broader corporate tax positions may also be obtained through advanced rulings.”

Finally, as ever, documentation is crucial, particularly as requirements become stricter in many emerging markets. “This is a critical issue,” says Escobar. “Many of the problems that companies encounter in emerging markets are analyzed by tax authorities years after the people making the decisions have moved on to different parts of the business. It becomes very difficult to deal with the conflict and to work out what actually was going on at the time.”

But this may be only part of the preparation required, warns Andrew. “Documentation, while essential, is only one part of the requirement to evidence appropriate substance in your structure. Companies also need to make sure they have appropriate intercompany agreements, documented processes, employment agreements and the reporting framework in place; the reporting structure all has to look and feel the same.”

The ever-longer arm of the law

Information exchange among tax administrations is now the norm, which means that the era of tax secrecy is well and truly over.
Cross-border information exchange by tax authorities is nothing new. Even as far back as World War II, some tax treaties had exchange provisions. But, over the years, relatively little information was actually exchanged. The first seismic shift came in 2009 with G20-country pressure to crack down on tax havens and bank secrecy by introducing agreements on exchange of information upon request. Now, a second major shift in information exchange is under way. Tax authorities across borders are cooperating to an unprecedented extent and significantly more data is now passing from one national body to another – and for issues that go far beyond bank secrecy.

Why now?
The catalyst for major action came in 2009 following the G20 meeting in London. “The crisis led countries to seek deeper revenues and to show their citizens that all taxpayers were paying their fair share of taxes in their home country,” says Jeffrey Owens, Ernst & Young Senior Policy Advisor to the Vice Chair-Tax and former head of the OECD’s Centre for Tax Policy and Administration. “With the combination of technical work that the OECD had been doing and political support from the G20 in place, things really began to move forward.”

Three years on, the policy and regulatory environment for information exchange on tax matters has changed substantially. The OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes now extends well beyond core developed markets, with support not only from the G20 but also international institutions such as the World Bank, International Monetary Fund, European Commission, European Bank for Reconstruction and Development, and Asian Development Bank as well as regional tax bodies such as African Tax Administration Forum, and Inter-American Center of Tax Administrations. “There is now universal acceptance that effective information exchange on tax matters is an essential part of a well-governed and stable financial system,” says Mike Trott, who has just completed a three-year term as Chair of the Global Forum on Transparency and Exchange of Information for Tax Purposes at the OECD.

In April 2009, the OECD launched its list of jurisdictions supporting bank secrecy and impeding information exchange. Countries were scored on banks, secrecy, tax, and depending on the steps that they had made to ease the flow of information and clamp down on bank secrecy. Today, not a single country remains on the OECD’s “black” list, although some jurisdictions are still working toward implementation of standards. In the past three years, Global Forum has moved from a relatively fragmented group to a focused, peer-driven forum at the forefront of driving international standards on tax transparency. At the regional level as well, there is a proliferation of standards for information exchange and implementations of active exchange measures.

A company concern
The rise of information exchange has significant implications not only for high-net worth individuals, but corporates as well. Key areas of focus for information exchange include transfer pricing, along with aggressive tax planning that uses hybrid or highly structured products involving a connection with a tax haven or offshore financial center. But ultimately, any item of income, deduction or credit with cross-border effects can have information exchange implications, as can indirect taxes. For example, if one country determines that an incorrect excise tax rate has been applied, there may be a presumption that incorrect rates are being used in other jurisdictions as well, notes Arjo van Eijsden of Ernst & Young’s Tax Policy & Controversy Group.

And it is becoming more likely all the time that inconsistencies will be uncovered. Since 2009, more than 800 bilateral tax information exchange agreements have been signed under the auspices of the Global Forum and the number continues to grow. Multilateral agreements are also on the rise. On 1 June 2011, an amended Convention on Mutual Administrative Assistance in Tax Matters, a multilateral OECD agreement, came into force. Following the Forum’s October 2012 meeting in Cape Town, South Africa, 50 countries have either become signatories or have stated their intention to do so. The expanding and broadening of the Convention, also attributed to the G20’s call for action, provides for exchange of information, the facilitation of joint audits and other provisions. And notably, the convention is open to both non-OECD and non-EU countries.

At an EU-level, exchange measures continue to grow. The Interest Savings Directive now requires EU Member States to provide other EU countries with information on interest savings held in other countries. The directive also includes an automatic exchange of information for all 27 Member States on cross-border interest flows. Another measure is the EU’s Council Directive, which has broader rules for administrative cooperation and new rules for the exchange of information that go into effect on 1 January 2013. Here again is another push for automatic exchange, taking place at the same time. The directive provides for automatic exchange of information regarding income from employment, directors’ fees, life insurance products not covered by other EU information exchange measures, pensions and ownership of and income from immovable property.

Yet another information exchange initiative is the US Foreign Account Tax Compliance Act (FATCA), which is aimed at preventing tax evasion by US citizens and residents through the use of offshore accounts. The act not only affects US companies – it impacts foreign financial institutions and certain other foreign entities with US assets or clients.

Joint and simultaneous audits
Coordination of joint audits is starting to go beyond mere information exchange. “Governments are beginning to move from just cooperating to actually coordinating their codes to get better tax compliance,” says Owens. The rise of joint audits – by which two or more countries form a single audit team to co-operate on a taxpayer examination - is one notable area in which this coordination is already happening. For example, the new EU Directive on Mutual Assistance facilitates joint audits as of 1 January 2013. While such audits mean that a taxpayer’s position across borders will quickly become transparent, joint audits can also benefit companies as much as they do governments. “If you have a joint audit, it helps you to resolve issues on a real-time basis and it reduces the risk of double tax information partners in the room,” explains Owens. “I think tax directors need to examine more carefully the work that’s being done by the Forum on Tax Administrations really began to move forward.”

On the horizon
As these activities continue to increase, so does the speed at which countries are signing bilateral and multilateral agreements to expand the international exchange of information. “We have seen an increase in the frequency of exchange and in the contents of the information exchanged,” notes van Eijsden. “We are also seeing that the information is being exchanged more quickly than in the past.”

Moreover, the work of the organizations overseeing these initiatives has only just begun. Peer reviews, which are designed to assess a country’s implementation of information exchange agreements, are under way, who has just published Phase 1 reviews - which review the legal provisions in place - have been done for about 80 countries. These reviews test that the legislation is established and assess whether there are any legislative barriers to effective exchange of information. What will now happen is a move to Phase 2, which covers how countries have implemented the exchange, or “Phase 2. These reviews will look at each country responds to a request for information, if it does so on time, whether the information is of a high quality and so on,” explains Owens.

As information exchange rises, so does the question of confidentiality. Some issues to be addressed include how much information the tax authority can ensure that it will maintain the confidentiality of information received, and how to prevent speculative searches for incriminating information, so-called “fishing expeditions.”

Information exchange in a smaller world
It is difficult to overstate the impact that information exchange has had on the international tax landscape. “The era of bank and tax secrecy is well and truly over,” says Rowston. “And with the increasing level of cooperation occurring between tax authorities around the world, not only is non-compliance likely to be uncovered, but tax authorities are also improving their capacity to administer their tax systems.”

Owens agrees. “Over the next decade, there is going to be one word that’s going to dominate the tax debate, particularly the international tax debate, and that word is transparency,” he says. In an era of increasing financial and reputational risk - and exchange of information - that’s a word for multinationals to heed.
A personal risk for corporate travelers

Business travelers are becoming important targets for tax authorities and companies ignore the tax risks of a mobile workforce at their peril.

By Victoria Sheasby

The art of taxation,” said Louis XIV’s Finance Minister, “consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.”

As a country’s own citizens and taxpayers tend to hiss loudly, governments around the world are looking for foreign geese to pluck as they try to recoup the tax revenues lost during the global financial crisis: tax receipts across OECD countries fell to their lowest level in two decades after the crisis, adding pressure to already overstretched government finances.

Against this backdrop, the highly paid globetrotting executive, brokering deals and business across borders, has become a popular target for tax authorities globally. “Short-term business travelers are a vulnerable constituency,” says James Egan, Global Head of Ernst & Young’s Global Immigration practice. “They are not voters. The local population is feeling very hard pressed, and the authorities see them as a source of revenue they can exploit and for which there is lots of public support.”

That short-term business travel creates tax liabilities for individuals and companies is nothing new. What is new is the capability of the authorities to track this business activity, to pursue lost revenues more aggressively.

Travel in the information age

Advances in technology and information exchange have given the authorities muscle. Responding to perceived vulnerabilities in border controls after 9/11, governments invested hugely in border technology and smart passports. They now have accurate, up-to-date and traceable data on the comings and goings of foreign nationals within their borders. And they have found this data as useful for tracking immigration and tax rules differing between countries than for the needs of individual expatriates. It’s not wholly a corporate issue since they deal mainly with the needs of individuals and companies have responded more slowly to the increased risks they face from more aggressive enforcement. “Five years ago, we were educating corporations, and they didn’t want to know,” says Jay Sternberg, Principal of Ernst & Young’s Global Tax Services, “because these companies are struggling with is who is responsible for managing the risks.”

While the authorities have upped their game, companies have responded more slowly to the increased risks they face from more aggressive enforcement. “Five years ago, we were educating corporations, and they didn’t want to know,” says Jay Sternberg, Principal of Ernst & Young’s Global Tax Services, “because these companies are struggling with is who is responsible for managing the risks.”

In their search for revenues, some tax officials are even beginning to supplement immigration data with detective work. Foreign nationals traveling to Nigeria on business, for example, stay in only a handful of major hotels in Lagos. The authorities are going into these hotels and tracking who is staying and for how long. In the United States, officials have demanded access to executives’ PCs to review their business activity. The information exchange does not stop at a country’s borders. Like the multinationals they track, tax authorities are crossing borders. By exchanging data with their counterparts overseas, tax agencies can compare risk profiles for companies operating in their jurisdiction.

Shifting destinations

Globalization is also increasing the revenue opportunity. Although difficult to quantify, revenues that tax authorities can collect are substantial. The United States reckons it is owed considerable sums in underwithheld taxes, penalties and interest by domestic short-term business travelers.

Given the revenue opportunity, it is not surprising that some countries are focusing on tightening up their regulations as well as better enforcement. Mexico, India, Sweden and Australia all introduced new requirements for business travelers in 2012, which are likely to result in higher costs for employers. In the United States, the new regulations are even more aggressive than their European counterparts, requiring companies to pay $5m in back taxes and penalties after failing accurately to report home-paid income. In China, a manufacturer was forced to pay $US33m in back taxes and penalties following the largest payroll audit ever undertaken by the Chinese authorities. And in India, a European multinational faced penalties of £5m for failing to report full home-paid compensation for employees assigned to work there.

The consequences of failing to address the issue can be severe. One UK corporation was forced to pay £40m in back taxes and penalties after failing accurately to report home-paid income. In the United Kingdom, the threshold for triggering a PAYE liability is the legal equivalent of opening up an office in the host country. Creating a PAYE is the biggest tax risk companies face from sending employees on business or assignments overseas, bringing with it a host of expensive regulatory, filing and tax obligations. “The threshold for triggering a PAYE is becoming lower,” says James Egan. “And there’s not a CFO that hates more than having a new PAYE thrust on him.”

Some countries, the logic is, the more the authorities are able to capture data on their activities. “This is where the whole issue has become difficult for companies to deal with,” explains Kevin Cornelius, Human Capital Leader at Ernst & Young Switzerland, “because these issues do not traditionally fall into any one department. It’s not entirely an HR and mobility issue since they deal mainly with the needs of individual expatriates. It’s not wholly a corporate tax department issue because they are interested in permanent establishment and transfer pricing risk, nor payroll and immigration. Legal have an interest due to reputational risk. Finance have an interest because they have to control payroll. So what a lot of companies are struggling with is who is really responsible for managing the risks, issues and administration.”

At the moment, involving all these functions appropriately is key to managing financial risks as well as administrative ones. Given the number of moving parts, many companies choose to use a proprietary system, such as Ernst & Young’s Traveler Risk and Compliance (TRAC) system, which alerts companies to tax, payroll and PE implications of business travel. “Although you can’t take all the risk off the table,” says Egan, “you can mitigate it.”

Once they understand the scale of the population, they need to establish a mechanism to track short-term business travelers and capture data on their activities. “This is where the whole issue has become difficult for companies to deal with,” explains Kevin Cornelius, Human Capital Leader at Ernst & Young Switzerland, “because these issues do not traditionally fall into any one department. It’s not entirely an HR and mobility issue since they deal mainly with the needs of individual expatriates. It’s not wholly a corporate tax department issue because they are interested in permanent establishment and transfer pricing risk, nor payroll and immigration. Legal have an interest due to reputational risk. Finance have an interest because they have to control payroll. So what a lot of companies are struggling with is who is really responsible for managing the risks, issues and administration.”

The amount one UK corporation was forced to pay in back taxes and penalties for failing to accurately report home-paid income.

£40m
In an interview with Ernst & Young, Dave Camp, the Chairman of the House Ways and Means Committee, says the path to successful tax reform in the United States requires input from business.

**Reforming America’s tax code**

In an interview with Ernst & Young, Dave Camp, the Chairman of the House Ways and Means Committee, says the path to successful tax reform in the United States requires input from business.

Dave Camp has been chairman of the US House of Representatives’ Committee on Ways and Means since 2011, the committee that oversees revenue measures. He identifies tax reform as his top priority in the next two years and makes the case for why this is needed, as well as the tensions involved in designing a system that is in sync with the rest of the world.

You've been an outspoken advocate of tax reform, and there seems to be a growing consensus on the need for real changes in the US tax system. When you talk to your colleagues in other countries, what do they say about the current state of US tax law?

Dave Camp: They’re dumbfounded! They’ve made a lot of the reforms that we need to make, so they kind of look puzzled, like, “Why aren’t you doing this?” So you’re trying to explain the lack of action here a lot of times. They’re doing it — they’re reforming their codes; they’re simplifying, they’re lowering rates because they know that if they can attract those high-paying jobs, their economies will do better, the government revenues will go up and they’re going to be able to meet the needs of their citizens.

**Let’s focus on the business tax side now. One area where there seems to be widespread agreement among policymakers and among business leaders is the need to reduce the US corporate tax rate. You’ve talked about reducing the corporate tax rate to 25%, which would bring the US rate much more in line with the rates of your major trading partners. How do you envision getting to a significant reduction in the corporate tax rate with a constraint of revenue neutrality?**

Well, the 25% rate is obviously our goal, and we’re going to have to go through and look at all of the various tax provisions and understand the impact of making those changes to the code. If we can get a tax code that meets that goal, we believe there will be a pro-growth element to that and you’ll actually see revenue to the Government. That’s been the case in every tax reform that’s occurred, whether it was the Kennedy years or the Reagan years, and I believe that could happen again.

You’ve talked about your objective of making the United States a more attractive place to invest and you held a hearing focused on the tax considerations of foreign companies investing into the United States. How should US tax reform affect inbound investment?

We need and want more of it. Plain and simple. I want the United States to be the most attractive place in the world for capital investment. And what we are hearing from foreign-headquartered companies with US operations is that the best thing we could do is lower our corporate rate.

Thinking about the rest of the world, as you look at the design of what would be an optimal US international tax system, not only for today’s economy but also for the future economy, are there particular insights that you see to be gained from the choices that other countries have made in their international tax approaches?

We’ve tried to get insight into what other countries are doing, but that doesn’t mean we’re going to mirror them because we have our own unique challenges and our own unique economy. But I do think it’s very important to get that sort of understanding because that’s how we’re competing with. So we do have to have some sense of what’s working, and why, in other parts of the world, but we’re going to need to design a uniquely American tax system for us.

What do you see as the benefits of undertaking international tax reform on a revenue-neutral basis, and why do you see that as so important?

I think if you have one section of tax policy being used to pay for another section of tax policy, it would be very hard to get consensus on the sorts of reform you need. This is all about “How do we get our economy moving again? How do we get job growth in the United States and how do we get people back to work?” And one of the ways you do that is not have an antiquated, outdated tax system that actually penalises the kind of job growth that might occur in the United States by bringing dollars back. But we have to understand that not every country has our rules, so there does need to be some sense of dealing with the base erosion issues. We’ve got a number of ideas out there and we’ve not settled on one, and we’re still getting input; we got more feedback in the committee as late as yesterday. So it’s a very important area — it’s an important area to get right — and that’s why I think it was very important to get out there early, in a more detailed way, and give those affected stakeholders an opportunity to come back with feedback.

Your international tax proposal has advanced the debate by providing details that allow businesses to do both qualitative and quantitative analysis of the potential impact of the proposed changes to their operations. What should businesses be doing to keep this dialog going as your work advances?

Well, we want those evaluations and thoughts. Again, we’ve got really good people on the committee — good members, great staff on the committee — but we can’t possibly know the nuances and complexities of every business in America as those who own and operate them and are employed in them do. So we’re trying to understand what’s going to work. This is all about trying to get the best tax code in the world for the United States so that we can be the number-one economy, we can have the best credit rating, we can have the highest job growth, we can have the highest GDP growth. And the result of that is that those benefits will extend to people, with more jobs, higher income and more prosperity. That’s what this is all about.

Now some questions about the process for getting tax reform done. In thinking about the legislative path for tax reform, do you think that tax reform is separable from entitlement reform and deficit reduction?

I do. I think they’re all critical issues facing our nation, so I’m not trying to minimize the others, but I do think you can do tax reform on its own. I think if you try to make tax reform about reducing the deficit, it makes it much harder. I think tax reform should move on its own, in a comprehensive way, and not be seen as a path to reducing the deficit or balancing the budget.

It’s interesting to hear you talk about what the rest of the world is doing and how we should consider some of those changes they have made. At the same time, you are clear on the need to create a uniquely American tax system. One of the tools that these other countries use is VAT. What is your thinking on that these days?

I don’t see it having viability. Having said that, I’m not going to foreclose any discussion but I don’t personally see it as a viable alternative. It’s been rejected 97-0 in the Senate, it’s never been popular and I don’t see it as really an alternative. But I’m not going to foreclose anyone else in terms of discussing that issue, and I think a good example of that is a 2011 hearing we had on alternative systems of taxation.
The rise of a new role

International companies are employing specialist skills to mitigate the risks of a renewed focus on controversy over tax.

By Nigel Gibson

With governments struggling to pay off their debts and companies squeezing every last ounce of profit out of their operations, it is no wonder that disputes over tax are becoming more frequent. Indeed, the risk of disagreement, particularly between national authorities and international companies, has rarely been greater. Is it time for a new hero or heroine to appear? Enter the newly crowned heroine to appear? Enter the newly crowned head of tax controversy.

Part of the problem is that, as the pace of globalization has accelerated, and with it the mobility of capital, so the amount of tax collected from companies by governments within the OECD has declined, particularly over the past 25 years. Countries have countered this by broadening their tax bases, sometimes with limited success. In some developed markets, disagreements have sometimes on a real-time basis, particularly about international companies, messages can quickly become mixed. Penalties differ: what might be just a warning in one jurisdiction could result in criminal sanctions or a tough penalty in another.

What is clear is that globalization has created not just opportunities in new markets for firms able to move quickly; it has also underlined the value of such things as intangible assets, royalties, service fees, the financing of subsidiaries within a group and, of course, intellectual property. As the balance of economic growth shifts toward services, these add up to greater weight than they did before.

From here, too, it is a short hop to the complexities of transfer pricing. Transfer pricing is the tool for allocating profits where economic activities cross borders and, as such, is one that is a frequent subject of disagreement between companies and tax authorities. Add to that the fact that the size of tax losses carried forward by companies has risen steadily in recent years, and it is no wonder that disputes are on the rise.

New routes to consider

To guard against abuses, more and more governments have chosen to apply new rules often to restrict the way in which losses can be used to offset tax. So much so, in fact, that rarely has the pace of change in the way tax is regulated been so brisk or difficult to manage. No wonder heads of tax controversy have their hands full.

A prerequisite for the job is not just the willingness to travel but also an understanding that a multilateral approach to these problems is often the only way to solve them. As Pascal Saint-Amans, Director of the OECD’s Centre for Tax Policy and Administration, noted recently in an interview with Ernst & Young’s Global Tax Policy and Controversy Briefing: “Interest in transfer pricing has been growing for 20 years and is still growing. So how do you best use transfer pricing to avoid double taxation?”

This is not to suggest that all such issues necessarily result in litigation. Indeed, tax controversy leaders have a variety of alternative resolutions to explore. These range from the political, such as ensuring strong and respectful relations with relevant tax administrations, through to the practical, such as ensuring solid documentation and preparation for tax audits. At a different level, there is also progress being made within tax administrations too. In March 2012, tax officials from 90 countries agreed that the rules on transfer pricing need to be simplified, that the guidelines governing intangibles should be more straightforward and that disputes on such issues should be easier and faster to resolve. Until they are, more and more companies are likely to need a head of tax controversy to help them steer a course through the minefield ahead.
Leading controversy

Nancy Chassman, Global Head of Tax Controversy at the American insurer AIG talks to T Magazine about the challenges she faces.

T Magazine: What is your role at AIG and how has it evolved during the past year or so? Is it likely to be the same in, say, five years’ time?

Nancy Chassman: As Head of Global Tax Controversy at AIG, I am responsible for providing leadership on global tax controversy matters and for working closely with senior management and our regional tax controversy leaders to ensure we are proactively and effectively managing our audits and tax litigation. In the past year, I relocated to London from New York to assume this newly established position and to set up a framework to implement a global tax controversy function.

One very important aspect of global tax controversy management is the enhancement of our relationships with tax administrators around the world. I believe that, through cooperation with tax authorities, we will mitigate tax controversy and resolve tax disputes in a timelier manner. Today, we are operating in an environment where many tax authorities are aggressively expanding their enforcement activities and are also seeking ways to improve collaboration with large businesses to resolve tax disputes. Tax administrators are employing new mechanisms to better target resources to higher-risk taxpayers.

We see this in countries like Australia, which has instituted a risk-based differentiation framework, and the Netherlands, which has a horizontal monitoring audit process. The key to becoming a lower-risk taxpayer in these types of audits is transparency. Many large companies recognize this changing global tax landscape and are proactively taking steps to develop relationships with tax administrators, which will ultimately lead to financial benefits.

Five years from now, I believe my role will have evolved to one of more strategic oversight, as we will have established a comprehensive global tax controversy platform.

With tax authorities exchanging more information, do you find yourself fighting fires or are you able to develop policies that will benefit the corporation in the medium term? If so, how?

As part of this global trend of increased tax enforcement activities, we have seen more information exchange among tax authorities. My objective is to align AIG’s approach to tax controversy with these new realities of global tax administration. As tax authorities expand their collaboration efforts, we continue to manage our global interactions and information requests with tax authorities in a transparent and cooperative manner aimed at seeking mutual resolution. However, it is important to understand and monitor how tax authorities interpret information provided to them and how it will be used for tax administration purposes.

How big an issue is transfer pricing (TP) in your dealings with tax authorities around the world? Why is it so controversial?

TP is clearly a high-priority compliance issue for many tax authorities today and, very often, it results in controversy and uncertainty due to the complex tax rules and varied interpretations of those rules. TP transactions are very factual and the issues that arise often require economic analysis where experts may disagree, particularly when applied against the local TP rules. When tax authorities review our TP transactions, our approach is to provide the relevant TP documentation and work with the tax authorities to achieve certainty on the methodology and outcome. As more countries adopt Advance Pricing Arrangements, this is an excellent mechanism to obtain certainty on TP.

For many international companies, controversy over tax is a question of governance and reputation. How does this affect your approach to the task, how you operate and who you report to within the corporation?

I report to the Head of Tax Risk at AIG and routinely interact with senior management. The AIG tax risk management function is aligned with our corporate governance policies and is an integral part of our corporate philosophy and operations. My role as Head of Global Tax Controversy is to provide leadership on matters of global tax controversy and to champion the vision that AIG seeks to create and maintain a gold plate reputation with respect to tax policy and administration.

If tax authorities around the world continue to become more aggressive in their demands, will you have to become more adversarial in reply? There are indications that tax enforcement around the globe is expanding and becoming more aggressive in some jurisdictions. I believe tax authorities and taxpayers have a mutual interest in promoting an effective and fair tax administration and we understand the role and responsibilities of the tax authorities. An adversarial relationship is not productive for either party or the tax system. When audits become contentious, it is important to stay focused on being cooperative and transparent.

Nancy Chassman

Based in London, Chassman takes global responsibility for tax controversy for global insurance giant AIG.
How to talk about tax

James Henderson
As CEO of Bell Pottinger Private, Henderson has worked in public relations for over 25 years across all sectors and has extensive experience in financial services, natural resources and consumer industries. He has also spearheaded many corporate media campaigns including the Water Industry, Lloyd’s of London, Walpole and the British Chambers of Commerce.

The public mood toward taxation has changed dramatically. There was a time, not long ago, when society did not pay much attention to how much tax a company paid. That has all changed since what you might call “the tax spring,” when pressure groups and the media started picking up on examples of perceived tax avoidance. In today’s climate of economic austerity, the public expects everyone to do their bit. Expectations about good citizenship are particularly high for well-known and popular consumer brands. However, in recent months, a range of companies have come under attack in the media as a result of their tax arrangements, which prompts the question of how best to respond and communicate about tax affairs in the event of a crisis emerging.

In the past, many companies have tended to avoid revealing much about their tax affairs. Some have hidden behind the inherent complexity of tax management and planning, and a few have even engineered additional complexity to give themselves further protection. This will no longer be tolerated. Instead, companies must be prepared to become more transparent. A large organization that takes advantage of a particular tax break or structures its affairs in a certain way must be prepared to explain why they have made those choices. In much the same way that companies explain their remuneration policies, so they should be able to explain their tax policies.

As companies are increasingly expected to give back more to society, they also need to be able to show the public exactly how they are doing this. Companies need to have a policy to explain clearly how they impact positively a country’s social and economic prosperity. This should be part of a broader communication program that shows the overall economic impact of the company: the scale of investment; the number of jobs created; and other key drivers. Tax should form part of this communication. Companies need to demonstrate that they are doing more than the bare minimum; they need to be able to judge what’s right and be seen as a good citizen. Otherwise, companies should not be surprised if, sooner or later, their behavior attracts unwanted attention. If a company finds itself in this situation, the first thing to do is establish all of the facts and correct any inaccuracies. Ideally, companies should respond to crises as quickly as possible – but not until they have established the key facts and arguments that they need to make. The company should also identify one individual who takes responsibility for the communications efforts. In most cases, this should be the CEO. Assigning a more junior executive to the role can give the impression that the company is not taking the issue sufficiently seriously.

When it comes to dealing with the media, companies need to be open and approachable. They have to decide how much information they are going to give to the media and then stick to that. Giving away too much at the wrong time could enflame the story. At the same time, companies need to make sure they keep their customers on side and informed.

There are certain things to avoid when there is a crisis. Arrogance and denial can be common pitfalls. Often, companies pretend that they don’t have a problem or avoid tackling it in the hope that it will blow over. This is a mistake. In any crisis, companies need to communicate constantly and clearly, and skating over the issue will rarely have a positive outcome.

Companies must also be open and flexible. Often, they must react quickly to new developments, and be willing to change their approach. This calls for strong leadership. Inevitably, some companies find this easier than others. Hierarchical companies can often struggle with being flexible in a crisis because they are unable to adapt or change quickly enough.

The government has also got an important role to play here. When a tax crisis arises, it is always the company that has to justify why they took a certain tax position. There is never any communication from the government as to why they have made a particular position possible. Companies should lobby the government to be more transparent and set out the economic benefit of making possible certain tax structures.

Finally, companies have a common interest here. They should work together to discuss these issues and come up with a set of acceptable industry guidelines around tax. These may vary between sectors, or company sizes, but the broad concepts should be the same. Such guidelines would reduce the temptation to adopt a more aggressive stance, while a common set of guidelines would offer companies much greater protection and strength in numbers in the event that they come under fire.

James Henderson,
CEO, Bell Pottinger Private
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