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Tax Risk Management

From Risk to Opportunity

Chapter 4

Tax Risk Management and Corporate Taxpayers – International Tax Administration Developments

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This chapter is based on information available up to 10 December 2009.

1. Tax risk management: the different perspectives of tax authorities and corporate taxpayers

Risk has been defined in the European Commission's *Guide on Risk Management for Tax Administrations* ("Fiscalis Guide") as: "Anything negative that can affect the organization's ability to achieve its objectives".[1]

On this basis, ascertaining the objectives of the organization in question is critical to the question of risk management. The objectives of taxpayers and the tax administration will not be identical and will sometimes conflict, although at other times they may overlap.

Corporate taxpayers may have a range of tax strategies, depending on their tax philosophy.[2] Most large corporates will want to balance profit maximization with other objectives which include the reduction of risks such as unsatisfactory compliance, which may threaten reputation, and the cost of disputes with revenue authorities. They will also want to steer clear of too much volatility in reported profits, since this is disliked by the market. What they consider to be the correct balance between these factors will depend on the overall business and risk philosophy of the board of directors as filtered through to the tax department. The risks outlined will be dealt

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1. European Commission Directorate General Taxation and Customs Union, *Risk Management Guide for Tax Administrations,* Fiscalis Risk Analysis Project Group, Brussels: European Commission, 2006 (hereinafter "Fiscalis Guide"). See http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/gen_overview/Risk_Management_Guide_for_tax_administrations_en.pdf, p. 13.

2. B. Erle, "Tax Risk Management and Board Responsibility" in: W. Schön (ed.), *Tax and Corporate Governance*, Munich: Springer, 2008.

with by internal risk management and control of decision making within the context of broader controls exercised by the company.

From the perspective of tax administrators, the relevant risk is the institutional risk that the revenue authority will not achieve its objective of tax collection.[3] Four broad categories of risk for the revenue authorities and governments have been identified. These all relate to the risk that the expected levels of revenue will not be collected. They have been identified as (i) register risk (the risk that tax yield is reduced by inaccuracies in tax registration); (ii) filing risk (the risk that tax yield will be reduced by failure of taxpayers to file their returns); (iii) payment risk (failure to pay amounts due); and (iv) declaration risk (where returns are incorrect due to error or deliberate act).[4] All these risks have to be tackled with limited resources, thus those resources must be allocated efficiently to where they will have best effect.

It is the last of these risks which is of greatest importance in relation to large corporate taxpayers. The vast majority of the corporations under discussion in this volume will wish to ensure that they have good systems in place for reporting and paying the tax which they believe on best advice is properly due within the law. The key risks for the tax authorities lie in systems failures but also in areas of uncertainty and lack of agreement in relation to the amount of tax payable. In this context, the risk borne by the tax authorities may be considered by them to include the risk of what the Fiscalis Guide calls "barely legitimate tax avoidance". There will be grey areas where the corporate taxpayer may believe that its actions are within the law but where the revenue authority takes a different view. There is a risk to revenue authorities of collecting less tax than they expected on their interpretation of the law, even if their interpretation turns out to be incorrect according to the courts. Whilst not a declaration risk in the sense of the return being incorrect, it may be seen by the tax authority as creating a "tax gap".[5]

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3. J. Black, "The Emergence of Risk-Based Regulation and the New Public Risk Management in the United Kingdom", *Public Law* (2005), p. 512.
4. Fiscalis Guide, op. cit., Para. 2.4.
5. See in the United Kingdom, for example, Her Majesty's Revenue & Customs (HMRC), *Measuring Tax Gaps 2009*, London: HMRC, December 2009 at Annex I which defines the estimated tax gap for very large businesses as "tax under consideration on issues under dispute less estimated yield from issues under dispute". Para. I.11 states that: "The main cause of the net tax gap [in this category of taxpayers] is where HMRC unsuccessfully challenges avoidance or loses in litigation cases". These are not strictly cases of under-declaration since the taxpayer has declared the correct amount of tax as the law stands, although not as the revenue authority wanted it to be.

Uncertainty about interpretation of tax legislation is an area of risk for both corporate taxpayers and tax administrators in different ways. Tax administrators may have a different view on the meaning and intention of the legislation than that of the in-house experts or the company's professional advisers.[6] Reducing the areas of uncertainty is often a question of improving tax law,[7] but the complexities of modern taxation systems make it unlikely that the law can be rendered sufficiently certain to remove all grey areas. There is therefore a need for the creation of a framework which provides for a process by which to reduce and manage uncertainty. Modes of resolution which do not become expensive and time-consuming in cases where the taxpayer is broadly compliant and wishes to cooperate will be in the interests of the revenue authorities and corporate taxpayers alike, provided that the processes are fair and transparent and open to proper judicial appeal where necessary. Differences in interpretation of legislation need to be identified in good time, so that transactions can be based on a full understanding of the position being taken by the revenue authorities. In order for this to happen, disclosure by taxpayers needs to be full and timely. For both taxpayers and tax administrators, good corporate governance and structures for enhanced cooperation between taxpayers and revenue authorities can be seen as the key to managing risks in this area.[8]

Thus it can be seen that although taxpayers and tax authorities have differing perspectives, there may well be shared approaches and mutual lessons to be learned in how to tackle the problems of both sides as to tax risk management. There are many advantages to be gained, although it is important also to recognize the limitations of this administrative approach, which cannot substitute for good law making.[9]

2. Economic and social developments

Corporate income taxes in countries within the Organisation for Economic Co-operation and Development (OECD) have been declining for more than 25 years as a response to increasing mobility of capital and various in-

6. Centre for Tax Policy and Administration Forum on Tax Administration Information Note – General Administrative Principles: Corporate Governance and Tax Risk Management, Paris: OECD, July 2009 (hereinafter "Information Note"). See http://www.oecd.org/dataoecd/37/19/43239887.pdf, Para. 19.
7. Fiscalis Guide, op. cit., Para. 1.2.
8. Information Note, op. cit.
9. For a discussion of this point in a UK context, see J. Freedman, G. Loomer and J. Vella, "Corporate Tax Risk and Tax Avoidance: New Approaches", 1 *British Tax Review* (2009), p. 74.

herent problems with taxing corporate income.[10] This has meant that many countries have attempted to increase their corporate tax base by way of compensation. Until recently corporate revenues have not fallen too heavily or have even increased as a percentage of GDP, but this has not only been because of base broadening. Rather it is explicable by the increased profitability of the corporate sector.[11] Even before the recent economic crisis, it was being predicted that the factors which have enabled countries to maintain their tax revenues despite lower corporate tax rates were unlikely to continue. Recent economic developments which have reduced corporate profitability will be reflected in substantially reduced revenues from the corporate sector and this will increase pressure on revenue authorities to find ways of collecting more tax from corporate taxpayers.

For revenue authorities the current economic crisis presents a challenge and an opportunity. They have been concerned about tax risk management in relation to large corporations for some time, but public and political opinion is now making it acceptable to impose new and more stringent requirements on corporations, especially financial businesses. It is in the context of this climate that approaches to tax risk management by the revenue authorities are now being developed, although the groundwork was laid well before the recent crisis.

3. Background to tax-related risk management and approaches to regulation

3.1. The growth of risk management

Risk management began emerging as an important tool in policy and business literature at the end of the twentieth century and has now entered both private and public sector management thinking to become an organizing concept.[12]

10. OECD Policy Brief, *Reforming Corporate Income Tax*, Paris: OECD, 2008. See www.oecd.org/dataoecd/30/16/41069272.pdf.
11. Id.
12. M. Power, *The Risk Management of Everything*, London: Demos, 2004.

3.2. Corporate governance

New forms of regulating corporate governance in general have been developing for some 20 years now, in response to a series of corporate scandals. In some countries these have taken the form of codes, enforced in various different ways,[13] whilst in others, notably the United States, there has been legislation.[14] Public companies are required to adopt a variety of mechanisms for internal control and self-scrutiny as well as external audit and extensive reporting. On the whole, tax has not been a focus of these regulatory schemes,[15] but the development of the role of the board of directors, executive and non-executive has not gone unnoticed by the revenue authorities and this has been one basis of an agenda for bringing tax into the boardroom in an effort to broaden the view taken by companies of taxation issues.[16] An early lead from the Australian Tax Office (ATO) has led to the subsequent development of this agenda by other revenue bodies and the OECD as discussed below.[17]

At the same time, companies have been developing the quality of their internal controls as a way of improving corporate governance and financial reporting. Given the importance of taxation as an element of cost and risk, it is not surprising that this has come into the internal control framework for corporate taxpayers.[18] It is natural that the revenue authorities should seek to harness these trends and the growing emphasis on corporate social responsibility in an effort to improve taxpayer cooperation from the large corporate sector.

13. For example the UK Combined Code, comprising the Cadbury and Greenbury Codes and the Netherlands Corporate Governance Code.

14. The Public Company Accounting Reform and Investor Protection Act (Sarbanes-Oxley) of 2002 (Pub L. 107-204, 116 Stat. 745).

15. An exception to this is the interpretation issued in June 2006 by the Financial Accounting Standards Board (FASB): Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 calls for the recognition and measurement of tax positions taken or expected to be taken by US companies.

16. J. Owens, “Good Corporate Governance: The Tax Dimension”, in: W. Schön (ed.), *Tax and Corporate Governance*, Munich: Springer, 2008.

17. In January 2004, the ATO Commissioner of Taxation wrote to the chairpersons of 1,500 listed companies urging them to take a more active role in making decisions about tax planning. Attached to the letter was a list of ten questions that boards could consider putting to their tax advisers with a view to identifying and managing relevant tax risks. ATO Practice Statement Law Administration PS LA 2004/14, available at http://law.ato.gov.au/atolaw/view.htm?Docid=PSR/PS200414/NAT/ATO/00001.

18. Netherlands Tax and Customs Administration Co-ordination group on the treatment of very large businesses, *Tax Control Framework*, March 2008.

3.3. Responsive regulation and enhanced cooperation – A compliance model

In a parallel development, an academic literature on regulation has emerged and been adapted to the needs of revenue authorities. Australia was an early pioneer of the tax risk management model for tax authorities, utilizing the concept of responsive regulation and a compliance model based on the notion of an enforcement pyramid derived from the work of Braithwaite and Ayres.[19] The compliance pyramid seeks to select an enforcement strategy that reflects the behaviour of the taxpayer. It works on the basis that most taxpayers voluntarily comply with the tax system and therefore can be regulated by way of cooperation and trust. These compliant taxpayers form the majority at the base of the pyramid. The taxpayers at the tip of the pyramid are those who are engaged in tax evasion and they must be dealt with by way of deterrence and penalties. In the centre are taxpayers who wish to be broadly compliant but who may need more help or persuasion to comply, or who may be prepared to take advantage of grey areas in the law. To the tax authorities, those taxpayers in the central, grey area represent a risk, as well as the more obvious group of deliberate evaders at the tip.[20]

This model was originally developed with individual taxpayers in mind. Braithwaite modified it for use with large businesses.[21] He argued that large corporations are even more likely than individuals to want to comply with the law or, as he put it, to have a "reasonably arguable position" but at the same time "there are many who do not intend to comply with what the [tax authority] regards as the policy purposes of the parliament's tax laws". This makes the pattern of large business compliance egg-shaped rather than pyramidical with large numbers of corporate taxpayers falling into the grey area of tax avoidance.

It follows from the compliance model that it will be efficient for the revenue authorities to use resources to improve the likelihood that taxpayers

19. I. Ayres and J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, Oxford: Oxford University Press, 1992. For a description of the way in which this model came to be developed for the ATO and adopted by other jurisdictions and the OECD, see K. Murphy, "Moving Forward towards a More Effective Model of Regulatory Enforcement in the Australian Tax Office", 6 *British Tax Review* (2004), p. 603.

20. See Australian Taxation Office, *Introduction to the Compliance Model;* available at http://www.ato.gov.au/corporate/content.asp?doc=/Content/5704.htm.

21. J. Braithwaite, "Large Business and the Compliance Model", in: V. Braithwaite (ed.), *Taxing Democracy*, Aldershot: Ashgate, 2003.

within the grey area will comply with the revenue authority's view of what some call the true "spirit" of the law[22] without recourse to litigation. Braithwaite admits that law reform is the first "circuit-breaker" needed to push those in the grey middle bulge down into the white base of the egg,[23] but further developments are also necessary to manage this problem. Braithwaite suggests that this must include the building of cooperative relationships with the potential to reduce compliance costs for business and increase compliance effectiveness for the revenue authorities.[24] In this suggestion we see the beginnings of the *enhanced cooperation* approach within a context of escalating regulatory options where that cooperation is found to be ineffective as developed by the OECD in its subsequent papers.

3.4. Risk rating

The approach to compliance outlined above is often used in conjunction with risk assessment, involving the profiling of taxpayers, using risk indicators (risk rating) in order to decide where to focus resources to achieve maximum compliance with what is available. Braithwaite's "pyramid" approach suggests a process of responsive escalation. Risk-based regulation emphasizes analysis leading to targeting.[25] Whilst not identical they appear to work well together.

As outlined by Michael D'Ascenzo, Commissioner of the ATO, risk-based profiling can be achieved in a large business context as follows:

> Using a range of both financial and tax-specific indicators, we profile large business comparing their business performance with their tax outcomes. Quantitative indicators for each group are compared with their market peers, along with other issues identified through intelligence and analysis.

22. The spirit of the law is, of course, a highly contentious concept, involving as it does a view of legal interpretation which relies on the views of the revenue authorities or current government, rather than purely interpretation by the courts using whatever information they are permitted to take into account. In some jurisdictions there will be more scope for purposive interpretation by the courts than in others, and some jurisdictions, but not others, may permit courts to look at background papers, but every tax system imposes some limits on the extent to which courts can interpret legislation in such a way as to close gaps left by the wording of the statute. This means that there may be a gap between the interpretation given by the courts and the view of the current revenue authorities on the true meaning and intent of the law.
23. J. Braithwaite, op. cit., p. 179.
24. Id., p. 195.
25. R. Baldwin and J. Black, "Really Responsive Regulation", 71(1) *Modern Law Review* 59 (2008), p. 66.

> Profiling involves the use of risk engine analysis that examines taxpayer-reported information, data from other agencies, our own intelligence and publicly available information against risk filters to identify potential compliance risks.
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> The risk filters are periodically reviewed for their effectiveness and changed as necessary to reflect the lessons from our compliance activities.[26]

3.5. Limitations of the risk rating approach

Whilst profiling, or risk rating, as described above, may be very efficient and has had success in a number of countries, it is a tool that needs to be handled with care. Treating taxpayers differently depending on their profile enables tax authorities to use their limited resources efficiently but also has the potential to result in unfair treatment for one taxpayer in relation to others. The line between good management and an unfair or disproportionate use of this tool is a thin one. As pointed out by Baldwin and Black, the criteria used may not be purely technical but in fact may be contentious. Although apparently an administrative device, this could hide important policy issues and make scrutiny and accountability in relation to those issues difficult.[27] There could be tension between efficiency and constitutional values unless the discretion available to revenue authorities is used with great care.[28]

Risk-based frameworks also run the risk of being too backward looking and failing to respond to unpredicted and unpredictable issues.[29] Further, they may focus resources in high-risk areas at the expense of lower-risk areas. In time, unless supplemented by other programmes, this can lead to under–deterrence of low level risk activity and “substitute widely spread risks for lower numbers of larger risks”. It is not certain that this will always be efficient.[30]

26. “Good governance and tax risk management”, speech to the Australian Risk Policy Institute, University of Canberra, 10 July 2008. See http://www.ato.gov.au/corporate/content.asp?doc=/Content/00153731.htm.
27. R. Baldwin and J. Black, op. cit., p. 67.
28. K. Yeung, *Securing Compliance: A Principled Approach*, Oxford: Hart Publishing, 2004, p. 170 and 248; and see J. Freedman, G. Loomer and J. Vella, op. cit.
29. J. Black, op. cit.
30. R. Baldwin and J. Black, op. cit.

4. The OECD initiatives

4.1. The Seoul Declaration and the study into the role of tax intermediaries

In 2006, the OECD Forum on Tax Administration (FTA) countries agreed on the Seoul Declaration to address their concerns about non-compliance with tax laws in an international context. A study team was set up to improve understanding of the role tax intermediaries play in the operation of tax systems. Ultimately, however, the study team, in its report into the role of tax intermediaries (the "Intermediaries Study"),[31] concluded that revenue bodies also need to consider the taxpayer's role, which they referred to as the "demand side" of the market for "unacceptable tax minimization arrangements". It is against this background that several recent papers relating to tax risk management produced by the OECD must be understood. Following the Intermediaries Study the OECD has published a further study on the tax compliance of banks[32] and in July 2009, the OECD FTA published an information note (the "Information Note") and a guidance note (the "Guidance Note") to provide information to governments about good country practices.[33]

4.2. Aggressive tax planning

The Intermediaries Study was unable to define "unacceptable tax minimization arrangements" in view of variations between the legal frameworks of FTA countries. Instead, consultations led to the identification by the study team of two areas of concern for revenue bodies which it described

31. *Study into the Role of Tax Intermediaries*, Paris: OECD, 2008. See http://www.oecd.org/dataoecd/28/34/39882938.pdf (hereinafter "Intermediaries Study"). See also Tax Intermediaries Study *Working Paper 5: Risk Management*, Paris: OECD, 2007 (hereinafter "Working Paper 5"). See http://www.oecd.org/dataoecd/59/59/39003865.pdf.

32. OECD, *Building Transparent Tax Compliance by Banks*, Paris: OECD, 2009 (hereinafter "Bank Compliance Report"). See http://www.oecd.org/document/28/0,3343,en_2649_33749_43384796_1_1_1_1,00.html.

33. Information Note, op. cit.; and Centre for Tax Policy and Administration Forum on Tax Administration: Compliance Management of Large Business Task Group Guidance Note – Experiences and Practices of Eight OECD Countries, Paris: OECD, July 2009 (hereinafter "Guidance Note"). See http://www.oecd.org/dataoecd/36/32/43241144.pdf.

under the common head “aggressive tax planning”. These two concerns or risks are:

- Planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences. Revenue bodies’ concerns relate to the risk that tax legislation can be misused to achieve results which were not foreseen by the legislators. This is exacerbated by the often lengthy period between the time schemes are created and sold and the time revenue bodies discover them and remedial legislation is enacted.

- Taking a tax position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law. Revenue bodies’ concerns relate to the risk that taxpayers will not disclose their view on the uncertainty or risk taken in relation to grey areas of law (sometimes, revenue bodies would not even agree that the law is in doubt).[34]

4.3. Tax risk management and risk rating

The Intermediaries Study concludes that in order to deal with these risks, revenue bodies must use the tool of risk management to identify risk and to allocate resources to respond to those risks. The report outlines five attributes which revenue authorities must show when dealing with all taxpayers. These are: understanding based on commercial awareness; impartiality; proportionality; openness (disclosure and transparency); and responsiveness.

If revenue bodies demonstrate these five attributes and have effective risk-management processes in place, the Intermediaries Study team suggests, this should encourage large corporate taxpayers to engage in a relationship with revenue bodies based on cooperation and trust, with both parties going beyond their statutory obligations.[35] In their view this is what is meant by the term “enhanced relationship” in this context. The view of the Intermediaries Study team is that this should benefit not only revenue authorities but also taxpayers because taxpayers who behave transparently and who represent lower risks will be regulated in a lighter touch way and will have lower compliance costs, with increased certainty at an earlier

34. Intermediaries Study, op. cit., Glossary.
35. Id., p. 5.

stage. For many corporate taxpayers this will work well, with real time disclosure and good access to commercially aware revenue officials in whom they have trust, and they will therefore cooperate. They will receive a lower risk rating than others.

For a corporate taxpayer to go beyond its statutory obligations requires that some benefit can be shown in return, since otherwise the directors might not be performing their duty to the company.[36] Providing more timely disclosure than is strictly required might be an example of going beyond legal obligations that could advantage the company by removing uncertainty and increasing trust. The benefit to the company can take the form of reduced administrative costs and a better relationship with the revenue authorities and also preservation of reputation.

In some circumstances this might result in paying more tax than would be absolutely necessary if the most favourable interpretation of a taxing provision was adopted or if intricate tax planning was undertaken. Not every business will be prepared to restrict its tax planning activities in this way, since they may feel that the financial benefits of what the Intermediaries Study calls "aggressive tax planning" outweigh the advantages of cooperation offered.

In recognizing this, the Intermediaries Study recommends that revenue bodies will need to have effective risk-management processes in place to identify these taxpayers and allocate the necessary level of resources to deal with them: they will be given a higher risk rating. The Intermediaries Study team did not attempt to formalize the risk rating process and left it to individual FTA countries to decide how to take this forward, if at all.[37] It did explain, however, that risk assessment is more subtle than a simple "high" or "low rating".

Risk profiling needs to take into account a variety of factors. These include the size and structure of the taxpayer and its activities. The bigger and more complex the taxpayer's structure and affairs the greater the potential for significant issues to arise, but the Study is clear that size on its own is not an indicator of risk: the largest taxpayer could be low-risk. Other indicators of risk relate to the quality of the taxpayer's processes and account-

36. For a discussion of the duty of directors in this context, see W. Schön, "Tax and Corporate Governance: A Legal Approach", in: W. Schön (ed.), *Tax and Corporate Governance*, Munich: Springer, 2008; J. Freedman, "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle", *British Tax Review* (2004), p. 332.
37. Intermediaries Study, op. cit., p. 25 and Working Paper 5, op. cit.

ing systems and the taxpayer's behaviour, particularly its disclosure levels. Another relevant factor, according to the Intermediaries Study team, is the extent of agreement over interpretation of the law. Whilst explicitly stating that taxpayers are entitled to disagree with the revenue authority's view of the law and to challenge it through litigation if necessary, the Intermediaries Study team points out that the focus on resource allocation means that revenue authorities "will see persistent disagreement over interpretation of the law as a risk indicator".[38]

Thus a taxpayer who engages in "aggressive tax planning" as defined by the Intermediaries Study and set out above may be rated as high-risk whilst at all times taking a tenable interpretation of the law (although one which the revenue authorities believes was not intended by the legislators). If the view is tenable, this must mean that there is a chance that the tax planning scheme will be upheld as effective by the courts. The extent to which this is likely to happen depends on the way in which tax law is interpreted by the courts, which varies from country to country. For example, where there is a general anti-avoidance rule or principle of abuse of law, it may be more likely that the final decision of the court will be in line with the revenue's expectations, although even in those jurisdictions the revenue authority's view of the law will not always be upheld. In Working Paper 5, the Intermediaries Study team admits that if tax planning works and is supported by the courts, only governments and legislatures can change the wording of the law to alter that interpretation.[39] In that case the value of the enhanced relationship may be to bring information about the scheme to the attention of the revenue authority earlier than would otherwise be the case. Allocating more resources to companies that are prepared to engage in so-called "aggressive tax planning" seems reasonable in so far as such companies clearly need more engagements so that disputes can be managed and if necessary litigated, but if a high-risk rating begins to carry negative connotations beyond that, constitutional issues begin to arise about the acceptability of penalizing a taxpayer for behaviour which is ultimately upheld by the courts.

4.4. Corporate governance

In accordance with the general trends described above, within the context of enhanced cooperation, the OECD papers place considerable reliance

38. Intermediaries Study, op. cit., p. 26.
39. Working Paper 5, op. cit., Para. 6.

upon corporate boards understanding more about tax issues and integrating tax policy into their general approach to corporate governance. In their Working Paper on Risk Management[40] the study team comments that:

> (…) the boards of an increasing number of corporate taxpayers are articulating a tax strategy that aligns with wider corporate governance and that has regard for the spirit of the law. This signal from the most senior level means that these corporate taxpayers' interpretation of the law is more likely to be aligned with the revenue body's interpretation of the law. By virtue of this, such corporate taxpayers are less likely to enter into costly disputes with revenue authorities than their competitors who, by
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> contrast, choose to place reliance on fine distinctions of black-letter law, especially those who couple this with a high determination to minimize tax liabilities through the use of creative transactions and structures, regardless of the commerciality of those transactions or structures.

The objective of the study team is that corporate taxpayers will adopt a policy that reduces the tax risk of the company by abstaining from engagement with artificial tax schemes which, even if they might work technically, will be challenged by the revenue authorities and/or might cause reputational damage if exposed in the media. The concern of companies with reputation is undoubted, although it is less obvious that engaging in tax avoidance affects reputations badly.[41]

The Information Note issued by the FTA in July 2009 details the experience of Australia, Canada and Chile in this connection and concludes that experience shows that large businesses that have good corporate governance and more transparent relationships with tax administrations can expect fewer audit interventions and hence greater certainty.[42] The enhanced relationship approach discussed in the Intermediaries Study is endorsed. It is emphasized that the starting assumption of tax administrators should be (unless there are indications to the contrary) that large businesses are closely managing and scrutinizing their material risks and issues, and that they are minimizing their compliance risks through effective internal controls and seek to properly apply the law.

40. Id., Para. 12.
41. For further discussion of this point, referring to the recent campaign by *The Guardian* newspaper in the United Kingdom, see J. Freedman, G. Loomer and J. Vella, op. cit., p. 90.
42. Information Note, op. cit.

Best practice suggestions are contained in the Information Note.[43] For example, it is proposed that revenue authorities initiate a direct dialogue with directors and boards about the administration's expectation that they will ensure that their business has a good corporate governance approach to managing risks. This relies upon voluntary cooperation but it is also suggested that reporting requirements should ensure that significant risks are elevated to decision makers such as the chief financial officer, the chief executive officer, the board or its audit committee.[44] Where poor governance is widespread, the Information Note states, experience suggests that legislative solutions that place responsibility on senior executives and boards may be helpful.[45]

Practical advice to directors and senior management, it is suggested, could include that they have a broad understanding, at least from a financial and business perspective, of the major tax issues that arise in the normal ongoing operations of the business. Further, they should oversee the overall amounts of different taxes paid by the business; be aware of whether these amounts are increasing or decreasing, and how the tax administration is likely to perceive these trends. The directors and senior management should be aware of the relationship the business has with tax jurisdictions, the level of scrutiny of its affairs and the stance that it and its advisers adopt in relation to tax compliance and tax planning. The Information Note sets out questions that boards may want to consider, based on those devised by the ATO.[46]

The Information Note refers to the work of major accounting firms to show that directors are increasingly accepting the importance of tax risk management and incorporating this into their corporate governance procedures.[47] Corporate taxpayers and revenue authorities share the aims of achieving certainty, speedy resolution of disputes and administrative cost reduction. This is an incentive for large corporations to cooperate with tax authorities in this enterprise and the enhanced cooperation being introduced in many jurisdictions is being welcomed by business as well as by the tax author-

43. Id., Paras. 38-44.
44. For an example of legislation being introduced to this effect, see the UK Finance Act 2009, imposing duties on senior accounting officers of certain large companies to take reasonable steps to establish and maintain appropriate tax accounting arrangements: J. Freedman, "Section 93 and Schedule 46: Duties of Senior Accounting Officers of Large Companies", *British Tax Review* (2009), p. 620.
45. Information Note, op. cit., Para. 47.
46. Id., Attachment A.
47. Id., Para. 26; and references listing papers by Ernst and Young and KPMG.

ities.[48] By acting to reduce the demand from large businesses for artificial tax schemes through pointing out the risks of failure, penalties and reputational loss, the tax authorities hope to reduce the supply from those intermediaries who devise such schemes. There is some anecdotal evidence, though nothing more as yet, that this is having some effect on the tax industry, although it may simply be that activity is becoming more tailored and subtle to meet the new demands. The question of behavioural change is one which those applying risk assessments will need to keep in mind if risk rating is to be of value.

Despite this use of risk rating and calls to good corporate governance, if, as suggested above, tax risk management is linked to the achievement of an organization's objectives, it cannot be expected that the objectives of the revenue authorities and those of the corporate taxpayers will always be identical. Tax law remains complex and its intention is not always uncontentious. Furthermore, commercial transactions can often be achieved in different ways and some will be more tax efficient than others. Disputes over the correct amount of tax arising from transactions may be reduced but will not be completely eliminated through improved corporate governance.

4.5. International experience of the risk management approach

The experience of various different revenue authorities with the risk management approach is set out in some detail in the Guidance Note published by the FTA.[49] The factors and indicators used by tax administrations when risk assessing large taxpayers are discussed and the major compliance issues commonly associated with large taxpayers are outlined. International non-compliance remains a significant area of concern since globalization means that tax planning is increasingly focused on ways to minimize worldwide tax. Increasing cross-border cooperation will be pursued as a means of dealing with this. The use of technology to tackle the problems addressed by tax authorities is also discussed.

The Guidance Note finds that risk assessment has been institutionalized by all eight of the countries examined (Australia, Canada, France, Ireland, the

48. Id. On the United Kingdom, for example, see the survey of tax directors reported by J. Freedman, G. Loomer and J. Vella, op. cit.
49. Guidance Note, op. cit.

Netherlands, Norway, the United Kingdom and the United States), coupled with a focus on building better relationships between the tax administration and large corporate taxpayers. Real time management approaches are also highlighted. Some, but not all of the listed countries, are employing corporate governance principles to assist in improving tax compliance. There are differences in the level of risk analysis from country to country, but they are all using this as a way of managing and prioritizing their work. All the participating countries have also recognized the need to train their workforces to deal with this new approach. Many are using new technology to collect additional data to enhance compliance risk and assessment and to ensure consistent treatment of large taxpayers.

The Guidance Note ends by emphasizing the importance of tax authorities designing a mission statement for the large taxpayer segment to stress and publicize the goals and commitments of the large business unit and to encourage voluntary compliance.

4.6. Tax compliance and banks

The Intermediaries Study isolated one particular category of tax intermediaries, investment banks, as posing particular issues because some of them, the study team believed, were involved in aggressive tax planning in the inter-bank finance market as well as in trading for their own account ("proprietary trading"). Even where banks are not involved in designing complex structured finance transactions (CSFTs), they will usually be participants because of the need for a finance provider. The Intermediaries Study did not fully explore these issues but a further study was set up to undertake a follow-up study on banks.

The consequent Bank Compliance Report was published by the OECD in 2009, led by the tax administrations of Australia and the United Kingdom.[50] It was not initiated as a result of the current global financial crisis and the Report states that:

> The global financial crisis developed during the course of this study. Neither tax policies nor tax administration appear to have been significant influences on the events or behaviours which led to the crisis. Nevertheless revenue bodies now have an opportunity to work with other regulators to improve transparency, governance and tax compliance which in turn may help move towards more sustainable systems.

50. Bank Compliance Report, op. cit.

The Bank Compliance Report makes recommendations for revenue bodies and for banks. These are a continuation of the recommendations for an enhanced relationship with all companies, with encouragement to banks to be more transparent and with revenue authorities encouraged to pursue risk assessment based on understanding the corporate governance and other systems of banks and to have other systems to detect high-risk behaviour. In addition, there are proposals for better training for revenue staff in this complex area. The importance of international cooperation is also stressed, since many of the concerns relate to cross-border arbitrage. The need to fully exploit the instruments already available for information exchange is made clear; for example, Art. 26 (Exchange of Information) of the OECD Model Tax Convention on Income and on Capital and the Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters.

For banks, the Bank Compliance Report recommends that good practice includes decision making at chief executive officer or board level; transparency in relation to CSFTs implemented both for clients and on the bank's own account; ensuring that appropriately trained staff review CSFTs for clients and consideration of the benefits of an enhanced relationship. It is suggested that as part of this enhanced relationship, banks should share their views with revenue bodies on tax risk assessment for products or services where there is potential for uncertainty around the tax treatment.

This special emphasis on banks has been translated into a Code of Practice on Taxation for Banks (the "Code") in the United Kingdom, whose staff were amongst those who led on this OECD report.[51] Whilst much in the Code is merely a description of existing good practice and is therefore useful and acceptable to that extent, other aspects go further. The overview to the Code requires banking groups signed up to the Code to "comply with the spirit, as well as the letter, of tax law, discerning and following the intentions of Parliament".

The difficulties involved in establishing what the spirit of the law is, if this means something beyond what the courts would hold the proper meaning of the law to be, have been discussed above. Despite considerable concerns about the extent to which this Code attempts to require the banks to go fur-

51. HMRC, A Code of Practice on Taxation for Banks, Consultation response document of 9 December 2009. See http://www.tax.org.uk/attach.pl/8285/10380/COPtax-banks-ResponseDoc0040.pdf.

ther than is required by law,[52] it appears that the UK government is continuing with this "voluntary" Code and that a number of banks will sign up to it. Since some are in no position to resist, it is hard to know how "voluntary" this Code truly is and to what extent it will eventually change behaviour.

4.7. Difficulties with tax risk management by tax authorities

The Intermediaries Study team deals with the need to control the risk rating process in an Annex to their report which discusses what they call "the impartial approach". The Annex states that revenue bodies should be able to:

> (…) challenge reasonably arguable legal positions adopted by taxpayers in circumstances where the revenue body also has a reasonable legal position it wishes to advance, reflecting what it believes to be sound tax policy.

On the other hand:

> Taxpayers have a reasonable expectation that revenue bodies will act consistently, objectively and fairly. It would seriously undermine trust and confidence for a revenue body to seek to extract as much tax from the taxpayer as possible regardless of whether it is due under the law, using whatever commercial or other leverage can be brought to bear.[53]

In this section of their report the Intermediaries Study team emphasizes the dangers inherent in their risk rating approach, stating that it would be an abuse of the revenue authority's considerable power if it were to advance arguments without a reasonable legal basis. If the risk rating process is intended to be not only a method of resource allocation but also a method of encouraging compliance, something that is clearly an intended outcome on the part of the Intermediaries Study and Bank Compliance Report teams, there could be a danger that revenue views and practice would be used to try to supplant the law in the practical sense of achieving compliance. It is strongly arguable that administrative devices of this kind should not be used to substitute for workable legislation.[54]

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52. See, for example, the comments of the Chartered Institute of Taxation, http://www.tax.org.uk/attach.pl/8285/10070/BankingCOP%20final220909.pdf and of the Financial Market Law Committee, Issue 146 – Proposed HMRC Code, http://www.fmlc.org/papers/Issue146Oct09.pdf. Both these papers were responses to a consultation on the draft code but few changes have been made to the latest version as a result.
53. Intermediaries Study, op. cit., Annex 7.2.
54. See note 9.

The Intermediaries Study acknowledges that, where revenue bodies are focusing on collecting a certain level of revenue, this can provide an incentive for their staff to behave inappropriately. Revenue authorities could delay resolution to encourage taxpayers to pay a premium over the tax due just to obtain certainty and finality. This, the Intermediaries Study team agrees, would be inappropriate.

This is a valuable discussion of the potential problems with the risk rating approach, but it is perhaps disappointing under a heading of impartiality that the Intermediaries Study does not recommend any formal constraints on the powers of revenue authorities in this area in order to discourage overenthusiastic use of this method. The Annex goes on to discuss the use of alternative dispute resolution as a possible mechanism to assist impartiality in the resolution of disputes by encouraging consensus rather than dispute. This may well be desirable in order to expedite resolution of issues and to achieve a result with less hostility, but it may be questioned whether it belongs under the heading of impartiality.

There are other possible difficulties associated with risk rating that are deserving of greater attention, some of which were discussed at 3.5.[55] First, the risk rating process may impose burdens on business in terms of data provision. If this falls on low-risk as well as high-risk taxpayers, it may be unhelpful. Second, relying on past behaviour may fail to take into account behavioural changes including those in response to the risk rating process itself. This means that risk assessments need to be checked and reappraised frequently to be of value. Thus, even where low-risk businesses have been promised light touch regulation, rechecking will be necessary. What is more, it may be that a business is low-risk as far as tax is concerned in terms of avoidance behaviour but nevertheless has very complex affairs. Such a business may need and even want considerable resource allocation from HMRC to deal with its tax affairs. Third, the focus on matters considered to be high-risk could result in the development of multiple lower-risk but still undesirable activities.

The fourth, and perhaps most significant potential problem in this connection is that risk rating uses an apparently administrative device to make policy outside the usual constitutional channels. Decisions about what type of activity is high-risk could appear to be technical, but might actually be

55. And see R. Baldwin and J. Black, op. cit., in a non-tax context.

highly contentious if they involve taking a view of the intention of tax legislation.[56]

5. The European Union

5.1. The Fiscalis Guide

In 2004, a Fiscalis Risk Analysis Project team began work on the *Guide on Risk Management for Tax Administrations* Fiscalis Guide, prepared by tax officials for use by tax officials.[57] This was published in 2006. Based on experiences of Member States, the Fiscalis Guide takes a wide view of risk management, which it defines as a technique to improve the tax administration's effectiveness. The paper ranges more broadly than this book; it deals with all types of taxpayer – individuals as well as all the legal forms of business. It also discusses the internal risks faced by the tax administration. After discussing principles and theories of risk management it goes on to practical examples. It also deals with technical details such as methodologies and uses of statistics, variables and information technology and with organizational aspects of risk management. The Fiscalis Guide is therefore an important resource for tax administrations in Member States.

5.2. Tax risks arising for tax administrations and corporate taxpayers in the Member States

Membership of the European Union increases tax risk for corporate taxpayers and the tax authorities in those states since an additional layer of legislation and judicial activity adds to uncertainty about the application of tax law, especially since there are many areas where the law is still developing and where political agreement has not been reached, and seems unlikely in the near future.

In the context of European Community (EC) law, national revenue authorities do not possess the power to make changes to deal with what they perceive to be problems as they do in the case of domestic tax issues. One of the greatest tax risks for tax authorities within the European Union is that the European Court of Justice (ECJ) will find that national legislation infringes European law. The cost of compensating taxpayers in such cases

56. Id.
57. Fiscalis Guide, op. cit.

can be very significant.[58] Part of tax risk management for the tax authorities is therefore to assess the likelihood of such an infringement and to take action to change legislation as soon as possible, but the outcome of litigation can be hard to predict as European case law is still developing and is taking different twists and turns.

Taxpayers also face uncertainty as to whether national legislation is EC compliant or not and can only ascertain the position through expensive and lengthy litigation in some cases. They may make major gains through such litigation eventually, but the costs could be significant too, not only in legal fees but in management time and complications in terms of the relationship with the revenue authorities. Nevertheless, litigation of this type has been shown to be essential in order to establish and develop the law, given that the political process is currently leaving many tax issues unresolved and it would seem unreasonable for taxpayers to be considered high-risk because they were litigating an uncertain point of European law. The decision on whether to litigate at a European level is, like all litigation decisions, clearly one involving many considerations for the taxpayer. Such decisions will need to be taken by a fully informed board. For tax authorities also, the decision of whether to litigate and when, if at all, to make changes to legislation to meet perceived breaches is one that involves balancing many considerations.

Even once a decision has been reached by the ECJ, it may take a considerable time before national legislation is amended and even then there may be questions over whether this has been done adequately. Continuing areas of uncertainty include the areas of cross-border losses, exit taxes and the application of anti-abuse measures, on all of which the European Commission has produced communications to provide clarification but in all of which litigation continues at ECJ and national levels.[59]

Far greater uncertainty and therefore risk would be involved were the more radical developments that have been mooted to be introduced. The pro-

58. On the principles of such compensation, see *Francovich and Bonifaci v. Italy*, Case C-6/90 [1991] ECR I-5357; *Amministrazione delle Finanze dello Stato v. SpA San Giorgio*, Case 199/82 [1983] ECR 3595.

59. COM(2007) 785, Communication from the Commission: The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries; COM(2006) 825, Communication from the Commission: Exit taxation and the need for co-ordination of Member States' tax policies; COM(2006) 824, Communication from the Commission: Tax treatment of losses in cross-border situations.

posal for a common consolidated corporate tax base (CCCTB),[60] for example, would raise very great tax risk management issues for both tax authorities and taxpayers. Even if the technical tax base and allocation issues could be agreed, major questions about compliance monitoring and enforcement would remain with cooperation and coordination required across Member States. Enhanced cooperation regimes rely on a close working relationship with the relevant tax authority and highly skilled tax officials with an understanding of the commercial issues and the tax affairs of the corporate group. Dealing with a cross-border consolidation would present new challenges for such cooperation, but would also make it all the more important.

For the corporate taxpayer, entering into a new tax regime would be a tax risk as with any new regime with training required in order to set up new systems. At the same time, business representatives have expressed the view that the CCCTB would bring long-term benefits in having to deal with only one tax administration in Europe in due course, thus reducing compliance costs and enabling their governance structures and systems to follow optimal business organization rather than national borders.[61] Assuming that the new regime would be voluntary rather than compulsory, as seems likely, as with all such major tax decisions it would be for the board to decide whether the benefits of the CCCTB regime outweighed the costs and potential risks resulting from the uncertainties inevitable with the operation of a completely new system.

6. Conclusion

Tax risk management has become an important tool for tax authorities and taxpayers alike. Given their different objectives, their approaches will not always be identical, but there is a considerable overlap of objectives in terms of achieving greater certainty, fewer disputes and lower compliance and administrative costs. Transparency about decision making, speedy disclosure and real time working from both sides will be of great assistance and create a win-win situation.

60. For papers on the proposed CCCTB, see http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.
61. T. Keijzer, "Administrative Aspects of the CCCTB – A Business Perspective", in: W. Schön, U. Schreiber and C. Spengel (eds.), *A Common Consolidated Corporate Tax Base for Europe*, Berlin: Springer-Verlag, 2008.

Tax risk rating is, however, a tool which has to be handled with care by the authorities. It involves embedded policy decisions that can be masked as purely administrative processes, but for which revenue authorities need to be accountable.[62] There are potential dangers in tax authorities expecting too much from tax risk management and relying upon this to deal with uncertainties in the law through codes and guidance and enhanced cooperation.[63] Tax risk management and enhanced cooperation are developments which are being found valuable throughout the world but they are not a substitute for well designed tax law and systems.

62. R. Baldwin and J. Black, op. cit.
63. J. Freedman, G. Loomer and J. Vella, op. cit.