Tax in the Boardroom

A Discussion Paper

TAX

AUDIT ▪ TAX ▪ ADVISORY

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Executive Summary

Tax has changed dramatically in recent years. Its public profile has become much more conspicuous, it has acquired moral, ethical and social dimensions that have never been discussed before and, for these reasons, the business management issues associated with tax have become more complicated, more subtle, more steeped in risk and much more challenging.

Reactions in the tax world and the wider business community to these changes have been varied. No consensus has yet emerged about how companies and their tax functions can or should accommodate the unfamiliar ethical and social issues now associated with tax. This paper has been inspired by our belief that the most sensible way to reach such a consensus is for the interested parties to engage in an open, business-centered debate about the role, significance and management of business taxation in the modern world.

One thing is clear. Tax cannot remain in the 'splendid isolation' to which its technical nature and its perceived independence from the business mainstream have historically placed it. An attitude of benign assumption that tax is under control cannot provide the transparency demanded in these times of heightened sensitivity to corporate governance and responsibility issues. Conversely, lack of systemic review of tax could also deny companies access to the benefits of incentives created by tax competition between countries designed to attract and retain corporate investment.

As stakeholders outside the business look more closely at tax management and as global competition intensifies, companies must learn from their past experiences with other governance issues and work with external stakeholders to find common ground about what is acceptable in this new environment. Only in this way can they build the platforms they need to manage tax in ways that satisfy both owning and non-owning stakeholders.

Tax is embedded in the fabric of the capital markets in which wealth is created and companies compete. A company's policies for tax and its risks need to be as sophisticated, coherent and transparent as its policies in all other areas involving multiple stakeholders, such as suppliers, customers, staff and investors.

This paper distills KPMG's current thinking in this area. We hope it will stimulate further discussion at board level as well as below and help keep tax, its oversight and management, responsive to industry preferred practice developments in an ever changing world. If you wish to contribute to this debate, e-mail your comments to taxintheboardroom@kpmg.com.

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Context

It is surprising and in some ways regrettable that tax has taken so long to emerge from its isolation. Due to its numerous forms and the company's dual role as tax payer and collector, tax is deeply involved in company operations and affects major stakeholders, including suppliers, customers and staff. Its impact on the accounts, the bench-marking of performance indicators, the throughput of funds and regulatory compliance makes it a major financial management issue; and the revenues it generates give taxation significant political and social importance in every country in which companies operate and pay taxes. (See Appendix I for more on the growing importance of tax in the changing global environment.)

It is academic now as to why it had to take the recent crop of corporate scandals and collapses, the subsequent intense public scrutiny of how businesses run themselves and the tighter regulation that followed to raise the profile of tax to the elevated level its importance always warranted. Tax is out and there's no going back. It cannot retreat into its traditional obscurity behind the scenes. It has finally been recognized as a prominent player in the corporate drama and should be overseen and managed accordingly.

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Observations and Reactions

The business perspective

The directors of many companies acknowledge the need to change their attitudes towards tax, but there is little consensus about what to do and there are often a number of obstacles that need to be overcome before new, more appropriate arrangements can be made. What follows is a summary of our findings about current attitudes to tax around the world.

Current position

Our research and experience have shown that tax departments have tended to operate in isolation from boards and business units. Of course, in most cases they have operated ethically and in accordance with the law, but generally speaking the tax function has not had the same level of 'external' challenge, oversight, and management as other parts of the business. Reporting lines tended to end internally with the CFO and the tax department has not been monitored at a strategic level as have other business functions of similar importance. As a result tax risks have received only cursory attention outside the finance function at many companies[1].

Although they have had general goals, such as to achieve and sustain a target effective tax rate, few tax departments have had formal strategies or clear objectives aligned with those of the business, or been subjected to regular reviews.

Research conducted in 2004 found that at a third of the companies surveyed, their tax departments lacked any written objectives and only 14 percent had board approved objectives[2]. Tax strategies were rare and, where they existed, only 10 percent of those questioned felt they were widely understood outside the tax function. Most tax departments focused on compliance and the effective tax rate[2].

In a survey of tax and finance directors a third of respondents thought the tax function should spend more time on tax planning and less on compliance, but the perceptions of the finance and tax directors of the same company of the time the tax department actually spent on each were often at odds[3].

Regular formal reviews of the tax department by internal audit were carried out in only 22 percent of companies and even in those cases there was often a lack of agreement between tax and internal audit about what was being, or should be reviewed[3].

Over the past two years the proportion of survey participants who strongly believe that the financial and reputational risks around tax make it a boardroom matter has jumped by over 11 percentage points. The same survey found that 72 percent of respondents now think tax and its risks are boardroom issues[4].

The changing profile of tax

No business function can exist in a vacuum. There are signs that tax departments are becoming less isolated as senior executives become more interested in tax risks and internal controls, but there is scant evidence of a formal or comprehensive integration of tax into the mainstream[2].

This is due to the old walls between tax and the rest of the business being eroded by outside influence, rather than being dismantled systematically by internal action. External developments, such as the Sarbanes-Oxley Act (S-O) of 2002 in the U.S., new compliance programs in Australia and elsewhere and growing public scrutiny of tax, are forcing the issue.

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There is a growing belief at director level that tax needs more board level attention. Our discussions with senior managers suggest they too are beginning to see tax as a board issue. 'The penny started to drop that tax was a big number on the balance sheet'[5], as one survey respondent put it.

> "The whole of our executive board…know that, if we can keep cash tax down then we could, potentially, get a huge increase of valuation to our shares...and there's a lot of focus on share price, because a lot of remuneration is share-based. So, make no mistake, tax is quite high up on the agenda of a lot of people on the group board" said one CFO[5].

Tax and performance management

The irony, for those who believe tax needs to be seen as a board issue, is that directors themselves should be intensely interested in after tax measures because of the ways they are rewarded. Many directors have long had more than a passing interest in tax but only rarely have they fully acknowledged it.

The tax implications of major transactions are considered as they are conceived and implemented. Post-tax metrics are virtually always used when deciding whether or not to proceed with acquisitions and other head office projects and how to structure them[5].

But how deep does post tax measurement go? Not very deep in our experience.

Our research has shown that many managers below board level are evaluated on pre-tax numbers. The performances of investments originally assessed on a post-tax basis are then usually measured with pre-tax basis indicators. Therefore, although there are signs of a growing interest in post-tax measures, such as return on capital and free cash flow, which provide some comfort to shareholders, generally speaking, managers are not motivated by their assessment and reward systems to take tax into account in their day-to-day decision-making[5].

There are various reasons for this.

> "The biggest [tax] elements tend to be changes in capital structure, inter-group funding arrangements, transfer pricing and that sort of thing," a CFO explained "and a lot of them are driven through group considerations".[5]

Some feel it is unfair to measure business line performance on a cost line managers have no control over[5].

Others say that they have tax planners 'on the ground' in their business operations and there is therefore no need for post-tax performance metrics[5].

Another reason given for not using post-tax measures below board level was that they encouraged the wrong behavior, such as competitive tax planning between different parts of the business that benefited the individual business unit at the expense of the company as a whole. It was also felt that focusing too much on post-tax measures could send the wrong kind of signal to the local tax authorities, and so increase tax risk[5].

Tax may be considered on central projects, but is often ignored in day-to-day 'business as usual' trading or seen as something to be dealt with after the profit has been made by the trading divisions. But this mindset does not take into account the fact that there are more taxes than those disclosed on the 'tax line' in the financial statements – some taxes apply above the profit line.
Senior management taking a more operational stance on taxation should allow for all the taxes a business incurs to be identified and managed. It can also increase the chances of tax saving opportunities being identified where they could be most effective.

Attitudes to risk

Taxation has not usually been treated as a normal business risk. Our research suggests attitudes to tax planning have shifted in recent years, towards the risk-averse end of the spectrum. Companies are less inclined to engage in tax planning activity that might be construed as 'aggressive', because they do not want to be seen as 'high risk' by the tax authorities or presented by the press as engaging in 'unethical' tax behavior[2].

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To assess risk appetites we have informally asked a sample of tax executives to state which of five risk categories they feel at home in:

1. very conservative (nothing will knowingly be done that might provoke the tax authorities)
2. conservative (planning subject to rigorous technical review, legal opinion must give 70-90 percent comfort, no reputational risk tolerated, the company would not go to court to defend tax planning decisions)
3. as 2 (70-90 percent comfort, no reputational risk), but company would be prepared to defend planning in the courts
4. as 3, but only 51-70 percent comfort required
5. as 4, but some degree of reputational risk acceptable.

No one has chosen the fifth category; a few have chosen the first; roughly half have chosen the third; the rest have split evenly between the second and fourth. Interestingly, this implies a rather more conservative view than we have observed in the marketplace, which begs the question of whether boards can accurately judge what risks are being taken on their behalf[5].

"We are going to have to take the decision" said one CFO. "Are we going to pay more tax? Are we going to be happy to lose all our planning opportunities? Or are we going to get a little more aggressive in terms of the opportunities that are there and actually fight to keep them? I suspect we will go the second route".[5]

Many companies look more closely nowadays at the potential downside, when deciding whether or not to implement tax planning ideas, but it is often unclear whether management are making a fully informed decision or simply reacting to events.

Several survey respondents expressed concerns about the recent tendency by external stakeholders to make 'moral judgments' about tax planning and most executives took the view that they have a duty to their shareholders to reduce costs – of which tax is a major component – by all legal means.

There is some recent evidence of re-trenchment, following the initial shock of the corporate scandals and official reaction to them. Nevertheless, some feel that the moral and ethical pressures should be debated in a better informed context.

Authorities' stance

Appendix I summarizes changes in the attitudes of tax authorities in several representative jurisdictions during the past few years. There appears to be a trend towards a risk-based approach to identifying non-compliant tax payers. In some countries, such as Australia, the U.K. and the U.S., tax authorities are inclined to see a lack of board level involvement in setting the tax agenda as tantamount to bad management or, in some cases, negligence.

The tax authorities are also emulating the globalization of companies by sharing information and joining forces to work across borders to identify tax avoidance. The ethical argument is much in evidence as they attempt to establish criteria for what is 'acceptable'.

In the U.K., Australia and the U.S. efforts have been made to align tax regulation with modern corporate governance legislation and guidance. While this is to be welcomed – no one can argue with the tenets of good management – an agenda set solely by the tax authorities runs the risk of becoming too prescriptive and lacking the flexibility business needs. As the risks around tax increase, it is in the interests of companies to take the initiative and start a debate with the relevant regulators and other commentators.

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A Corporate Role for Tax

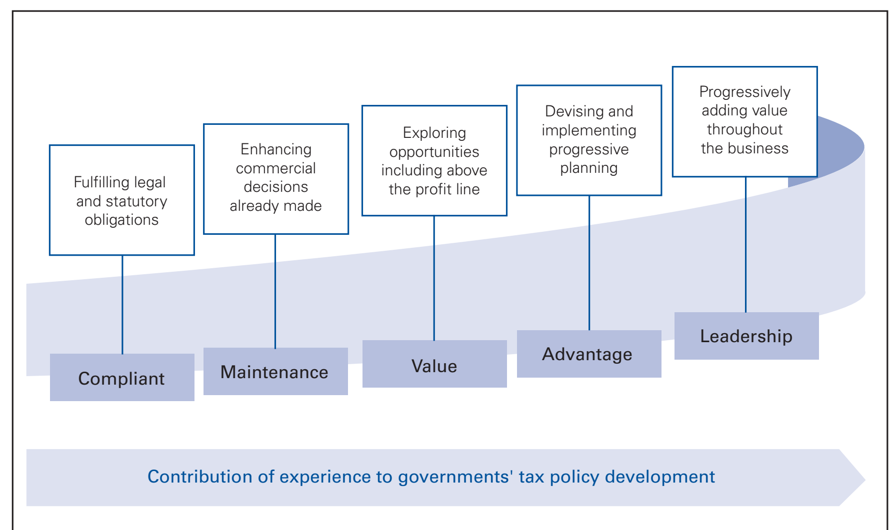
What does tax do for the business?

At the heart of good tax risk management is a high level decision on the overall position the company takes on tax – its tax philosophy. Once that has been decided by the board, required and acceptable behavior follows and the tax department can be left to develop an action plan, deal with risk areas and achieve the strategic goals they have been set.

We have already seen that the higher-level issues taxation is raising these days oblige boards to anchor tax, more securely and clearly than has been necessary in the past, into the overall pattern of corporate governance and business operations. A clearly articulated overall position on taxation is a first step towards this.

Establishing a position requires the management of a company to decide how it 'sees' tax. Is it a social levy the company has a duty to the local community to pay at whatever level is set by the local government, or is it a normal business cost the company has a duty to its shareholders to reduce to the lowest level possible within the law? The position taken by most senior managers of companies falls somewhere between these two views.

Having established its overall position or tax philosophy, the board must then decide what the company wants tax to 'do' for the business – what is its overall strategy for tax? If the overall position is closer to the social duty end of the philosophy spectrum the company's tax strategy can be expected to focus on compliance – on ensuring returns are filed correctly and on time, for example. Senior management may then capitalize on the board's philosophical decision, by emphasizing the company's contributions to the countries it operates in, and so enhancing its reputation as a socially responsible corporate citizen. There is a risk that unless this can be reconciled to the company's responsibilities to its shareholders e.g., by demonstrable efficiencies in dealing with the authorities, management could be accused of lax financial management by their investors.



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Many companies adopt a position closer to the 'duty to shareholders' end of the spectrum and see tax as a cost to be managed, albeit responsibly. A decision therefore needs to be made about how aggressive that management should be and consequently what is an acceptable level of risk. The previous diagram shows the range – does senior management want to use tax as a lever to establish or counteract competitive advantage, or is it happy to capture some additional value from tax planning, using tried and tested methods? In many ways, the decision will be driven by the performance indicators and culture of the organization as tax departments will be judged against the corporate background in which they operate.

This spectrum of positioning is not limited to responding to narrow shareholder value creation pressures. The enhanced shareholder value objectives incorporated within corporate social responsibility means that the role of tax should not be limited to cash contributions to the communities and countries in which an organization operates. A company contributes more widely by using its tax and commercial expertise to help the authorities develop tax legislation and administration relevant to the goals of the countries in which it operates.

In some countries and depending on the size of the organization, the board could decide to direct management to enter into discussions with governments about the amount of tax it is contributing to the local economy. Although we are increasingly seeing companies adding up the total amount of direct and indirect taxes they contribute in response to targeted questions from stakeholders, this is not used often enough by companies to stake a claim to be part of the tax policy development by governments.

Finally, it is worth noting that positions may change if, for example, the board has committed the company to deliver a particular effective tax rate to shareholders. As 'quick win' savings are exhausted, maintaining such a rate may oblige the company to more closely examine management of its day-to-day operations and the tax-efficiency of its locations. The need to deliver on public commitments tends to inspire increasingly radical changes in strategy and asset allocation and so is given added momentum when tax authorities try to prevent companies from using head office led mechanisms such as tax-efficient financing to maintain target effective tax rates.

Unless capital markets accept that corporations will incur an increasing tax burden as a consequence of conservative tax policies, a more fundamental look at the 'natural' tax rate generated by the mix of countries in which assets are created and located may be needed to achieve an acceptable tax burden.

External stakeholders

Non-owner stakeholders, including governments, pressure groups and society at large, are becoming more strident in their demands on, and criticisms of companies. Boards are coming under growing pressure to oversee their tax affairs in ways that reconcile their obligations to shareholders with the expectations of other interested constituencies.

There is talk of the duty of companies to manage their tax affairs in ways that are 'socially responsible'. It has been suggested that some tax planning arrangements are irresponsible, in this sense, because they serve no purpose other than to avoid tax exposure.

This can affect tax philosophies. Boards should recognize that although so-called 'aggressive' tax planning arrangements are creating value for shareholders in the short-term, they may destroy value in the long term, regardless of their legality

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and business substance, by damaging the reputations in the eyes of the interested external parties of the companies that implement them, the executives who approve them and the advisers who devise them. Reputational damage of this kind can have very material consequences. If a company is on a fiscal authority 'watch' list it could increase its tax risk and compliance costs, and more generally lead to preventive legislation, such as the tax shelter legislation in the U.S. and general anti-avoidance rules in Australia, that makes life harder for all companies operating within the jurisdiction.

Had such consequences been anticipated, the value of the short-term benefits of the aggressive tax planning arrangements, despite their legality and adherence with individual corporate risk tolerances, might have seemed less attractive. Companies have always had a duty to maximize shareholder value. In the past this has usually been seen to generate a consequential duty to minimize tax charges within the law.

This legal constraint is no longer sufficient in many people's eyes. Boards should recognize, when overseeing the design and monitoring of tax strategies and policies, that contemporary debates about governance, corporate social responsibility and ethics mean that even legal tax-minimization activity can generate reputational liabilities that can destroy shareholder value.

Striking a balance

It has become harder to strike the right balance between what is and is not industry preferred practice. In the past there was a clear distinction between legal tax avoidance and illegal tax evasion. The distinction remains clear in law, but has become blurred in the minds of governments, regulators and the public. So-called ‘aggressive avoidance’ tax planning arrangements that utilize reliefs that critics call ‘loop-holes’ have acquired what amounts to a quasi-illegal status. There are more variables to consider when evaluating tax planning and risk has consequently increased. Boards and senior management also need to fully understand the consequences from multiple perspectives (e.g. financial, legal, reputational, etc.) of not allowing the tax department to engage in legitimate tax planning.

This is a major challenge for companies, their tax advisers and the fiscal authorities, not least because business is denied the legal and reputational certainty of tax treatment it needs, due to the high level of movement of boundaries separating acceptable from unacceptable practices. An open and honest debate about what each stakeholder group wants and expects is needed, to reach a common understanding of what is, and is not acceptable. While acknowledging that the courts will ultimately decide what is appropriate and inappropriate practice, a consensual exchange of views is preferable to and more constructive than outright confrontation. Corporations should actively engage in that debate.

In the meantime board-sanctioned philosophies for tax need to provide tax departments with clearly defined parameters within which to assess and devise their overall strategy to achieve their goals and help manage tax risk.

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The Relationship Between Risk and Tax Management

Contrary to the conventional view, the risks of tax management have rarely been confined to tax planning. We have seen how a tax philosophy should lead to a tax strategy to cover compliance and planning. Tax risk, in its various shapes and forms, can be seen as anything that could prevent the achievement of the company's strategy, so its management is an integral part of tax management. Tax risks have grown and proliferated to such an extent in recent years (see Appendix II) that it is important that boards take a closer interest than they have in the past in overseeing the management of tax risk.

If a tax department has been given an objective to maximize after tax profits, for example, or to maintain a set effective tax rate, its approach to achieving its goal will determine the level of tax risk. An aggressive approach may satisfy shareholders, but may increase the risk of tax authority investigation or public scrutiny. The isolation of tax departments has meant that decisions about what is an acceptable level of tax risk have often been made without the board's knowledge or approval. This is no longer acceptable[5].

Tax risk should be managed both overtly and inherently.

Overt tax risk management employs policies, protocols and risk assessment tools, subject to reviews by internal audit using well tested methods. Although questions need to be asked about how well those who traditionally carry out these reviews actually understand specific attributes of tax risk, overt tax risk management is a familiar activity most companies feel comfortable dealing with.

TAX PHILOSOPHY				
	ALIGNMENT	RESPONSIBILITIES	FORMAL CONTROLS	THIRD PARTY REVIEW
CONTROL ENVIRONMENT	• Coordinated with overall risk management procedures • Aligned with commercial goals	• Defined areas of authority • Defind reporting lines	• Defined by policies • Policed and enforced • Procedures for dealing with control failures	• Internal audit • External auditors • External advisors
OVERT	• Risk assessment tools	• Portfolio analysis of tax risks	• Documentation protocols	• Communication protocols e.g., regular reports.
INHERENT	• Data integrity • Internal and external relationships	• Staff quality and quantity • Training programs	• Reporting systems • Use of technology	• Profile • Coverage

Source: KPMG LLP (UK) 2004

Tax risk is also inherently managed on a micro level, whether consciously or by default, in the way tax is dealt with on a day-to-day basis. As we have already seen, tax is often ignored at ground level, because it is seen as a head office matter. So tax risks have often not been fully understood or allowed for in everyday business decisions. Additionally, tax departments have historically been isolated, their ability to assess these risks has been limited and the risks have not been properly managed particularly in countries away from head office.

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We suggest tax risk management plans should cover overt and inherent perspectives. Once the philosophy and strategy have been set, the way tax is managed and reported should affect the level of risks run and thus the chances that the tax strategy's goals should be achieved.

Some boards oversee the management of tax risks through sub-committees – audit, finance or an executive committee. A few have official board policies on tax risk, but many boards and senior management react to rather than prepare for risk. U.S. companies are more sensitive to tax matters after the recent corporate scandals and S-O, and increasing numbers have established procedures for referring tax matters to the board. Many respondents to one of our U.S. surveys said the main change has been the documentation and reporting of processes and procedures required by S-O Section 404[6] – they already had control systems, but there was no formal documentation to support them[7].

We question whether the sub-committees really understand the risks on which they are signing off. Are they being presented with the right performance indicators and variables? Tax, beyond a number in the financial statements, is such unfamiliar territory for boards and many senior executives that explaining the issues to those responsible for approving risk management policies is a challenge in itself. We suggest that the need for insightful communication of tax issues has been underestimated in the past, particularly with respect to taxes beyond the effective corporate tax rate and also in territories outside the head office country.

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Tax Governance and KPMG's Preferred Practice

Corporate responsibility

The parties involved in the debate about what is acceptable behavior in tax should learn from their experience in the wider corporate governance debate, try to avoid unnecessary conflict, and search for common ground. A lot of what we propose here as KPMG's preferred practice is simple common sense, but when debates become heated, common sense can become an uncommon quality. A common sense framework, within which businesses can conduct their tax affairs, could provide much needed clarity.

Investors need to be sure tax is being managed consistently in ways that support the business strategy and reflect the company's stated appetite for risk. Key non-owning 'stakeholders', including the tax authorities, need to be sure that tax is being managed ethically and in accordance with well-documented tax processes and control systems that are robust and are being rigorously and consistently applied. Businesses need to know that they are not over-paying their various taxes and are meeting their legal obligations.

A common framework to bridge the gap

Appendix III outlines our proposed preferred practice framework for the management of tax, to underpin the company's tax strategy. Whatever tax philosophy a business adopts, each aspect of tax management, as illustrated below, should be addressed. The framework could be a starting point for a wider debate.

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Behavioral indicators

KPMG's preferred practice indicators that give shape and substance to a company's tax management style and strategy should be supported by appropriate behavior patterns that we suggest should be promoted and exemplified by the board.

- An established 'tone from the top' – the tax philosophy
- Clear attitude towards deviations from procedures
- Active oversight of tax strategy, including risk strategy
- Ability to ask perceptive questions of tax management
- Insightful and timely reporting to board on material tax issues
- Appropriate reporting lines and access for the tax function
- Clear definition of responsibilities/delegation of authority
- Appropriate staffing of the tax function
- Appropriate controls within tax function
- Independent reviews of the tax function

Establish the 'tone from the top'

We are not suggesting the main board directors should get involved in the detail of tax, although an occasional visit to the tax team by a director to show how seriously tax is being taken might not come amiss. We are suggesting boards are responsible for setting out the philosophical and ethical principles, and overseeing the establishment of a robust and well documented control environment which is regularly and rigorously applied.

Clear attitude towards deviations from procedures

It is one thing to publish clear policies, philosophies and strategies for tax and tax risk, and issue well-documented processes and control systems, and quite another to ensure that the control environment they comprise is effective. The discipline imposed by a control environment can depend as much, if not more, on the way breaches of the rules are treated, as on the rules themselves. As the ultimate power in the company, it is the board's duty to ensure, through the way it mandates how deviations from established rules and procedures are treated, that the control environment actually controls.

Active oversight of tax strategy, including risk strategy

Implicit in the board's responsibility to create value for shareholders is a duty to identify opportunities to realize (or increase) tax benefits and to minimize tax liabilities. Boards should oversee the articulation of tax risk policies that are not unduly conservative and ensure that risks worth taking are taken in the interests of the business. Tax planning issues crop up in all sorts of places, from sourcing and re-structuring, to M&A, new ventures and new product and service development. They should be handled according to a clear and widely understood, board-approved tax strategy.

Ability to ask perceptive questions of tax management

As the originators of tax philosophies and policies and as the sanctioning authorities for tax strategies boards need to be sufficiently up to speed with fiscal matters to keep their tax managers on their toes. The following are the kinds of questions they could be asking their tax people, because these are the kinds of questions external audiences might ask of them:

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- What is our tax risk, how significant is it, who manages it and how?
- How do we do our tax planning, how is it monitored?
- Is our tax strategy acceptable to investors and non-owning stakeholders?
- What is the total amount of all the taxes we pay, what percentage of our profit is that?
- Do we know who is responsible for each of the various types of tax in our organization and do they know they are responsible?
- How accurate is the tax information provided for financial and tax reporting obligations?
- Are we being too prudent; are we over-paying tax?
- How do we compare with our peers?
- How does tax talk to the rest of the business, including the board?

Insightful and timely reporting to board on tax issues

Boards should be informed about issues that have, or can have, a material impact on group or subsidiary financial statements, significant enquiries from tax authorities and any compliance failures, such as late payments of tax.

The method and frequency of communications can vary, but the process should normally include a regular annual report on the state of the company's tax affairs.

Appropriate reporting lines and access for the tax function

Senior management should take responsibility for defining reporting relationships and communications arrangements for tax at both group and operational level.

Group tax generally is part of the group finance function in which case it should report directly to the group CFO, who will either report to the board, or obtain direct access to the board for the tax director when that seems more appropriate. The greater the degree of reporting line separation between the tax department and the board, the greater the potential risk of divergence of policy and execution.

An important point for senior executives to remember when approving reporting systems for tax is that they should embrace all taxes. Group tax departments tend to focus on corporate income taxes and neglect transaction taxes, such as VAT and excise duties. Reporting lines and access must cover the whole tax system at group and business unit level.

Definition of responsibilities/delegation of authority

The group tax director is accountable for tax matters throughout the group and for developing a group tax strategy consistent with the group's stated tax philosophy and policies (including a clearly defined appetite for tax risk) for which approval should be obtained from the group CFO in the first instance and ultimately from the board.

The tax director should also be responsible for developing and gaining the board's approval for strategic tax plans, for making the priorities known to head office and the subsidiaries and for assigning responsibilities for implementing tax strategies to help meet each subsidiary's needs and risks.

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Appropriate staffing of the tax function

A tax function is only as good as its people. If circumstances are forcing tax to come in from the cold, and become more integrated with the business mainstream, it is increasingly important for tax people to understand business issues.

They should also be equipped with the reliable, tax-sensitized systems they need to monitor tax processes effectively and prepare timely and accurate returns, and have access to external advice and other services if and when required.

Senior management should ensure that high standards of tax management are achieved and sustained, that the tax function has the resources it needs, training is suitable, targeted and coordinated and that tax staff are motivated and assessed appropriately.

Appropriate controls within tax function

At a time of tightening regulation and changing relationships with the tax authorities, companies need to be sure their compliance processes, at both group and subsidiary level, are effective, that their reporting processes are prompt and precise and that relationships with the tax authorities and auditors are being managed appropriately.

Independent reviews of the tax function

Since familiarity can breed, if not contempt, at least a kind of blindness the board should, from time to time, and at least every three years, consider asking a competent professional firm unconnected with the company to review the tax processes. The terms of such review should be determined by the group CFO, in consultation with the group tax director, but should cover adherence to the declared tax philosophy, policies and strategy, compliance performance and the quality of advice provided by tax staff to other functions.

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Conclusion

Tax as a strategic issue is looming larger. Its public profile is rising as globalization and competition between tax jurisdictions generate a steady stream of new challenges for tax planning. In a business world where regulation and reporting requirements are getting tighter, where the press and the tax authorities are naming and shaming allegedly 'unethical' tax planning, where economic and reputational penalties for non-compliance are increasing and where pressure from shareholders to create more value is relentless, being 'tax compliant' is a state to which companies should aspire and boards should seek to achieve.

Some assume that to be compliant is to be pliable, submissive, acquiescent or weak, in some way. But compliant also means adapted to the environment, and there is little weak or pliable about that. Companies need to find ways to comply with the legitimate demands of their shareholders, as well as the legislative and regulatory demands of the societies in which they operate. To create and preserve value-creating reputations, they should be responsive to the demands of the public for high ethical and environmental standards. To discharge their duties to their shareholders, they should accept some risks and reject others.

Boards should set their tax philosophy, picking their way through the minefield of the modern business environment, acquiescing here, being adamant there, as they search for that elusive, value-maximizing state of compliance with the different, often conflicting demands of a range of interest groups.

A constructive debate amongst interested parties can help provide the compass boards need to find their way. Some may say such a compass already exists in the tenets of good corporate governance, but tax raises its own distinctive issues which have yet to be assimilated into the governance framework. A specific debate about tax, embracing a wide range of the business community, is in everyone's best interest.

If you would like to contribute to this debate, send an e-mail to taxintheboardroom@kpmg.com.

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Appendix I
The Changing Environment

Corporations, their boards, and their advisors have never been subjected to such intense scrutiny as they are today. Enron and similar corporate collapses in the U.S., Europe, and Australia have focused the attention of the media, governments and investors on financial reporting failures in major capital markets, and this new interest in financial reporting has led to a public examination of how corporations manage tax.

Tax is no longer the exclusive preserve of the CFO or the tax director, but it has yet to acquire a full voice in the boardroom. It needs that voice, because taxation is now a corporate governance and reputational issue, and is on the radar screens of shareholders and other important interested parties, including governments and potential investors.

Tax is now a reputational issue

Various corporate scandals including the Maxwell pension debacle in the U.K.[8], the HIH Insurance failure in Australia[9], the collapse of Enron in the U.S. and the implosion of Parmalat in Italy marked the advent of a new corporate era. Companies, their financial reporting and their auditors hit the head-lines initially, but soon the horizons of the daily press expanded and it is now common for tax, corporations, and their advisors to fill prominent pages.

It is not just the press. Governments struggling with steadily falling tax receipts and other local difficulties have become more interested in corporate taxation and populist politicians are up in arms too. For example, Early Day Motions have been tabled in the House of Commons urging the U.K. Government to investigate the effective tax rates of 21 named multinational corporations and the roles of banks and accountancy firms in "devising, marketing, promoting, implementing and concealing aggressive tax avoidance schemes".[10]

The emergence of pressure groups such as the Tax Justice Network in the U.K. is further evidence of the higher profile of tax on the wider business stage. Tax management has been the target of some emotional and, arguably, inaccurate comment in an increasingly heated debate about whether corporations are paying their 'fair share' of taxes. The main point is not that the accusations are often unjustified, but the fact they are made at all. Tax has news value now and, although often unfounded, 'naming and shaming' attacks on alleged tax avoiders can damage their reputations in the eyes of important stakeholders, which can lead to sharp short-term share price falls and the unwelcome attention of more than one taxing authority.

Tax is now a corporate governance issue

Previously tax had very little to do with corporate governance as long as legal compliance obligations were fulfilled, the tax position for accounting purposes was disclosed and sufficient legal and financial support was provided for judgments and estimates. Perhaps one of the most direct contributions to the debate has been the assertion by Mr. Michael Carmody, Australian Tax

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Commissioner, that tax is a corporate governance issue. Mr. Carmody believes boards should make conscious decisions about where their companies should position themselves on the tax risk spectrum and ensure the necessary controls are in place to maintain that position. He expressed this view in a letter to the Chairmen of the boards of directors of Australian listed public companies on January 29, 2004, and has re-iterated it in subsequent speeches and publications.

By making the direct connection between tax and corporate governance, Mr. Carmody has helped ensure tax is on the agenda of Australian corporations' stakeholders and this view of tax is gaining currency elsewhere in the world.

Shareholders are now interested in tax

Shareholders and their agents are increasingly concerned with how corporations manage tax and the extent to which management exposes them to greater risks. Henderson Global Investors Ltd. ('Henderson') wrote to the Chairmen of FTSE 350 companies in 2004 asking them about how their companies manage tax, because a "company's management of its tax affairs is an important aspect of its overall strategy to deliver long-term shareholder value".[11] Henderson have said, in a report published in February 2005, that they will take up the findings from the survey with individual companies and incorporate them more generally in ongoing conversations.

Financial reporting regulation affects tax

Despite the wider debates, tax is inherently an issue between corporations and governments. However, court cases recently filed but as yet undecided, suggest that shareholders are attempting to use legislation that has traditionally been foreign to tax to constrain how corporations manage tax where they do not approve of certain board decisions or policies. This new approach by shareholders may become common given the legislation that has been, and is forecast to be, enacted by governments in response to the financial reporting failures[12].

Tax management is also included in the corporate governance debate not least because of the reach of the S-O Act in the U.S., and similar developments in other jurisdictions. The internal controls scrutinized include controls over the accounting, reporting, and calculation of a corporation's tax charge. As SEC Chief Accountant, Donald T. Nicolaisen, put it: "The accounting and reporting of income taxes has received increased scrutiny by investors, analysts… That spotlight is likely to continue. Welcome to the new world".[13]

A sophisticated response by governments

Governments are becoming more sophisticated in their approach to international tax. Existing measures relating to thin capitalization, controlled foreign companies, foreign investment funds and more recently transfer pricing, are no longer seen as adequate for handling tax competition and international tax avoidance or evasion.

One of the main priorities of governments has been to improve their access to information about corporate tax planning from both corporations and foreign tax authorities. Perhaps one of the most significant development is the signing of a Memorandum of Understanding between the tax authorities of Australia, Canada, the U.K. and the U.S. to create a joint task force to assist these authorities in identifying and curbing 'abusive tax schemes' or planning arrangements.

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KPMG's emerging preferred practice and communication

Although tax is a business issue, it is one that uses a technical language. It would be very unusual to find a board that was conversant with detailed tax legislation for example. Boards need their tax advisors, both internal and external, to translate for them the implications, potential benefits and risks of specific tax planning and strategies. Tax people should be encouraged to highlight emerging 'red flags' at the right level. Advisors can help boards decide whether their companies lie where they want them to be on the tax risk spectrum. They can report back on whether existing internal controls are sufficient to meet their tax obligations and give guidance as to how they should or could relate to relevant stakeholders, such as the authorities, about tax.

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Appendix II
Tax Risk

GENERIC	
TYPE OF RISK	NATURE OF RISK
Compliance	• Technical or factual inaccuracies. • Miscoding of expenditure. • Late submission of returns. • Late payment of tax. • Poor presentation of tax planning.
Planning	• Failure to plan. • Technical imperfections in planning. • Excessive aggression in the planning. • Failure to implement planning correctly.
Accounting	• Incorrect recognition of tax liability.

TRANSACTIONAL	
TYPE OF RISK	NATURE OF RISK
Technical	• The technical basis of the tax treatment is successfully challenged.
Accounting	• The tax analysis is dependent on an accounting treatment which is not accepted.
Change of law	• A change of law affects the transactions before maturity, break even point or the required return is met.
Inconsistency	• The treatment adopted and arguments to support one transaction prejudice arguments in another transaction.
Concentration	• Multiple transactions fail as a result of a single technical failure.
Implementation	• The risk that the transaction will not be implemented as required so that it falls on a question of fact.
Administrative	• The ongoing administration of the transaction is not correctly recorded in the accounts, or the tax return; elections are not made; or there is some operational failure.
Reputation	• The transaction or approach significantly prejudices the relationship with the fiscal authority. • Publicity concerning the transaction adversely affects standing with shareholders, counterparties, policyholders and other customers.

Source: KPMG LLP (UK) 2004

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Appendix III
KPMG's Preferred Practice Indicators

ASPECTS OF MANAGEMENT	TAX PREFERRED PRACTICE INDICATORS
Strategy	• Tax strategy derived from and aligned with the business strategy. • Tax strategy understood, agreed, and supported by the board. • Documented, communicated and understood policies around key strategies and risks. • Strategies in place to address stakeholder expectations with suitable controls around them.
Relationships and communication (internal and external)	• Tax department seen as a business partner with relationships and clear points of contact across the business. • Tax department reporting to the board and located close to CFO, as the first point of contact for tax related issues. • Tax department goals and strategic drivers are understood by the business as a whole. • Tax department stakeholders identified (e.g., finance, legal, fiscal authorities, etc.) and relationships managed.
Staff	• Tax team to understand role in achieving business strategy and frame service delivery with this in mind. • Clear roles and responsibilities around management of tax, including adequate support of internal clients. • Use of appropriately qualified staff with defined areas of responsibility. • Training programs for suppliers of tax information and tax team.
Process and technology	• Tax processes coordinated with management of taxation to help improve efficiency and accuracy. • Tax technology systems coordinated with accounting systems. • Tax relevant information built into coding processes and accounting systems.
Risk management and control	• Tax risk policy aligned with business risk policy. • Control environment established by the board. • Risk identification and control processes in place and subject to checks.
Accounting	• Forecast and report activities coordinated with finance function. • Controls to confirm accuracy of provisions in place, e.g., adequate audit trails. • Accounting consequences of any tax planning fully considered.
Coverage	• Taxation on the boardroom agenda. • Adequate coverage of all taxes. • Formal process to raise awareness of tax within the business.
Planning	• Tax department proactively involved at strategic level. • Tax department to have easy access to management information and decision makers. • Tax department procedures aligned with risk policies.

Source: KPMG International 2005

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