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Enhancing the Better Corporate Governance Practice: From Accounting Scandals to Tax Risk Management

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D e c l a r a t i o n   o f   A u t h o r s h i p

I h e r e b y c o n f i r m t h a t I h a v e w r i t t e n t h e t h e s i s „***Enhancing the Better Corporate Governance Practice: From Accounting Scandals to Tax Risk Management***“ *by myself and independently and that I have mentioned all the literature and other sources appropriately in the list of references.*

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Enhancing the Better Corporate Governance Practice: From Accounting Scandals to Tax Risk Management

Abstract:

Recent accounting scandals and current global financial crisis have brought new demands on the whole corporate world. The call for better corporate governance is strengthening in all business areas including tax. Tax non – compliance brings substantial risks for both tax payers and tax revenue authorities. The way how companies manage their tax risks can significantly influence their overall financial performance and reputation. The paper deals with issues of tax non – compliance as a lack of good corporate governance practice. The main goal of the paper is to put tax into the concept of corporate governance. Moreover, the paper deals with the concept of tax risk management as a way of how tax compliance in general could be enhanced and introduces the current international practice in this field.

Key words:
Corporate Governance, Tax Risk Management, Tax Compliance

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Introduction

The recent accounting scandals have reinforced the importance of corporate governance. The terms as honesty, openness, and transparency have become an inseparable part of all areas of business. Governments all around the world are daily loosing significant amounts of their tax revenues due to the inappropriate tax compliance practice. Therefore, the broad spectrum of stakeholders is showing an increased interest in the field of tax issues. In addition to this, the current financial crisis has put a strong emphasis on financial reporting standards. Legislative requirements including the tax obligations are changing rapidly. Big multinational companies are no longer able to keep their tax agendas in "black box" since such behaviour lead to substantial risks. Therefore, there has been a significant increase in internal control mechanism and connected risk management practice in order to meet all current legal requirements and ultimately, to satisfy the needs of all involved stakeholders.

The interconnection of corporate governance and tax risk management is a frontier in current corporate governance debates. The main aim is to put the concept of tax compliance into the field of corporate governance which is a frontier issue in current corporate governance discussion but still belongs to one of the less studied areas of corporate governance theory. Therefore, the paper provides a practical overview of current tax governance. In addition to this, key issues regarding the interconnection of corporate governance and tax risk management will be addressed. Moreover, the paper elaborates on current international practice in tax governance and related tax risk management.

The first part of the paper examines the interconnection between tax and corporate governance. First of all, the term tax compliance is introduced. In this respect, the paper elaborates on the concept of tax planning and related tax avoidance and tax evasion. The classical examples from practice are mentioned in order to advert to consequences arising from the avoidant and evasive behaviour. Additionally, the concept of corporate governance is introduced since the non – compliance can be seen as a lack of good corporate governance system. Subsequently, the first part of the paper shows how tax and corporate governance are interrelated.

The second part of the paper deals with the concept of tax risk management from the corporate governance's perspective. The tax risk management is one of the methods of how the general tax compliance can be improved while mitigating the broad spectrum of risks arising from the complex character of tax obligations. First, the tax risk management from the tax revenue authorities' perspective is introduced and subsequently the paper examines the tax risk management from the perspective of the tax payers since both tax revenue authorities and tax payers pursue different aims which, however, lead to the ultimate common goal, better tax compliance.

Finally, the third part of the paper examines the current international experience in the field of tax risk management and corporate governance. For the purpose of this paper, the current practice in the United States, the United Kingdom and Australia is addressed since these are the main initiators in this field and have also been an inspiriting example for other countries in enhancing the better tax governance practice.

1. Tax and Corporate Governance

Benjamin Franklin reflected the serious impact of taxes when quoting that "nothing is certain but death and taxes".[1] Taxes are in most countries one of the most important sources of public revenues. Therefore, there is a big pressure on companies on how well they govern and subsequently fulfil their tax obligations and how they are able to comply with the particular legislation.

Unfortunately, paying taxes in accordance with law has not been, and still is not, for many companies a matter of fact. Taxes have been demonized to the extent that taxation is often regarded as something wrongful. The attitude towards taxes is therefore not always positive and such perception of taxes lead some companies to broad spectrum of tax avoidant practices. The consequences are serious. Non – compliance can lead to significant risks for companies in particular. Moreover, the way of the attitude to tax compliance influences in ultimate consequence total tax revenues of particular country.

Therefore, following chapter deals with the character of tax compliance and explains how thin is the dividing line between legal and illegal behaviour while fulfilling tax obligations.

1.1 From Tax Compliance and Tax Planning to Tax Avoidance and Tax Evasion

"Countering the tempting logic that tax avoidance is good for shareholders is the fact that tax avoidance opportunities require obfuscation and, consequently, open the door to managerial opportunism. Indeed, several high-profile cases of managerial opportunism, including Enron, Tyco, and Dynegy, had their genesis in tax – planning activities. These activities, and the secrecy they demanded, became the cover for activities that were not in shareholders best interests."[2]

Professor Mihir A. Desai, Harvard Business School

[1] From http://www.phrases.org.uk/meanings/death-and-taxes.html
[2] From http://hbswk.hbs.edu/item/4902.html

1.1.1 Tax Compliance

Tax compliance refers to the situation where tax payers are fulfilling their tax obligations fully in accordance with law. According to Alm, tax compliance is the reporting of all incomes and related paying of all taxes with respect to tax law, regulations and court judgements.[3] Singh defines tax compliance as declaring all taxable incomes accurately within the stipulated legal period without any follow – up actions from the tax revenue authorities.[4]

The scope of current tax compliance varies across different jurisdictions and taxation roles. Tax compliance has become an internationally perceived notion. According to Hoyng, global tax compliance means "integration with accounting and reporting, automation of processes and the ability to organize tax processes around it."[5]

OECD defines tax compliance as ability of a tax payer to fulfil following legal obligations:

- Registration in the system.
- Timely filing or lodgement of requisite taxation information.
- Reporting of complete and accurate information.
- Payment of taxation obligations on time.[6]

Additionally, Murphy describes following activities as being a part of tax compliance:

- Compliance with tax law in all countries in which particular tax payer operates.
- Disclosing all relevant information about tax claims.
- Paying the right amount of tax at the right time and in the right place.
- Ensure that the tax submissions reflect the real business transactions the particular tax payer undertakes.[7]

[3] Alm, J., 1991, A Perspective on the Experimental Analysis of Taxpayer Reporting: The Accounting Review
[4] Singh, V., 2003, Tax Compliance and Ethical Decision – Making: A Malaysian Perspective
[5] In Bakker, A.; Kloosterhof, S. Tax Risk Management: From Risk to Opportunity
[6] OECD, Compliance Risk Management: Managing and Improving Tax Compliance
[7] Murphy, R. The Missing Billions The UK Tax Gap

1.1.2 Tax Planning

Tax planning has undergone an impressive development in recent decades. The main reasons for tax planning are cost savings and optimization of cash flow.[8]

Ulph defines tax planning as a "taxpayer's adjusting his real social, economic or organisational affairs to obtain the "best outcome" in response to the tax system. This does not necessarily mean paying the smallest possible amount of tax. If the price of earning additional profits was to pay additional tax this might still be advantageous."[9] In this respect, tax planning can be perceived as a part of tax compliance.

According to Self, the tax planning has to relate to a certain business transaction, such as the sale of a products or services and the way in which the tax planning is performed has to be commercial.[10] That is, what makes tax planning different from tax avoidance and tax evasion.

Based on the fact, that tax law is not always precisely defined, tax payers often tend to misinterpret the meaning of the law in their own way which is beneficial for them. In that respect, tax planning can be seen as not being a part of tax compliance but rather a way of tax avoidant behaviour. The extent to which tax payers dispute the law depends mainly on their basic willingness to comply. Generally, if tax payers fail to comply with tax law, then they might be considered as non – complaint. Following lines deal with avoidant and evasive behaviour as a two most significant ways of non – compliance.

1.1.3 Tax Avoidance

Tax avoidance is a term which refers to legal reduction in tax liability. Such reduction of taxes is usually unintended by tax revenue authorities but is permissible by law.[11] Avoidance is mostly performed by structuring transactions whose only purpose is to decrease the tax

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[8] Elgood, T.; Fulton, T.; Schutzman, M. Tax Function Effectiveness
[9] Williams, D. F. Tax and Corporate Social Responsibility
[10] Freedman, J., Beyond Boundaries
[11] From http://www.scribd.com/doc/239537/Tax-Evasion-and-Tax-Compliance

liability. In that respect, tax avoidance, contrary to the tax planning, is artificial. Therefore, avoidance is often regarded as being a grey area between tax compliance and tax evasion.[12]

Ulph defines tax avoidance as a situation where a “taxpayer uses artificial or contrived methods of adjusting their social, economic or organizational affairs to reduce their tax liability in accordance with the law while not affecting the economic substance of the transactions.”[13]

Murphy explains tax avoidance practices as those where tax payers for example seek to:

- Pay less tax that might be required by the law interpretation in particular country.
- Pay tax on profits in countries which does not appear to be that where those profits were earned.
- Pay the tax by a person who did not really generate the taxable income as declared.[14]

1.1.4 Tax Evasion

“The difference between tax avoidance and tax evasion is the thickness of a prison wall.”[15]

Denis Healey, former UK Chancellor of the Exchequer

Tax evasion occurs when a tax payer deliberately fails to fulfil tax obligations. It is an illegal activity undertaken in order to reduce a final tax liability. OECD defines tax evasion as situation when a tax payer pays less than he is legally obliged by hiding income or related information from the tax revenue authorities.[16]

Williams defines tax evasion as “any criminal activity, or any offence of dishonesty punishable by civil penalties, which is intended to reduce the incidence of taxation. This

[12] Murphy, R. The Missing Billions The UK Tax Gap
[13] Williams, D. F. Tax and Corporate Social Responsibility
[14] Murphy, R. The Missing Billions The UK Tax Gap
[15] Ibid.
[16]From http://www.oecd.org/document/43/0,3343,en_2649_34897_31919851_1_1_1_1,00.html

might involve theft, fraud or forgery in relation to tax, or specific statutory offences of tax evasion, depending on the jurisdiction concerned."[17]

According to Franzoni, evasion problem originate in the fact that the variables that define the tax base are often not "observable". In economic terms, the external observer can not see the true and fair tax liability of the tax payer and therefore, a tax payer can take advantage of such imperfect information.[18]

Murphy shows tax evasion practices as those where tax payers for example seek to:

- Fail to declare all or part of their taxable income.
- Deduct an expense from their taxable income that they really did not incur or which they were not entitled to deduct.
- Submit a tax return that appears to be legal but only because relevant facts are.
- Not disclosed to the tax authorities.[19]

From above mentioned definitions it is clear that it is important to distinct between the artificial or even illegal tax transaction and the properly tax planned scheme which arises from the real business transaction and is fully in accordance with law. According to Murphy, no one has the obligation to pay more than is required by the law but everyone should be expected to pay the tax that is required by law.[20] At this point, the main problem arises. The interpretation of the law is very often not clear. Moreover, the global character of current business operations makes it even harder to set clear and obvious regulations. Such misinterpretation of tax regulations leads to both tax avoidance and evasion. Following lines show the real examples from practice where tax law was misinterpreted.

1.1.5 Examples and Consequences of Tax Avoidant/Evasive Behaviour

Tax avoidant and evasive behaviour have significant consequences both on particular company and public as a whole. One of the most serious consequences of such tax sheltering for public companies is the negative market reaction on such behaviour. Hanlon in that

[17] Williams, D. F. Tax and Corporate Social Responsibility
[18] Franzoni, L. A. Tax Evasion and Tax Compliance
[19] Murphy, R. The Missing Billions The UK Tax Gap
[20] Ibid.

respect mentions following reasons for such negative reaction. First, if the tax avoidance becomes detected, a company is consequently a subject to additional taxes, penalties and interests which previously were not accounted which would lead to lower company's earnings as reported previously. Subsequently, the market will most likely react negatively. Secondly, if the organization is identified as a tax avoider, the company might have serious reputation problems while being labelled as a "poor corporate citizen". Last but not least, if the company tend to act aggressively towards tax authorities, then, it might act aggressively also towards investors as well. Following cases of Tyco International Ltd. and Dynegy Inc. are classical examples of tax avoidant/evasive behaviour where tax oriented transactions which did not have any real business purpose occurred. The third example describes the current value added tax frauds in the Europe as a way of tax evasive behaviour and its consequences.

Dynegy Inc.

Dynegy is an energy company, established in 1998 as a merger of NGC Corp. and Chevron Corporation, and a large owner of energy plants and a significant player in the field of natural gas and coal business.[21]

The aggressive tax scheme by Dynegy started when investors began to question the quality of Dynegy's earnings due to the widening gap between Dynegy's net profit and operating cash flows. As a consequence, Dynegy structured a complex web of tax shelter transaction so that to improve the operating cash flows. This project, called "Project Alpha" boosted operating cash flows by $300 million, and thereby reduced the gap between operating cash flow and net income. Such transaction created a $79 million tax benefit for Dynegy. In the reality, those $300 million was a bank loan disguising as operating cash flows on Dynegy's 2001 financial statements.[22]

Olis, one of the former Dynegy's tax executives involved in the fraudulent scheme, was convicted to 24 – year sentence. The Company had to pay $468 million to settle violation of securities laws primarily related to Project Alpha. Dynegy's shares lost more than half its value on the exact day when Dynegy disclosed an investigation into Project Alpha by Securities and Exchange Commission. There were more than fifty victims of Dynegy's fraud

[21] To learn more about Dynegy's history see http://www.dynegy.com/default.asp?r=1

[22] For more information about the Dynegy case see http://www.sec.gov/litigation/litreleases/lr17744.htm

which was the cause of such high sentence for Olis. In addition, one of the shareholder, the University of California Retirement System, suffered a loss amounting to $105 million.[23]

TYCO International Ltd.

Tyco was founded in 1960's as a manufacturing company dealing with high – tech materials and energy conservation products. In 1974, Tyco was listed on New York Stock Exchange and increasingly enlarged its market share through the aggressive acquisition strategy. In 1990's, Tyco's new CEO, Dennis Kozlowski, continued in the massive acquiring strategy which lead to more than 1000 acquired companies between 1990 and 2001.[24] "Tyco's market capitalization in 2001 was $116.3 billion, making it one of the top 20 – valued public companies listed on the New York Stock Exchange."[25]

Tyco aimed to minimize its tax obligations through the aggressive tax strategies. The strategy was based on relocating earnings from countries with high income tax rates to tax heavens. As the result of such strategy, the average foreign tax rate faced by Tyco in the early 1990s was higher than 50% while by the end of 1999, the average foreign tax rates were below 20%. Moreover, in 1996, Tyco had one subsidiary in a tax heaven, while in 2001, Tyco had more than 160 subsidiaries in tax heavens.[26]

According to Desai, Dyck and Zingales, the main issues which characterized the way of the Tyco's tax strategy were following. First, the tax avoidance strategy was facilitated by the high level of centralization of power by CEO Dennis Kozlowski and CFO Mark Swartz. Secondly, managers were able to "manufacture post tax profits at relatively low cost through pre – tax profit shifting to foreign source obscured true underlying business profitability."[27] Mangers were abusing corporate loan programs and funds for personal purposes. [28] Moreover, Kozlowski and Schwartz were issuing bonuses to themselves and other employees without approval of Tyco's board of directors.

[23] From http://goliath.ecnext.com/coms2/gi_0199-7216047/The-challenge-of-white-collar.html
[24] To learn more about Tyco's history see http://www2.tyco.com/wps/wcm/connect/tyco+who+we+are/Who+We+Are/History/
[25] Levensohn, P. N., Tyco's betrayal of board governance
[26] Desai M., Dyck A., Zingales L., The Protecting Hand: Taxation and Corporate Governance
[27] Desai M., Dyck A., Zingales L., The Protecting Hand: Taxation and Corporate Governance
[28] Ibid.

In 2002, the Tyco’s financial accounting first came under review. Just in the same year, Kozlowski resigned before he was accused of tax evasion on some purchases of expensive art purportedly made with company funds.[29] Both Kozlowski and Schwartz were indicted on charges of theft and civil fraud. It is estimated that Tyco’s avoidant behaviour has cost common equity owners approximately $88 billion in lost shareholder value.[30]

Dynegy and Tyco provide a good example of how tax avoidant transactions give an opportunity to managers to mislead investors and shareholders by inappropriate compliance which brought about serious consequences for both companies.

VAT Carousal Frauds

The value added tax is harmonised under the common system since 1967 when the First VAT Directive came into force in order to ensure transparency in the “de – taxing” of exports and “re – taxing” of imports.[31] Currently, the EU is harmonizing the VAT legislation across all 27 member states. Due to the growing importance of international trade and expansion of the European Union and due to the fact that VAT is generally perceived as being sensitive to frauds, different types of fraudulent behaviour are occurring. Carousel VAT frauds represent the current major concern of European Member States mainly based on the alarmingly growing rate of its quantum and sophistication.

The main reason for fraudulent transaction is based on the fact that EU allowed businesses to purchase intra – Community goods and service without being charged VAT. Carousel frauds are the example of such tax non – compliance, tax evasive behaviour, and are based on the principle of so called “missing trader”. The fraud is based on importing of goods without VAT as an intra – Community supply of goods to another Member State, then selling them through a series of domestic companies which are all VAT taxpayers, before exporting it again. The first link of the chain goes missing without accounting for VAT while the last link of the chain reclaims the input VAT from the state. Such transactions are mostly performed with ease mobile goods such as computer chips and mobile phones. Moreover, currently the

[29] Ibid.

[30] Levensohn, P. N., Tyco's betrayal of board governance

[31] For more information about VAT see http://www.europarl.europa.eu/ftu/pdf/en/FTU_4.18.2.pdf

carousel fraud is performed in the case of carbon permissions for its ease to trade such goods via computer. According to International VAT Association, estimates of those VAT frauds vary from €60bn – €100bn per annum for all Member States.[32] Therefore, the EU currently addresses those issues in order to reform the system of VAT legislation in order to avoid such tax evasive practices which have significantly influence the total amount of the public revenues.

As explained above, tax compliance is an extreme complex area which might have, if not performer well, a wide spectrum of consequences both on corporate tax payers and society as a whole. Tax compliance increasingly requires high demands on tax and finance functions. Tax revenue authorities, in current turbulent times in particular, call for better practice in tax compliance in order to mitigate avoidant and evasive behaviour of tax payers and subsequently collect as much tax revenues as possible. Increased existence of tax challenges by tax authorities are one of the ways how tax authorities can achieve such goal. Therefore, the way how companies are able to comply with tax law can make them different. Moreover, a wide spectrum of risks is arising from the character of tax compliance. Following chapters are therefore trying to find a possible solution of how generally tax compliance can be improved in order to mitigate those risks. In this connection, theory and practitioners deal with issues of inappropriate tax compliance and puts tax into the concept of corporate governance as one of the possible solutions for improving the tax compliance. Following chapter therefore examines the general concept of corporate governance and subsequently the interconnection of corporate governance with tax.

[32] *International VAT Association.* Combating Vat Fraud in the EU : the Way Forward

1.2 The System of Corporate Governance

Corporate governance is a multi – faced discipline which deals with ways of how companies govern their particular operations. In this chapter the concept of corporate governance will be introduced.

1.2.1 Definitions of Corporate Governance

The whole issue of corporate governance was strongly reinforced after the huge corporate scandals like Enron, WorldCom, above mentioned Tyco, Dynegy etc. The concept of corporate governance is in nowadays business world a hot topic for the wide spectrum of corporations and become a crucial tool for demonstration of the effectiveness and stability of particular company. Corporate governance is a very dynamic field which is currently due to the current global economic crisis even more strengthening its importance.

There are many definitions which describe the concept of Corporate Governance. According to OECD, "corporate governance is the process by which companies are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."[33]

Clarke describes corporate governance as "the way corporate entities are governed and about the exercise of power over corporate entities."[34]

Moreover, according to Robert Monks and Nel Minow, corporate governance can be seen as "the relationship among various participants in determining the direction and performance of

[33] Definition from http://e.viaminvest.com/WhatIsGorpGov.asp

[34] Clarke, T. Theories of Corporate Governance : The Philosophical Foundations of Corporate Governance

corporations. The primary participants are the shareholders, the management and the board of directors."[35]

1.2.2 Agency Theory and Corporate Governance

Based on the above mentioned definitions, it is clear that corporate governance deals with different interests within the corporation and tries to harmonize the processes within the company in order eliminate possible threats arising from such diverse interests.

Before we describe the scope and purpose of corporate governance, it is suitable to introduce the agency theory which is for necessary for understanding of the whole concept of corporate governance. Agency theory is a broadly applied term in the economic theory. In the corporate governance's point of view it is a shareholder who is treated as a principal and managers, acting as agents. The principal – agent problem arises from the separation of ownership and control in companies and from the different interests of both principal and agent.[36] In that respect, managers fail to maximize the shareholders value and rather maximize their own interests. Moreover, there are significant agency costs which are arising from the relationship principal – agent. These refer mainly to the decline in the firm's value due to the agent's behaviour.[37]

The system of good corporate governance is seen as a remedy to the agency problem while mitigating such differences in interests and thereby reducing agency costs. According to Mallin, corporate governance prevents any single individual from holding to much influencing power and ensures that the company is run at the best interest of all involved stakeholders.[38] Such mitigation of agency costs can be achieved i. a. by setting an appropriate internal monitoring system which would lead to the mitigation of the opportunistic behaviour of agents. Generally, corporate governance is seen as a widest system of internal and external control mechanism.[39] An example of such internal control mechanism can be a well

[35] Monks, R. A. G.; Minow, N. Corporate Governance
[36] Roberts, J. Agency Theory, Ethics and Corporate Governance
[37] From http://www.scribd.com/doc/34013436/Agency-Problem-and-the-Role-of-Corporate-Governance
[38] Biswas, P.K. Agency Problem and the Role of Corporate Governance Revisited
[39] Ibid.

developed system of risk management. The concept of risk management, namely tax risks management, will be introduced later on in this paper.

1.2.3 The Scope of Corporate Governance

According to Financial Reporting Council, “the purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long – term success of the company.“[40] Corporate governance, according to Tricker, deals with “the structure, the membership and the processes of the governing body.” The relations between shareholders and other possible sources of finance, company and its contractual stakeholders, the effects of the local regulatory environment so as the influence of legal institutions are vital in understanding the scope of corporate governance.[41]

In the theory, there are different approaches to the whole concept of corporate governance and therefore different points of view arise when speaking about the scope of corporate governance. In addition to this, Macey describes the purpose of corporate governance as to “persuade, induce, compel and otherwise motivate corporate managers to keep the promises they make to investors. Macey goes on to say that good corporate governance “is about keeping promises while bad corporate governance is defined as promise – braking behaviour.”[42] Corporate governance theory has a considerable application to the practice and so many companies are applying corporate governance practices and adapt those into the nature of their business.

Nowadays, a lot of company’s boards see corporate governance as a regulative obligation rather than an effective way how to strengthen their business. In this respect, companies often fail to appreciate the importance of corporate governance practices in their particular business. Generally, corporate governance is seen as a discipline which, if performed well, brings a several benefits to companies. Good corporate governance practices ensure that all the interests of all involved stakeholders all met.

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[40] Financial Reporting Council, The UK Corporate Governance Code
[41] Tricker, B., Corporate Governance: Principles, Policies, and Practices
[42] Macey, J. R., Corporate Governance : Promises Kept, Promises Broken

According to Sir Adrian Cadbury, the scope of corporate governance covers all aspects of company directions, both internal and external. In addition to this, companies should address the whole spectrum of stakeholders whose engagement is crucial for company's sustainable success.[43]

One of the directions covered by the corporate governance is its influence on the concept of corporate social responsibility. Currently, there is a strong increase in influence of corporate social responsibility in the whole business world. Based on past corporate scandals and current economic crisis, the public interest in responsibility issues is significantly increasing. Corporate governance has been strongly reinforced due to this trend. Good corporate governance can significantly prevent companies from deviating from honest behaviour. The danger of existence of frauds is therefore minimized. In addition, the prevention from dishonest behaviour thanks to well set corporate governance procedures plays a key role for corporations in nowadays turbulent times. According to Erle, there is a strong connection between the success of the company and its reputation. Such reputation closely relates to the general perception of the company.[44]

Moreover, beside the fact that good corporate governance increases the likelihood that the company satisfy all the shareholders and stakeholders and fulfil the needs of social responsible behaviour, according to the study of Association of British Insurers, there is a significant interconnection between the company performance and the level of corporate governance. The study was performed based on more than 350 companies in the United Kingdom and it observes their FTSE All – Share Index[45] over the five years. The study has shown a clear relationship between corporate governance and performance of the company. Companies with poor governance has shown a weak performance while contrary to that, companies with good governance delivered higher returns and the volatility of their share price were significantly lower. The study concludes that corporate governance does have a

[43] The Committee on the Financial Aspects of Corporate Governance

[44] Erle, B., Tax Risk Management and Board Responsibility

[45] FTSE UK Index Series is a capitalization – weighted index and is design to represent the performance of UK companies. More information about FTSE All – Share Index are available on http://www.ftse.com/Indices/UK_Indices/index.jsp

substantial effect on companies' profitability and share prices.[46] In that connection, Tricker claims, that "corporate governance expenditures can be therefore cost – effective.[47]

In addition, good corporate governance is a suitable tool in reducing the investment risks. According to International Financial Organization, poor standards and weak enforcements within the scope of corporate governance are the main barrier for investors when deciding where to invest their resources. The increased standards in corporate governance lead to increased market valuations of companies which attract more investors. [48] Therefore, good corporate governance protects the interests of investors as potential shareholders. Moreover, good governance facilitates the decision – making processes. While the board select managers to run the business and fulfil their responsibilities, the board hold managers responsible for their behaviour. Good governance brings solutions to problems and enables to address strategic and operational issues promptly with high level of efficiency. Such streamlining of the business operations thanks to the sound system of corporate governance consequently leads to possible profit maximization.

Moreover, since the corporate governance is i. a. a way of an internal control mechanism, risk management is a part of good corporate governance systems. Companies are permanently under pressure of external risks arising from the character of their business. Not only above mentioned issue with investment risks, but also a wide range of other risks, is in nowadays business world a fundamental topic in current corporate governance discussions. Better corporate governance leads to better processes within a company which consequently minimize such risks.

As mentioned above, generally, corporate governance enters the broad spectrum of company's operations. The scope of corporate governance is very generous and so are possible outcomes which good corporate governance can bring to companies. In general, based on the above described characteristics of corporate governance, the system of corporate governance is understood as being very broad in terms of practical application. According to

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[46] Available on http://www.abi.org.uk/Publications/Governance_and_Performance_in_Britain1.aspx
[47] Tricker, B., Corporate Governance: Principles, Policies, and Practices
[48] See http://www.ifc.org/ifcext/corporategovernance.nsf/Content/WhyCG

Macey, “everything that influences the way the corporation is actually run falls within the definition of corporate governance.”[49]

Recently, the connection between tax issues and corporate governance has become a part of current corporate governance debate. The interconnection between both terms is arising from the character of above mentioned tax compliance which companies have to face to. Companies have not until recently dealt with tax compliance in alignment with the overall corporate governance strategy. Such behaviour can in the ultimate consequence lead, as for instance in the case of Dynegy and Tyco, to tax avoidant and evasive behaviour.

The following section of the paper examines the relationship between corporate governance and tax.

[49] Macey, J. R., Corporate Governance : Promises Kept, Promises Broken

1.3 The Interconnection between Corporate Governance and Tax

"If you ask me what tax has to do with corporate governance, I would say that it depends on the decisions you make as directors: whether tax remains obscured in its black box, with all the barriers to identifying and mitigating risks this entails, or whether management of material tax risk is built into the foundations of your business."[50]

Michael D'Ascenzo, Commissioner of Taxation

The interconnection of corporate governance and tax has not been a frequent object of theoretical studies but recently is has become clear that such interconnection has significant consequences on wide range of business processes. Therefore, tax should be a part of corporate governance and should be treated as such. This chapter deals with such interconnection and tries to find out how tax and corporate governance goes hand in hand together.

1.3.1 OECD Principles, Tax and Corporate Governance

The relationship between taxes and corporate governance is i. a. integrated in the OECD Principles. According to OECD Principles, corporate governance requirements and practices "are typically influenced by an array of legal domains, such as company law, securities regulations, accounting and auditing standards, insolvency law, contract law, labour law and tax law. Under these circumstances, there is a risk that the variety of legal influences might cause unintentional overlaps and even conflicts, which may frustrate the ability to pursue key corporate governance objectives."[51]

In that respect, it is necessary to bear in mind that corporate governance procedures vary from country to country mainly due to the different structure of governing bodies. There are countries with two – tier boards that separate the supervisory function and the management functions. Contrary to that, there are countries with so called unitary boards which consist of

[50] From Speech by Michael D'Ascenzo to the Australian Institute of Company Directors, Sydney, 16 February, 2010

[51] OECD, OECD Principles of Corporate Governance

executive and non – executive board members. The OECD Principles are "intended to be sufficiently general to apply to whatever board structure is charged with the functions of governing the enterprise and monitoring management. Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation."[52]

1.3.2 Tax and Corporate Governance from the Economic Perspective – Agency Theory as a Reason for Non – Compliance

In this chapter, the agency problem will be addressed again. But this time, the main emphasis will be based on the tax issues in connection with the diffused structure of the ownership. The main challenge in this respect is how companies can handle the problem of the separated ownership and related agency issues in order to ensure effective tax solutions which would be acceptable for both shareholders and stakeholders in the long – term period.

From the agency – theory point of view, for there to be a meaningful connection between taxation and corporate governance, it is necessary that the ownership and management of the company are separated. In such cases the incomplete character of contracting and monitoring leads to managerial opportunism.[53] As already mentioned above, the agency – theory is based on the fact that agents have different interests in comparison to those of the principals. In connection with the corporate tax policies, shareholders bear the burden of the taxes since taxes are reducing their profits and managers are those who make the decisions about the final tax liability.[54]

From the economic perspective, according to Franzoni, the variables that are defining the tax base such as income, sales, revenues, wealth, are often not directly observable. The external observer is not able to know the right tax liability of the tax payer. That is one of the reasons

[52] OECD, OECD Principles of Corporate Governance
[53] In Schön, W. Tax and Corporate Governance
[54] Ibid.

why tax payers tend to evasive behaviour since they are able to take advantage of such imperfect information. [55]

In addition to this, managers often tend to find suitable solutions to maximize their utility even if it is not in accordance to the interests of shareholders. Such situation where managers need to meet their earnings and cash – flow targets thanks to tax optimization are not rare. Above mentioned practice of Tyco International, for example, is a classical example of principal – agent theory where agents, in this case CEO Kozlowski and CFO Swartz, acted in their own interest. The risks arising from such behaviour, however, bear the owners of the company.

According to Desai and Dharmapala, there are two main preconditions for such tax agency problems. First, a tax – oriented transaction has to be desirable. Such "desirability" can for example arise when there is an intention to mislead the capital markets. Second, such transactions are commonly justified on the basis of secrecy as necessitated by tax objectives.[56] In addition to this, the above mentioned transactions depend on different particular corporate governance view of taxation and therefore their character is not unitary. First, the character of such tax oriented transactions is based on the nature of the particular tax system which widely differs in the practice and therefore differently influences the managerial decisions which consequently influence the extent of agency problem. Second, the different approaches to the nature of corporate governance environment are also significantly influencing the character of such transactions.[57]

According to the research of Desai, Dyek and Zingales, based on data from countries with different level of corporate governance practices, managers in countries with weaker corporate governance find it easier to divert from shareholders and so have higher incentive to avoid taxes in order to fulfil desirable financial targets. In this connection, based on this research, increased corporate tax rates increased tax revenues only in countries with strong corporate governance contrary to countries with weak corporate governance where the tax revenues declines when corporate tax rates increase.[58] In that respect, a certain sort of "Laffer

[55] Franzoni, L. A. Tax Evasion and Tax Compliance
[56] In Schön, W. Tax and Corporate Governance
[57] Ibid.
[58] Ibid.

– courve"[59] is generated by the weak level of corporate governance practice. Therefore, in that respect, corporate governance is seen as a tool for mitigation of above mentioned market imperfection in the form of imperfect tax information about the actual tax liability of the tax payer.

1.3.3 Tax and Corporate Governance from the Legal Perspective

The legal perspective looks at the interaction of corporate governance and tax from a slightly different point of view than the economic perspective. The legal perspective is based on the fact that, that tax law "regards the corporation as a taxpayer in its own right, and so is the corporation required to fulfil all the obligations to comply with administrative requirements and to pay the taxes when they fall due."[60] In that respect, the corporation itself is a taxpayer, not its directors, managers or shareholders. Countering this legal logic, according to Schön, the corporation seems to be a "taxpayer that dos not exist".[61]

Such conclusion brings us to the understanding of how tax and corporate governance are interlinked. While tax law defines the obligations for the tax payer, namely for the corporation, corporate governance "has to decide which persons involved in the nexus of contracts have to take care of the different obligations and entitlements which tax brings about."[62] Schön goes on to say that company, as a legal entity is not able to form tax strategies, fill in the tax returns or to transfer money to particular authorities and therefore it is necessary to define the exact responsibilities within the particular corporation. In this connection, we can make a link to above mentioned agency – theory since such defining of responsibilities in order to fulfil the tax obligations of the corporation leads to an opportunistic behaviour, moral hazard and other market failures.[63]

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[59] Laffer curve is a theoretical representation of the relationship between the rate of the taxation and the governmental revenues. The assumption is based on the fact that the higher the rate of taxation is, the lower the incentive for the rational tax payer to pay the taxes is. Therefore, the total governmental revenues are decreasing with increased tax rate and vice versa.

[60] In Schön, W. Tax and Corporate Governance

[61] Ibid.

[62] Ibid.

[63] Ibid.

The tax law[64] formulates the company's attitude to tax issues. In the case of unclear tax law, the tax burden is put exclusively on the tax payer who has to understand and subsequently apply such law into practice.[65] In addition to this, tax payers are often benefiting from such unclear legal situation. So called "loopholes in the law" can significantly influence the way taxpayers fulfils their tax obligations. If there is a space to take advantage of the unclear legal situation or moreover, if the company act contrary to law, than we speak about above mentioned tax avoidance and tax evasion respectively.

In the practice, in the case of unclear tax law, tax authorities are in the place to define which behaviour is the most acceptable one. In this respect, tax authorities might be seen a main interpreter of tax law.[66] According to Sartori, "one of the ways to enforce tax law rules (i.e. to increase corporate tax compliance) is to use corporate governance tools."[67]

1.3.4 Corporate Social Responsibility and Strategic Tax Planning

"Tax is the price we pay for a civilised society."[68]

Oliver Wendell Holmes Jr.

As mentioned above, corporate social responsibility has increased its influence significantly. Many large businesses have changed their behaviour and approach to corporate governance practices and business ethics. Paying taxes is a major company's contribution to society and therefore is closely connected to the concept of corporate social responsibility. According to Erle, paying taxes legally is considered as an important part of being socially responsible. Stakeholders' demand for ethical behaviour is increasing significantly and tax is one area where businesses have to show value – based behaviour.[69] In connection to this, Landolf and Symons from PwC go on to say that it does not necessarily mean that only paying only as

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[64] Sartori , N. Effects of Strategic Tax Behaviours on Corporate Governance
According to Sartori, tax law has generally three main objectives. Firstly, it increases the revenues for governmental actions, it redistributes wealth within the society and finally, it influences the way of the behaviour of tax payers."
[65] In Schön, W. Tax and Corporate Governance
[66] Ibid.
[67] Sartori , N. Effects of Strategic Tax Behaviours on Corporate Governance
[68] From http://en.wikiquote.org/wiki/Talk:Taxation
[69] Erle, B., Tax Risk Management and Board Responsibility

much taxes as possible is the responsible behaviour. Rather than that, the “call for corporate social responsible agenda on tax is about applying the relevant principles of CSR into the field of taxation and thus: accountability, transparency and disclosure, an ethical approach, engagement with all engaged stakeholders and last but not least setting of appropriate tax strategy.”[70]

Currently, relevant tax authorities from all around the world have become sceptical and very vigilant due to the various corporate scandals and particular dishonest behaviour. According to OECD Forum on Tax Administration, governments in industrialized countries are beginning to perceive corporate governance rules as potential tool for influencing the behaviour of tax payers when facing their obligations in front of tax authorities. In addition to this, stronger responsibilities of companies, namely top management and if relevant, audit committees, for their tax strategies were proposed. HMRC[71], for example, see the corporate responsibility issues as a “lever for improving the tax compliance”.[72] According to HMRC, corporations who embrace corporate responsibility should excel in following aspects: transparency, discloser, dialogue, alignment of tax with underlying business, recognition of reputation risk and adherence to the spirit of the law. [73]

Generally, corporate social responsibility has a broad relevance in all the operations performed by the companies. As growing numbers of stakeholders are interested in tax issues, there is a strong need so that the corporate tax strategy and general business strategy of the company go hand in hand together. Stakeholders need to understand the general company’s tax strategy. In this respect, such “socially acceptable tax planning” referred us to the above mentioned concepts of tax evasion and tax avoidance. In connection to this, tax planning is legal if performed in accordance with law. Such limitation by law is however not sufficient in current changing environment and demands of the wide spectrum of stakeholders. Therefore, according to Landolf and Symons, the boundaries between what is socially acceptable strategic tax planning are blurring.[74] Moreover, according to Sartori, some strategic tax behaviours can be seen as actions whose legality may be under doubt. For example transactions which do not have any certain business purpose but are rather carried out in order

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[70] PWC, Tax Management in Companies
[71] HM Revenue & Customs in United Kingdom
[72] In Schön, W. Tax and Corporate Governance
[73] Ibid.
[74] PWC, Tax Management in Companies

to mitigate the tax burden can not be seen as legally acceptable transactions and falls down within the concept of tax avoidance.[75]

It became clear from the practice that pure tax minimization strategies do not consider the "whole picture" of the business. Therefore, a broader concept of effective tax planning should be applied to get a clear value which is brought about by such strategy. The simple rule from the past that "the lower the taxes the better" is no more valid in a broader concept of the corporate behaviour. The value added arising from aggressive tax planning is controversial when taking into account all the possible damages which can be brought by such short – time oriented strategy. Current stakeholders are deeply interested in long – term information considering also the tax issues. Moreover, according to Sartori, "effective tax planning strategy does not consider only the role of explicit taxes, like a mere tax minimization approach does, but consider also other costs that arise in a world of costly contracting (like, for example, transaction costs, administrative costs and exposure to risk of sanctions)."[76] Such effective tax planning therefore falls within the concept of good governance and is strongly desirable by wide spectrum of stakeholders. Later on in this paper the concept of tax risk management is introduced as a main tool for ensuring such effective tax planning strategy.

1.3.5 The Influence of Corporate Governance on Corporate Tax Compliance

Generally, the whole system of corporate governance significantly influences the way a company handles its tax obligations and moreover, also the perception of such tax compliance by other stakeholders. In addition to this, Hanlon mentions the results of the study performed by his research team. The study has shown the positive correlation between corporate governance and stock price in context of bad tax compliance, namely tax aggressive behaviour. The survey examined the influence of the news about particular tax non – compliant behaviour of an organization on its share price. The results have shown that the stock price reaction is smaller for organizations that have better corporate governance. Thus, the survey has shown that poorly governed companies will have more negative response to

[75] Sartori , N. Effects of Strategic Tax Behaviours on Corporate Governance
[76] Ibid.

the news about tax aggressive behaviour.[77] In that respect, good corporate governance positively influences the perception of tax compliance by involved stakeholders.

Undoubtedly, taxes represent a significant portion of company's profit and thus are crucial for management decisions in all aspects of company's operations. Ironically in practice, according to Owens, there is generally still limited involvement of the shareholders in the management of corporation tax strategy. Firstly, it is necessary to ensure that tax policies do not encourage behaviour that is contrary to the interest of the company or its stakeholders. In general, particular tax rules can significantly influence the structure of after – tax costs. The extent of such influence depends mainly on these rules in country. According to Owens, some rules are directly connected to corporate governance issues. "All OECD countries tax systems deny a tax deduction for bribes and other illegal payments, thus increasing the costs of such payments. Deduction is in some cases also denied for certain types of corporate expenditures such as so called "greenmail" payments made in connection with corporate takeovers."[78] Moreover, there are also tax rules which encouraging certain corporate behaviour. These are usually in the form of deduction of some desirable actions such costs for charity contributions, certain types of publicly supported projects and activities and so one.

Another interesting point of view represents Freedman when elaborating on the differences between tax and financial accounting and its possible consequences on corporate behaviour. According to Freedman, "if there were a single method of accounting for tax and financial reporting, pressures to increase reportable profits for the markets on the one hand, and to minimize taxation on the other, might balance each other to create a healthy equilibrium in listed companies and produce a set of figures to "true" profits than results from separated systems."[79] Freedman goes on to say, that such convergence of commercial and tax accounts is not feasible in the real practice. Based on the theory, integration of tax and accounting systems is not possible, since both of them have different purpose.[80]

According to Friese, Link and Mayer, another effect of tax on the business operations arise from the character of the market in which tax consulting operates. Since auditing firms

[77] In Freedman, J., Beyond Boundaries
[78] In Schön, W. Tax and Corporate Governance
[79] Ibid.
[80] Ibid.

usually have a sound knowledge of their client's business operations, they have a major advantage when offering additional services such as strategic tax planning. "Such combined offer of tax planning advice and auditing services from the same provider may have adverse consequences since many tax structures are based on a certain accounting treatment."[81] In that connection, according to Nowotny, tax services, mainly in countries with higher book – tax conformity such as Germany or Austria, "pose a greater danger to the auditor's independence due to the fact that any tax advice has a direct effect on the company's financial statements.[82]

The first part of the paper dealt with the character of tax compliance and possible failures of tax payers when fulfilling their legal obligations. Subsequently, the concept of corporate governance in connection with tax was introduced. It has been shown that corporate governance can be an effective tool for mitigation of agency costs and thereby an effective tool for enhancing a better tax compliance practice. In addition, corporate governance set therefore a scene for internal control mechanism within the particular organization. From the tax point of view, tax risk management is one of such internal control mechanism. The concept of tax risks management will be addressed in the following section.

[81] In Schön, W. Tax and Corporate Governance

[82] In Schön, W. Tax and Corporate Governance

2. Tax Risk Management as a Part of Corporate Governance

The first part of the paper showed us that taxes in general should be a part of corporate governance processes. The complexity of tax makes fulfilling of the tax obligations more difficult to tax payers mainly due to the broad variety of risks arising from inappropriate tax behaviour. In current post – Enron times, it is absolutely crucial so that good corporate governance processes recognize and effectively manage those risks in order to meet the expectations of all involved stakeholders.

2.1 Tax Risk Management

The governmental requirements for reporting and tax issues have been increased dramatically. Such tendency might address the informational asymmetry resulting from above mentioned principal – agent problem.[83] In addition to this, emerging requirements and ethical standards require companies to put more emphasis on managing risks arising from their business operations. All such risks have a broad range of implications. If managed well, mitigation of those risks can bring a significant competitive advantage and can have a key effect on the future success of particular company.

In general, a risk management can be defined as a "deliberate action to improve the odds of good outcome and reducing the odds of bad outcome and is a way of working and thinking that will give better answers to better questions. Moreover, it is a tool for decision – making process and will help the organisation to reach its objectives." The main objective of risk management is then to provide an added value for relevant stakeholders.[84] According to Power, risk management became an important tool for broad spectrum of business operations at the end of twentieth century.[85]

In addition to this, it is important to say, that there is no method which would eliminate all the risks. Risk management provides management with an effective execution of their business

[83] Erle, B., Tax Risk Management and Board Responsibility
[84] European Commission, Risk Management Guide for Tax Administrations
[85] Power, M. The Risk Management of Everything

operations. According to the European Commission, “at a strategic level, risk management is used to protect the reputation of particular business, whilst at an operational level, effective risk management ensures delivery of major projects and programmes provides early warning of potential problems and identifies potential opportunities.”[86]

Tax risk management, in general, may be described as “the process of managing an organisation’s response and handling of risks that arise as a result of the existence of tax laws and their application to an organisation through the effective utilisation of an organisation’s resources and systems.”[87]

The scope of the tax risk management is, however, much broader. In order to understand the concept of tax risk management and tax risk in particular, it is necessary to bear in mind that tax risks management is applicable both by tax payers and tax revenue authorities since the character of their tax related objectives creates tax risks. Tax payers in general choose their tax strategy based on their tax philosophy which brings certain types of risks.[88] Contrary to that, 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.”[89] Introducing both of the perspectives is important since both of the parties are influencing each other while fulfilling their obligations and therefore, their tax risks have mutual consequences.

As it has already been shown earlier in this paper, tax risk management is an integral part of corporate governance. First of all, this chapter will look at the perspective of tax revenue authorities and governmental bodies since they actually “set a scene” for tax payers’ obligations and requirements and subsequently, the following chapter will address tax risks management from the perspective of the tax payer.

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[86] European Commission, Risk Management Guide for Tax Administrations

[87] Cameron, A. Tax Risk Management - Confronting the Issue

[88] Erle, B., Tax Risk Management and Board Responsibility

[89] In Bakker, A.; Kloosterhof, S. Tax Risk Management: From Risk to Opportunity, Ch. 4

2.2 Tax Risk Management from the Tax Revenue Authorities' Perspective

Introducing the concept of tax risk management from the tax revenue bodies' perspective is necessary in order the get the "whole picture" of tax risk management. Only by understanding this concept, the appropriate tax risk management practice can be applied by corporate tax payers. Such understanding of what is actually "in the middle of the interest" of the tax revenue bodies is a best starting point for corporations to develop an effective tax risk management strategy within the good corporate governance practices.

The fundamental objective of the revenue body is to collect the tax. Currently, the complexity of tax revenue authorities' compliance is increasing and therefore, new demands on the tax administrators are put. Such increasing complexity is based mainly on the character of the international trade, growing mobility of labour and capital, rapid changes in technologies etc.[90]

The main aim of the tax risk management from the tax revenue authorities' perspective is, according to the Intermediaries Study (Study)[91] of the OECD Forum on Tax Administration (FTA), to:

- "provide context for decision to allocate scares resource
- identify, and bring to the relevant law-making body's attention, areas where the law is not operating satisfactorily or is producing unacceptably high compliance costs
- where supported by specific risk profiles, gather evidence to make a case for additional resources or funding from government"[92]

In order to meet the above mentioned goals, tax revenue authorities should have in place the appropriate strategies and structures to mitigate the non – compliance with the particular tax law.

[90] See Intermediaries Report
[91] From OECD, Study into the Role of Tax Intermediaries
[92] OECD. Study into the Role of Tax Intermediaries

According to Freedman, there are four broad categories of tax risks for the revenue authorities and governments:

- Register Risk – arising from the risk that the tax revenues will be reduced by inaccuracies in tax registration.
- Filing Risk – arising from the risk that the tax revenues will be reduced by failures by taxpayers to file their tax returns.
- Payment Risk - arising from the risk that the tax revenues will be reduced by failures to pay tax obligations.
- Declaration Risk – arising from the risk that the tax revenues will be reduced by the incorrect tax returns due to errors or deliberates actions.[93]

Freedman goes on to say, that it is the fourth one of the above mentioned risks which is of greatest importance in relation with corporate taxpayers. Therefore, mitigation of declaration risks by the revenue authorities would lead to better compliance on the side of corporate tax payers. In addition to this, above mentioned risks are closely connected to the law interpretation. The above mentioned risks are even higher if there is a different view taken by the tax payer and revenue authorities at what is actually the action within the law. In some cases, tax authorities collect less revenue than expected on their interpretation of law when such interpretation turns out to be incorrect according to court rules.[94] Therefore, transparency of the tax administrators is a key in order to provide environment where all of the above mentioned risks are mitigated to minimal level.

In addition to this, according to the Study, there are generally two areas of risks for revenue authorities described by FTA under the common head “aggressive tax planning” and these are:

- Tax planning which is, as well as tax avoidance, legal and therefore tenable by the taxpayer but has unintended revenue consequences. Such risk relates to the situation where the actual legislation is misused to achieve certain tax results.

[93] In Bakker, A.; Kloosterhof, S. Tax Risk Management: From Risk to Opportunity
[94] Ibid.

- Tax planning which lead to the tax position which is favourable to the tax payer and might be part of the “grey areas” of the law. Such “might be” uncertainty is, however, not openly disclosed to the relevant tax authority.

According to Study, the better the tax administrator at the risk assessment is, the higher the effectiveness of the appropriate response to the certain behaviour of the tax payer.

In addition to this, according to the Study, revenue bodies have to use the risk management practices in order to be able to efficiently respond and solve those risks. The Study recommends tax revenue authorities five attributes of successful dealing with all types of tax payers. These are following:

- Impartiality
- Commercial awareness
- Proportionality
- Openness
- Responsiveness

The Study suggest that if above mentioned attributes are demonstrated by the tax revenues, the relationship between corporate tax payers and revenue authorities will be based cooperation and trust which will go beyond their regulatory obligations.[95]

Generally, based on the above cited Study, the revenue authorities might increasingly tend towards a tax risk management tools in order to mitigate the tax risk the revenue bodies are facing to.[96] In addition, such practice will directly enable to identify riskiness of the tax payers’ behaviour and consequently to find a best solution to deal with them effectively. The Study did not attempt to formalize the risk rating process which is therefore left to the individual country decision based on the particular legal environment. According to Freedman, various factors need to be taken into account while defining the riskiness of tax payers’ attitude towards their tax compliance. Firstly, it is size and structure of the tax payers’ business operations. Secondly, it is the level of tax payers’ financial discloser and last but not

[95] OECD, Study into the Role of Tax Intermediaries
[96] Ibid.

least, it is an extent of agreement over the tax legislation.[97] Moreover, corporate tax payers should bear in mind that current economic crisis is a unique possibility for tax revenue authorities to impose more and stringent requirements on corporations due to the fact that the public and political opinion is now making it more acceptable.[98] Tax revenue authorities have an essential role in ensuring corporate boards that they are ultimately responsible for their tax affairs.

Study suggests the following factors for considering the risk profile of the tax payer:

- "Effective tax rate
- Size, structure and complexity of the business and its financing
- Tax governance (existence of a tax strategy, accountability for tax decisions)
- Propensity to interpret the law in ways that differ from the revenue body's interpretation
- Appetite for tax planning and risk
- Strength of underlying processes and systems (integrity of accounting data)
- Complexity of legal arrangements
- Openness and transparency
- History of co-operation with revenue bodies"[99]

Tax risk management practice will help tax authorities to effectively fulfil their primary objectives. Understanding of tax authority's point of view helps corporate tax payers to understand what tax authorities are actually looking for when applying their tax compliance strategy towards a tax payer. Only such understanding can help to build up a strong corporate tax risk management strategy. Following chapter deals with the tax risk management from the perspective of corporate tax payer.

[97] In Bakker, A.; Kloosterhof, S. Tax Risk Management: From Risk to Opportunity, Ch.4,
[98] Ibid.
[99] OECD, Study into the Role of Tax Intermediaries

2.3 Tax Risk Management from the Tax Payer's Perspective

As mentioned above, tax issues, as a significant part company's costs, are increasingly interesting for the broad spectrum of stakeholders. That is mainly due to the broad spectrum of possible consequences of tax risks which are arising from the nature of tax obligations. There is no doubt that tax risk management is a part of corporate governance systems. Generally, taxes have not been on the agenda of the companies' risk management policies. Currently, the trend is being changed since the taxation issues give rise to more complex problems which can have significant consequences on the companies' daily business operations. According to Stancey, "companies have to remove tax from its "black box" in a systematic and enlightened way so that tax risks are identified, managed, and communicated in terms that are relevant to the business and understandable to stakeholders. In many cases, doing so will require the development of a completely new or expanded tax risk management system."[100] Therefore, tax risks can not be separated as an isolated issue and tax risk management has to be a part of the overall risk management strategy.

According to Neubing and Sangha, tax risk management should therefore "facilitate the common understanding among key stakeholders for the desirable outcome arising from particular tax position. Moreover, it should close the gap between current state and the desirable state."[101] In this respect, the "desirable state varies among companies based on their risk aversion to risks in general. A risk – averse company might be willing to invest more to their "safe" tax position since the risk avoidance is a key for their general strategy. Contrary to that, a company with lower level of risk – aversion might prefer a more aggressive tax position in order to achieve a lower effective tax rate.

In addition to this, above mentioned strategic tax planning and different forms of tax avoidance and evasion are being used in order to achieve an optimal tax burden arising from each type of transaction. Therefore, it is necessary to weigh the possible positive outcomes arising from such strategies against the effects of might – be failures of such strategies.

[100] Stacey, J., Managing tax risk : Weighing risk, opportunity, and transparency in a more restrictive regulatory and governance environment

[101] Neubig, T.; Sangha, B. Tax Risk and Strong Corporate Governance

According to Williams, the use of tax risk management tools should ensure the consistency in this connection.[102]

Tax risk management helps corporate tax payer to build up a certain “tax risk profile” which is characteristic for particular company. As explained earlier, such risk profile is subsequently taken into tax revenue authorities’ and all involved stakeholders’ account. If a tax payer demonstrates a high- risk profile, the probability of possible scrutiny and enforcement is higher. On the other hand, more transparent and lower – risk attitude towards tax issues can bring a significant savings in the form of tax compliance costs. In addition to this, OECD pointed out, that “large businesses that have good corporate governance and more transparent relationships with tax administrations can expect fewer audit interventions and hence greater certainty.”[103] Therefore, tax risk management and the related creation of particular accountable risk profile is beneficial for tax payers.

In order to develop particular tax risk profile, it is necessary to get to know the tax risks which are related to the character of tax compliance. Following chapter is dealing with the particular tax related risks which are crucial for the whole concept of corporate tax risk management strategy.

2.3.1 Types of Tax Risk – the Tax Payers’ Perspective

For companies, tax is an unavoidable expense which has strong effects on all company’s transactions and significant influence on company’s cash – flow and thus on its activities in general. In order to manage these activities well, at the lowest business risk level possible, it is necessary to deal also with those tax consequences. If it is not the case, the undesirable consequences such as high penalties or loss of the reputation can influence the company’s well – being. Therefore, risks arising from different business transactions have to be named so as the possible occurrence of negative returns arising from particular tax behaviour were minimized.

[102] David F Williams, Developing the Concept of Tax Governance
[103] OECD, Corporate Governance and Tax Risk Management

In general, all business activities undertaken by the company give rise to a certain types of uncertainties. Such uncertainties are then the main source for business risks. Tax risks are in this sense seen as an uncertainty about interpretation and application of tax law in relation to particular transactions.[104] According to Stacey, "risks arising from the application of taxes may also be viewed as market risks, in cases where tax is part of the price of a product and is therefore important to the market acceptance and profitability of that item."[105] Tax risks can be found in both every – day and non – routine transactions. Moreover, tax risks arising from particular transactions can have serious impacts not only on the particular company but also on its suppliers and customers. Managing tax risks is therefore about managing these issues and uncertainties.

According to Stacey, "organizations do not typically recognize the significance of tax risks and controls in the new regulated environment. Controls over planning, controversy, and management for tax are not being widely or systematically addressed, nor are the increasingly complex international aspects. In fact, in many cases the compliance project team does not include the tax executives in its planning."[106] Such behaviour is very narrow – sighted and companies should bear in mind that such approach to tax issues can have its significant consequences in the future due to the wide spectrum of risks arising from the character of tax compliance.

Practitioners generally describe the following types of tax risks relevant for the particular tax payer:

Compliance Risk

The compliance risk occurs when the company does not meet the organization's tax compliance obligations. According to PWC Tax Risk Management Guide, compliance risk primarily relates to the preparation, completion and review of an organisation's tax returns and the risks within those processes.[107] Therefore the size of the risk depends on the quality of the systems, processes and procedures adopted by the company to deal with its mandatory tax

[104] OECD, Corporate governance and tax risk management

[105] Stacey, J., Managing tax risk : Weighing risk, opportunity, and transparency in a more restrictive regulatory and governance environment

[106] Ibid.

[107] PWC, Tax Risk Management

obligations such as submitting the tax returns and communicating with relevant tax authorities.[108] In this respect, the compliance risk can lead to higher level of risk of increased intensity of challenges by tax authorities in connection with the verification of the validity of company's tax position.

Transactional Risk

Transactional risks include the risks involved in specific transaction undertaken by the company. In general, the more unusual and less common transaction, the greater the transactional risk is. Moreover, the transactional risks arise from the situations where tax department is not involved in the new business transactions and therefore an appropriate strategy can not be set and where there is a lack of duly ensured formal documentation of the particular transaction. In addition to this, revenues authorities are increasingly demanding the documentation relating to particular transaction.[109] Therefore, it is necessary so that all new company‘s transactions were properly governed and documented.

Operational Risk

Operational risks relate to the practical application of tax laws, regulations and policies by an organisation to the every – day routine of company's operations.[110] In addition to this, operational risks can possibly have a cumulative effect when repetition is involved. Moreover, current global character of the business operations strengthen operational risks significantly since the nature of cross boarder operations brings a higher risks due to multiple tax jurisdictions.

According to PWC Tax Risk Management Guide, the closer the tax function is to the business operations the better these types of risks are managed. Communication between the various parties is key." According to Neubing and Sangha, such risk is usually seen in situations where various stakeholders create strategies which have impacts on tax positions and which are not communicated with the tax department.[111]

[108] PWC, Tax Risk Management
[109] Ibid.
[110] Ibid.
[111] Neubig, T.; Sangha, B., Tax Risk and Strong Corporate Governance

Financial Accounting Risk

In practice, financial accounting risks relate to financial reporting issues such as the impacts of misstatements in company's reporting and required internal documentation. Namely, it includes the risks involved in numbers reported in tax accounts and related financial statements.[112] Such risk can arise from situations where there is a lack of sound expertise in accounting principles. The high quality of reporting is a key to provide transparency. In addition to this, the tax accounts on financial statements need to be presented in an appropriate way a classified correctly. In order for this to happen, the responsibilities have to set and particular organ of the company has to regularly oversight the quality of accounting practices within the company.

Reputation Risk

Reputation risks relates to potential impacts of particular types of tax oriented transactions such as aggressive tax planning, tax avoidance and evasion on corporate image and reputation. In this respect, companies are facing the threat of being publicly shamed via media while publicizing the amount of taxes paid or the penalties imposed due to the aggressive tax planning strategies.[113] Enjoying the good reputation is one of the core element which all companies trying to achieve. Tax issues and tax planning can significantly influence the reputation of the company. According to Baumgärtel, "it is extremely important to do nothing just for the sake of saving taxes, but always have sound economic business reasons."[114]

In this respect, there is also a direct connection to the above mentioned compliance risk which is closely related to reputation issues. Better reputation might decreased the level of compliance risk because tax authorities might see the company with better reputation as a one which most likely will not have any compliance problems or issues in this connection. Contrary to that, companies whose reputation is known as "aggressive tax planners" will consequently be under big scrutiny from tax authorities.

[112] Bakker, A., Kloosterhof, S. Tax Risk Management: From Risk to Opportunity, Ch. 3
[113] In Schön, W. , Tax and Corporate Governance, Part 5
[114] Ibid.

In order to eliminate such reputation risks there are basic principles companies should follow.[115] Most importantly, companies should keep away from transactions or services which might be qualified as a tax offensive. Secondly, according to Baumgärtel, companies should never give tax recommendation to their clients. The tax treatment on the client's side has to be taken by the client or his tax advisor. And finally, as mentioned above, all intended transactions have to have the business rationale and can not be commenced with the view to reduce the tax burden.[116]

Personal Risk

Last but not least, there is also a possible impact of personal risk which has to be taken into account while considering all the risks arising from tax issues. Such risk is closely related to the personal responsibility of an organization's officers which, in the ultimate phase, can occur in the form of fines, imprisonments and et cetera.[117] Such risk is therefore strongly dependent on the type of the contract and the form of personal liability of the officers.

Risk of Detection

In general, the higher the probability that the above mentioned risky tax activities will be detected by tax authorities, the higher the risk arising from such activities. The risk of detection depends on the auditing efforts of tax authorities.[118] According to Friese, Link, Mayer, increasing the risk detection is current aim of many tax authorities throughout the world. Therefore, new and updated legislations are developed which brings a new demands on companies.[119] In that regard, tax authorities often classify tax payers into different categories based on their overall level of tax "aggressiveness".

In general, taxpayers, while fulfilling their tax obligations, can choose between different ways of approaches with different levels of uncertainty and therefore different levels of risks. Particular attitude of a company to the above mentioned tax risks consequently formulate the tax position of this company. According to Neubing and Sangha, developing a concrete tax

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[115] In Schön, W. , Tax and Corporate Governance, Part 2
[116] Ibid.
[117] Cameron, A., Tax Risk Management - Confronting the Issue
[118] In Schön, W. , Tax and Corporate Governance, Part 5
[119] Ibid.

position is actually a certain type of company's investment since the investment into the certain tax strategy requires significant resources. Due to the existence of broad spectrum of tax risks, tax positions can bring a lot of unexpected outcomes. Therefore, companies have to consider not only expected return from the investment to such tax position but also the relative risk connected with such investment. [120]

2.3.2 Corporate Tax Risk Management and Risk Evaluation

The definition of above mentioned risks is useful to get to know where the possible threat is actually the in the company's tax planning strategy. In addition to this, such risks need ideally to be quantified in order to set the company's tax position into the certain scheme. Such process is very demanding and far beyond the scope of this paper. But in general, according to Neubing and Sangha, tax risk quantifications should involve following considerations which are a useful starting point for evaluating the riskiness of company's tax strategy:

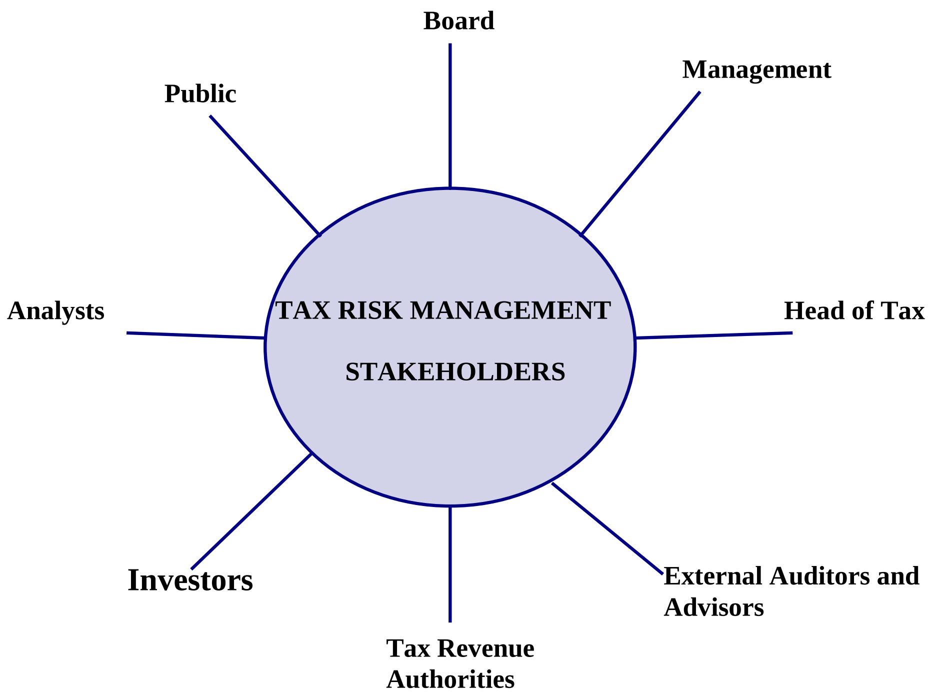
- "Level of tax authority.
- Strength of the business purpose behind the tax position and its documentation.
- Types of potential penalties.
- Experience with state and foreign tax administrators.
- One – time restatement versus multiple year look back"[121]

After taking into account those considerations, the overall level of risk will additionally depends on the particular tax position which vary from schemes with a high level of tax – avoidance to schemes with a very aggressive tax planning which might be perceived as illegal tax evasion.

[120] Neubig, T.; Sangha, B., Tax Risk and Strong Corporate Governance
[121] Ibid.

2.3.3 To who is Corporate Tax Risk Management Important?

In order to implement the effective tax risk management strategy it is necessary to understand who is actually involved in managing tax risks within the organization. Following section will introduce the different stakeholders who are influenced by the overall tax risk management strategy of the company.



[122]

The Board

In many jurisdictions, board is the key supervisory organ towards management of the company. Thus, the board serves as a protector of interests of shareholders. Therefore, risk management is the key area where board plays a significant role. In general, as mentioned above, there is a strong tendency to bring tax risk management closer to the overall corporate governance concept.

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[122] PWC, Tax Risk Management

In general, the main responsibility of board, according to OECD Principles, "is to oversee systems designed to ensure that the corporation obeys applicable laws, including tax competition, labour, environmental, equal opportunity, health and safety laws."[123]

According to Erle, there are two important challenges for the board while speaking about tax risk management issues. Firstly, the board needs to ensure that the internal corporate environment for all tax matters is appropriately aligned with the overall tax strategy. It includes setting the overall tax risk management framework from the strategy definition to ensuring strategy to operate adequately. Secondly, the board should ensure the external communication addressing the obligations arising from international reporting standards as well as the communication towards the external stakeholders.[124]

Management

Management in this respect, CEOs and CFOs, are ultimately responsible for the overall financial performance of the company. As mentioned earlier, tax as a significant part of company's cost plays an important role in this financial performance. Generally, CFOs are representing the tax issues at the board level, however, there is a new pressure in some countries for CEOs to become more active in the tax issues.[125] Based on the above mentioned character of risks arising from tax issues, it is necessary so that the management of the company has a sound interest in managing such risks. Moreover, the above mentioned personal risks arising from insufficient tax risk management are the one which directly influence the management of the company.

Management is responsible for monitoring of how the tax risks are being managed so that the overall strategy set by the board will be met.

[123] OECD, OECD Principles of Corporate Governance
[124] Erle, TRM and the Responsibility of Board
[125] See PWC, Tax Risk Management

Head of Tax

As the particular tax strategy is agreed by the board, head of tax or tax department particularly, is responsible for maintaining the tax risk management processes. Historically, that was not the case, since traditionally, tax directors simply reported to the CFO. The trend is now changing and the tax director become an important part of decision making process including the strategic issues including the management of tax risks.

According to Neubing and Sangha, current business developments are forcing the whole corporate community to put more emphasis on the issues connected with their tax departments and require the tax directors to better understand and communicate their tax risks within the whole organization.[126] In addition to this, according to PWC, the head of tax should be responsible for all areas of tax risk management. Such involves ensuring that the right people with right knowledge and skills are in place, the appropriate procedures and processes are met and performed in time and effectively.[127] In addition to this, the head of the tax should mediate a link between tax issues and other strategic objectives of the company such as cash flow management, earnings per share etc.

External Auditors and Advisors

While a management of the company is fully responsible for the financial performance of the company and the information arising from the financial statements, the external auditors make sure that these financial statements do represent the "fair picture" of the financial condition of the particular organization. The audit firms and external advisors do generally have a sound knowledge of the company's business and therefore are able to provide a tax risks management related services directly tailored to company's needs. External tax advisors provide taxpayers with expert advice on their tax issues. Such advisory therefore plays a significant role in setting the overall client's risk profile. Moreover, those services contribute to the reduction of risks of their clients since the general level of tax compliance of the client is increased.

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[126] Neubig, T.; Sangha, B. Tax Risk and Strong Corporate Governance

[127] PWC, Tax Risk Management

Tax Revenue Authorities

Tax authorities in general operate such the reviewers of the correct fulfilment of tax obligations of companies. Their valuation tax risks of companies they are looking at are significant for future relationship between the company and governmental bodies in general. In addition to this, tax authorities call for an effective tax risks management processes so that the transparency and consequently good relationship between tax payers and tax authorities were achieved. As already mentioned above, tax authorities are increasingly taking a sophisticated approach to tax risk management. When risks are managed well and transparently, the cooperation between tax payers and tax authorities will become smoother. The role of tax revenue authorities is absolutely the key in enhancing the better corporate governance practice. Their demands and related requirements on tax payers significantly influence the way how companies comply with tax law. The third section of the paper shows the current trends and approaches of chosen tax revenue authorities to “their clients”, tax payers, in respect to corporate governance and tax risk management.

Investors, Analysts and Public

Investors and analyst are primarily interested in company’s financial statements and thus also in accounting and related tax risks. It is crucial for companies to reduce their risks at the minimal possible level so that the credibility was achieved. Analysts who are influencing the opinion of the future investors need to understand the trends in the whole tax risks management strategy of the particular company.

Moreover, managing the tax risks is no more at the edge of the public opinion. Involved public needs to know that the particular organization is committed to the value creation. In that respect the way how the company fulfils its financial related obligation is absolutely crucial for potential investors. As mentioned above, the increased interest in corporate social responsibility calls for better transparency also in the field of taxation. The way of how tax risks are managed can significantly influence the level of the company is perceived by the public and consequently by investors.

After having introduced the main tax risks arising from the character of tax compliance and the broad spectrum of stakeholders who are engaged in the tax issues, it is clear that tax risk management can significantly change the whole riskiness perception of the particular company. Therefore, the tax risk management has inherently become a part of corporate governance practices. Following chapter will try to answer the question of why tax risk management should be a part of a board responsibility and therefore perceived as an activity enhancing a better corporate governance practice.

2.3.4 Tax Risk Management as a Responsibility of Board

"…I am suggesting that you, the leaders of your organizations, should have a mechanism to oversee tax risk as part of your governance process…"[128]

Douglas H. Shulman, IRS[129] Commissioner

"Most of the material weaknesses and the business processes have to do with taxes…result of this development is that tax is becoming increasingly important in the boardroom."[130]

Theo Poolen, Deputy Director-General, Dutch Tax and Customs Administration

According to OECD, by reducing the tax risk, boards can increase the level of corporate governance. "The standard of corporate governance has a direct bearing on whether a company has a high, moderate or low tax risk level."[131] As explained earlier, that tax risk management is a part of the overall corporate risk profile. Therefore, it is necessary so that the tax issues concerning the attitude to risk were the part of the strategic agenda issues. In connection to this, according to Carmody, "CEO and board should concisely decide the position they wish to take on tax planning, rather than have it made for them by others."[132]

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[128] From http://www.irs.gov/newsroom/article/0,,id=214451,00.html

[129] The Internal Revenue Service (IRS) is the tax revenue body of the United States federal government. The IRS is responsible for collecting taxes and the interpretation and enforcement of the Internal Revenue Code. For more information about IRS see the http://www.irs.gov/

[130] From http://www.ey.com/GL/en/Services/Tax/International-Tax/Tax-administration-without-borders---Successfully-managing-tax-controversy-and-risk---Include-global-tax-risk-as-a-corporate-governance-issue

[131] OECD, Corporate governance and Tax Risk Management

[132] KPMG, Oversight of Tax Risk, Including Disclosure of Uncertain Tax Positions

In general, the board is responsible for overseeing the risk management and should be involved in the risk oversight process. Such level of involvement depends on the structure and composition of the board. In practice, the attitude of boards towards tax issues is changing significantly. Based on the KPMG survey, more than 70% of responded directors considered tax issues and related risks as a board issue.[133] In addition to this, the survey has shown that wider range of senior executives is interested into tax issues due to its material impacts on financial statements. The same results brought the survey of Ernst & Young. According to E & Y's survey, tax directors of large international organizations perceive tax risk management as a critical factor of corporate governance.[134] The majority of the respondents admitted the importance of the tax planning which would be consistent with the overall company's risk profile. Based on this survey, tax risk management is increasingly gaining acceptance at board level. CEOs and boards particularly are becoming engaged by the tax risks arising from the character of their business.[135]

According to Erle, the board should set general standards for tax issues by defining a global tax philosophy and setting a framework for the governance of tax issues throughout the business.[136] The particular tax philosophy should set ethical norms and standards of the company when dealing with all the above mentioned stakeholders. The main goal of the board should then be to implement a particular tax risk management strategy with a best balance between risk and opportunity. In practice such balance includes that companies should not overpay their taxes but all the legal obligations needs to be appropriately fulfilled. Erle defines two main objectives and challenges for the board. First, it is the development of the internal corporate environment that is handling all tax matters appropriately in accordance to the particular given tax strategy. Secondly, the board needs to ensure that the adequate external communication including the fulfilment of the reporting requirements and the general communication with all involved stakeholders.[137]

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[133] From Erle, B., Tax Risk Management and Board Responsibility
[134] From http://www.ey.com/global/
[135] From http://www2.eycom.ch/publications/_catalog/en.aspx?xp={http://www2.eycom.ch/library}:article&hr=All%20printables
[136] Erle, B., Tax Risk Management and Board Responsibility
[137] Erle, B., Tax Risk Management and Board Responsibility

Since board should be fully responsible for tax management practice, it is the board that should set the general strategy by defining the certain tax philosophy. Such philosophy could be defined as “a code of conduct for tax issues.”[138] A clearly set an overall tax position and attitude towards tax is a first step to anchor tax issues into the whole concept of corporate governance. Having established the overall tax philosophy, the board has to additionally decide on the way how to manage tax. According to Erle, most companies perceive tax as a “cost factor” and therefore board should decide the level of “aggressiveness” towards tax with a certain level of risk which is acceptable according to the overall company’s risk strategy.

2.3.5 Benefits of Tax Risk Management for Corporations

Tax risk management brings a wide spectrum of benefits if managed well and used in alignment with overall corporate governance practice. According to Stacey, the need for proactive tax risk management has never been greater. “A formalized tax risk management approach can provide an organization with a better understanding of tax risk, increased confidence in achieving regulatory compliance, the identification of new tax-planning opportunities, and a language for more productive communication.”[139] Stacey in that respect mentions following benefits of tax risk management for corporate tax payers:

- Setting a particular tax strategy which will be understood at board level.
- Better internal communication between business units and tax matters.
- Creating of new tax opportunities.
- Improved effective tax rates and consequently earnings per share.
- Fewer possible tax challenges by tax authorities.
- Enables cost savings due to the more effective working practice.[140]

More generally, tax risk management is one of the main tools for enhancing the relationship with tax revenue bodies. As already explained earlier, different tax positions of tax payers produce different “tax profiles” in the mind of outside stakeholders. Tax payers have to

[138] KPMG, Tax in the Boardroom : A Discussion Paper
[139] Stacey, J. A., Managing tax risk : Weighing risk, opportunity, and transparency in a more restrictive regulatory and governance environment
[140] Ibid.

understand that such perception affects how tax authorities may challenge particular tax behaviour. Tax risk management, as a part of corporate governance practices, positively influences such perceptions of outsiders due to the mitigation of above mentioned tax risks which consequently creates a better tax profile towards all involved stakeholders.

Tax payers who are able to manage their tax risk effectively will benefit from lower risk rating from tax revenue authorities than others. Freedman goes on to say that tax payers who are able to go beyond their statutory obligations, such as more timely disclosure than required, might increase trust and relationship with revenue authorities which would lead to preservation of reputation of the particular tax payer.[141]

According to OECD, both tax payers and tax revenue authorities share the same aims of achieving certainty, speedy resolutions of disputes and administrative cost reduction. From that perspective tax risk management helps due to the mitigation of tax risks to cooperate with tax authorities. Such cooperation will consequently lead to reduction of artificial tax scheme.[142] In addition to this, tax payers who are able to align tax issues with wider corporate governance concept, through well developed tax risks management practices, are likely to be in less legal disputes with tax revenue authorities whose requirements are currently significantly arising.[143] Ideally, if tax payers sufficiently fulfil those requirements and obligations set by the tax revenue bodies, such situation will lead to good mutual cooperation among both tax payers and tax authorities which will consequently lead to satisfaction of all involved stakeholders. In this respect, tax risk management ensures such win – win situation.

Moreover, good corporate governance demands a tight relationship with external advisors. According to Friese, Link, Mayer, such relationship has to be prevented from possible conflicts of interests. Such conflict can arise from the situation where one advisory company advises on tax planning and at the same time provides auditing services.[144]

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[141] Freedman, IBFD, Ch. 4
[142] OECD, Study into the Role of Tax Intermediaries
[143] Ibid.
[144] In Schön, W. , Tax and Corporate Governance, Part 5

3. Enhancing the Better Tax Compliance in Practice – The Anglo – Saxon Developments

Due to the serious consequences of non – tax compliance, reporting and documentation requirements are increasing worldwide. Therefore, companies have to take into account different local regulations as well as different expectations of stakeholders. In many jurisdictions, governmental bodies are introducing standards which are strengthening the need of transparency in the financial reporting practices in order to mitigate the undesirable tax avoidant and evasive behaviour. Tax revenue authorities are currently facing such challenging demand and are trying to set an effective system for tax governance since they are responsible for ensuring that corporate boards fully understand their responsibilities in tax issues.

Moreover, the increased call for international coordination in the field of financial reporting and discloser has led to the collaboration among tax authorities. The main aim is to enhance the tax compliance and mitigate the cross – boarder non – compliance behaviour. In 2006, 35 tax revenue authorities signed the OECD Seoul Declaration, whereby the collaboration towards better tax administration was agreed. In connection to this, OECD Seoul Declaration identified four areas which are crucial in meeting the above mentioned objectives. These are as follows:

- "Further developing the directory of aggressive tax planning schemes so as to identify trends and measures to counter such schemes.
- Examining the role of tax intermediaries (e.g. law and accounting firms, other tax advisors and financial institutions) in relation to non-compliance and the promotion of unacceptable tax minimization arrangements.
- Expanding its 2004 Corporate Governance Guidelines to give greater attention to the linkage between tax and good governance.
- Improving the training of tax officials on international tax issues, including the secondment of officials from one administration to another."[145]

[145] From OECD, Third Meeting of the OECD Forum on Tax Administration

This section of the paper elaborates on the current situation and developments in the Anglo – Saxon world. This part of the paper therefore examines different experience in promoting the tax governance practice in the United States, United Kingdom, and Australia, countries where tax risk management practice has become an inseparable part of the corporate governance system. These countries are pioneers in the tax governance practice and have already influenced other well developed countries in promoting and enhancing the tax compliance practice.

3.1 USA

The system of corporate governance in the United States was heavily criticized due to the numerous corporate failures in the early 2000s. Theses failures have finally served as a catalyst for wide spectrum of legislative changes which are currently influencing lot countries all over the world. It is estimated that cost of non – compliance in the United States of America excess USD 300 billion. Such estimation is based on the concept of "tax gap" which stands for the difference between taxes owed and taxes actually collected.[146]

In the US the tax risk management practices as a part of the overall corporate governance framework is significantly evolving. The regulative environment is affected mainly by Internal Revenue Service (IRS), Securities and Exchange Commission (SEC), the Financial Accounting Standards Board[147] (FASB) and state and local tax authorities. Generally, there is no a certain codification of tax risk management practice but the US legislation enacts the exact requirements regarding the tax issues for tax payers.

3.1.1 Sarbanes – Oxley Act

Sarbanes – Oxley Act (SOX) is a United States federal law enacted in 2002. It sets new standards for the regulation of financial practice and corporate governance for all US public company boards and management as a reaction to numerous corporate scandals in the USA. SOX is divided into eleven titles which are subsequently divided into several sections. The main aim of the SOX is to enhance the whole corporate governance practice particularly financial reporting practice of publicly traded companies in order to ensure investors about its correctness and fairness. SOX targets corporate boards, managers, and auditing professions. The Act is applicable to all publicly registered companies under the jurisdiction of the SEC and called for the creation of Public Company Accounting Oversight Board, a non – profit

[146] See http://www.irs.gov/newsroom/article/0,,id=158619,00.html

[147] Financial Accounting Standards Board (FASB) is an organization in the private sector for establishing standards of financial accounting that governs the preparation of financial reports by nongovernmental entities. These standards are recognized by the Securities and Exchange Commission and the American Institute of Public Accountants. The main aim of FASB is to establish and improve standards on financial accounting and reporting by non – governmental entities in order to improve transparency towards investors and other users of these financial reports. For further information see the http://www.fasb.org.

organization to oversee companies' auditors to protect the interests of shareholders.[148] According to Petolick, it is quite often in the practice that companies that are not subject to SOX apply SOX as risk management principles to meet and enhance their tax compliance practice.[149]

In the past, the public company's financial statements were reviewed annually by an external auditor, while currently, as for example stipulated in Section 302 of SOX, chief executive officers and chief financial officers are responsible for the accountability and validity of financial statements as well as for the control mechanism which ensure such discloser practice. In that respect, Section 302 refers to the corporate responsibility of financial reporting. According to the stipulations in Section 302, managers are no longer out of the financial reporting accountability.

Section 404 of this Act requires a need of conduct of an assessment of the company's internal control effectiveness over financial control. Senior management is required to annually assess and assert the way how the internal control and financial reporting is performed. Moreover, external advisors are required to report specifically about such management's evaluation of company's financial reporting. Section 404 of SOX is, according to Miller and Rittenberg, a holistic set of requirements for implementation of fraud risk management processes that would alert the appropriate levels of governance of potential frauds or illegal acts within the company."[150]

Subsequently, section 1001 of that Act requires for the signing of corporate tax returns by chief executive officers. [151] In this sense, the tendency towards higher involvement of top executives in the tax issues is increasing significantly. Moreover, SOX encourages the more independent and proactive role of audit committees as well as their responsibility for external accounting and advisory companies.[152]

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[148] For more information about PCAOB see http://pcaobus.org/Pages/default.aspx

[149] In Bakker, A.; Kloosterhof, S. Tax Risk Management: From Risk to Opportunity, Ch . 16

[150] E. Rittenberg, K. Miller,Sarbanes-Oxley Section 404 Work – Looking at the Benefits, The Institute of Internal Auditors Research Foundation, 2005

[151] See the whole Sarbanes – Oxley's text at http://www.sec.gov/about/laws/soa2002.pdf

[152] Section 301 of SOX, for more information see http://www.sec.gov/about/laws/soa2002.pdf

SOX is in general one of the main legislative tools which has enhanced the corporate governance practice in the Unites States. In addition to this, the introduction of SOX has led to the development of formal control frameworks as for example already mentioned COSO Internal Control – Integrated Framework. Moreover, SOX does not have the relevance only in the USA but are also of importance to USA subsidiaries of foreign based larger companies and other non USA entities that are registered with the USA Securities and Exchange Commission.[153]

3.1.2 Interpretation No. 48

In 2006, FASB issued an interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes". This law is effective for all companies reporting in accordance with the US GAAP and establishes the financial statement accounting for uncertain tax position. In that respect, companies itself are required to recognize and measure the effects of tax on their financial statements. FIN 48 is therefore a regulation which requires certain entities to provide a tax risk management assessment in order to provide the wide spectrum of stakeholders with transparency in their financial accounting for income taxes.

FIN 48 is a two – steps process. In the first step, called "recognition", the particular organization has to evaluate the certainty of its all tax positions. Such tax position stands for a position stated on the final company's tax return including both domestic and foreign transactions. It includes also underreporting of taxable income and even non – compliance activities. If the particular tax position is more likely than not that the certain tax position will be sustained upon examination, then particular tax position has to be measured in the second step. There are a lot of factors which management has to take into consideration when evaluating its tax profile. Those could be the level and the way of disclosers in the tax fillings. The second step, "measurement of benefits", is applicable for tax positions which meets above mentioned "more likely than not" recognition. As stipulated in the Interpretation No. 48, "the tax position is measured to determine the amount of benefit to recognize in the

[153] OECD, Corporate governance and Tax Risk Management

financial statements. Tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement."[154]

Besides enhancing the tax compliance practice of the tax payers, FIN 48 might improve the mutual cooperation of tax payers and tax revenue authorities. Last but not least, such mutual cooperation should lead to the reduction of costs arising from possible tax challenges.

3.1.3 The IRS Approach

The IRS is a bureau of the Department of the Treasury. "In fiscal year 2009, the IRS collected more than $2.3 trillion in revenue and processed more than 236 million tax returns." The mission of IRS is to "provide America's taxpayers top quality services by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all. "[155]

Current US Administration focuses on reviewing the US tax code. According to the "Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation" (Report)[156], the current US tax code is too complex which imposes significant costs on tax payers. Such complexity, according to the Report, results to errors in tax compliance which additionally increasing the administrative costs of the whole system. Therefore, the main challenge for the IRS will be to close the loopholes in the tax law and its simplification.

The IRS's mission statement describes roles of taxpayers and itself as follows:

- "In the United States, the Congress passes tax laws and requires taxpayers to comply.
- The taxpayer's role is to understand and meet his or her tax obligations.

[154] From http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820931560&blobheader=application%2Fpdf
[155] For more information about IRS see http://www.irs.gov
[156] The Report from the President's Economic Recovery Advisory Board, to see the whole Report see http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report_for_final_vote.pdf

- The IRS role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share."[157]

In October 2009, Shulman, IRS Commissionaire, gave a speech to the National Association of Corporate Directors (NACD)[158], in which the role of the board of directors was strongly encouraged. According to Shulman, "corporate boards of directors play an incredibly important role in the vibrancy of businesses and our economy. Boards are a source of creative ideas, strategic thinking, and, importantly, governance and oversight. Boards hold management accountable, and in that role, understanding the risk posture of the company is critically important…Tax strategies can also present a financial and restatement risk, and sometimes when the cases are high profile, a significant risk to corporate reputations. In today's business climate, the general public has little tolerance for overly aggressive tax planning that can be viewed as corporations playing tax games...Board members – like you – are critically important to making sure that the tax system works well and is worthy of the confidence of the American people."[159]

Moreover, besides stressing the importance of the corporate boards in the tax management, the Commissionaire recommended following issues as a mechanism to oversee tax risks as a part of the corporate governance process. These are following:

- "Set a threshold confidence level for taking a tax position.
- Discourage or eliminate opinion shopping by tax departments by having an independent tax firm, which has some direct dialogue with the board of directors, review major tax positions.
- Specifically address transfer pricing and the relative profit allocated to low – tax jurisdictions, and make sure they reflect real economic contributions made in those jurisdictions."[160]

For ensuring the better compliance practice, in 2005, the IRS drew up a pilot program called Compliance Assurance Process (CAP) mainly for large businesses. The main aim is to

[157] From http://www.irs.gov/irs/article/0,,id=98141,00.html
[158] The whole speech is available at http://www.irs.gov/newsroom/article/0,,id=214451,00.html
[159] Ibid.
[160] Ibid.

identify possible problematic issues prior to the tax filling and thereby mitigate the risks arising from tax compliance. According to IRS, the CAP will “reduce taxpayer burden through the contemporaneous exchange of information about completed events and transactions that affect tax liability and will also foster compliance by helping the Service achieve its goal of shortening examination cycles and increasing currency for taxpayers while enhancing the accurate, efficient, and timely final resolution of increasingly complex corporate tax issues.”[161]

The CAP programme includes following activities:

- Communication of information about completed transactions in a manner that is timely and allows a meaningful analysis of material items affecting the tax return.
- The review of significant transactions immediately after completion, while knowledgeable personnel and necessary records are most accessible.
- The sharing of all relevant data and positions between the Service and the taxpayer.
- The early identification of compliance issues in need of resolution.
- Access to and willingness to participate in issue resolution methods.
- Determination of return acceptance prior to filing.[162]

[161] From http://www.irs.gov/irb/2005-50_IRB/ar14.html
[162] Bakker, A.; Kloosterhof, S. Tax Risk Management: From Risk to Opportunity, Ch . 16

3.2 United Kingdom

In the past few years there has been a significant shift in the tax risk management practice in the United Kingdom. The current debate is based mainly on topics of tax compliance and tax avoidance and those have become a generally perceived public topic. Such developments are not surprising. The corporate tax avoidance in the United Kingdom is estimated to the amount of £11.8 billion.[163]

Generally, the whole system of corporate governance in the United Kingdom has developed since the corporate scandals emerged at the turn of 90s. In 1992, the Cadbury Report addressed the main corporate issues regarding the relationship among the particular parties within the corporate structure. Based on the "comply or explain" concept, companies listed on the London Stock Exchange should have complied with Cadbury's recommendations or, if not, explain why they had not. In 1998 the Cadbury Report and Greenbury Report which set recommendations about the system of remuneration of directors were brought together and so called Combined Code came into the world.[164]

After huge wave of corporate scandals in the USA, the Financial Reporting Council (FRC) became responsible for updating the Combined Code[165]. Currently, the Combined Code "sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders."[166] All listed companies are required to report on how they comply with the principles of the Combined Code. Nevertheless, this requirement is still based on the "comply or explain" principle. From the financial point of view, the Combined Code stipules that "boards should present a balanced and understandable assessment of the company's position and prospects."[167] Moreover, in that respect, the board is responsible for determining and evaluating the extent of the all significant risks and is required to take in an appropriate strategic tools how to deal with those.[168] Such requirements

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[163] Murphy, R., The Missing Billions The UK Tax Gap
[164] Financial Reporting Council, The UK Approach to Corporate Governance
[165] Ibid.
[166] Ibid.
[167] Financial Reporting Council, The UK Corporate Governance Code
[168] Ibid.

are therefore fully in accordance with above mentioned shift of the risk management, including tax risks, onto the top of board agenda.

3.2.1 The HMRC's Risk Based Approach

HMRC was formed in 2005 based on the merger of Inland Revenue and HM Customs and Excise Departments responsible for the collection of taxes.[169] The general objectives of HMRC are to improve the level of tax compliance while ensuring that individuals and businesses pay the right amount of tax due. The shift towards better governance in tax compliance was stressed in the Varney's review from 2006. The review team lead by Varney, the former chairman of HMRC, consulted with more than 140 large businesses in the United Kingdom their concerns about the overall tax system. The main aim of this review was to enhance the mutual relationship which would lead to better compliance practice. Both businesses and HMRC agreed on building up a mutual relationship based on trust and transparency. HMRC concluded that allocation of their resources according to the risk level can both ensure effectiveness and mutual enhanced relationship. Therefore the review came up with four outcomes that both HMRC and businesses are looking for.

These are:

- "greater certainty,
- an efficient risk based approach to dealing with tax matters,
- speedy resolution of issues,
- clarity through effective consultation and dialogue."[170]

This report was a trigger for the new approach for enhancing the better practice in tax compliance in the United Kingdom. In 2007 was introduced the HMRC's risk assessment methodology known as Tax Compliance Risk Management (TCRM) which defines a new

[169] From http://www.hmrc.gov.uk/menus/aboutmenu.htm
[170] From http://www.hmrc.gov.uk/large-business/review-report.pdf

approach to tax risk management practice in the UK.[171] The focus is based mainly on the largest UK corporations marked as being among FTSE100[172].

The whole TCRM Process is operated through a standard template which includes six factors as follows:

- "Complexity – What is the potential for risk in the size, scope and depth of business or tax interests?
- Boundary – What is the level of complexity of international structures, financing and connected party issues?
- Change – What is the degree and pace of change affecting the business and its tax obligations?
- Corporate Governance – The level of management of risk and accountabilities, openness and cooperation.
- Tax strategy– The use of tax planning and extent to which tax payer's judgements likely to match HMRC views.
- Delivery – Customer's ability to deliver right tax at right time through processes, systems and skills"[173]

All above mentioned factors are subsequently evaluated according to the riskiness of particular tax payer in order to set a certain risk profile. Organizations with low – risk profile will be given a so called "light touch" which includes less tax challenges. Contrary to that, tax payers with non – low tax risk profile will be subject to more tax challenges. In 2009 for example, there were 40% of large organizations in the United Kingdom which had a low risk rating from the HMRC.[174] Therefore, the current main aim in the United Kingdom is to increase such proportion in order to build up a better mutual transparent relationship.

[171] The whole TCRM Process is available on http://www.hmrc.gov.uk/manuals/tcrmanual/index.htm
[172] Stands for a share index of 100 most highly capitalised companies in the United Kingdom listed on London Stock Exchange
[173] The standard template is available on http://www.hmrc.gov.uk/manuals/tcrmanual/attachments/busriskrevtemp.doc
[174] HMRC, Making a difference: building effective relationships with large business

3.2.2 Current Developments

One of the main current challenging issues for HMRC is how to ensure that large corporations will put their tax agendas high up onto the board level in order to ensure that tax accounting processes of large UK companies is adequately performed. In the Schedule 46 of the Financial Act 2009, the new duties of Senior Accounting Officer (SAO) were introduced. This act refers to the qualifying companies which is “a UK incorporated company that in the preceding financial year either alone or when its results are aggregated with other UK companies in the same group, has turnover of more than £200m or has a relevant balance sheet total of more than £2bn.”[175] The SAO is the director or officer fully responsible for company’s financial accounting arrangements. As stipulated in the Schedule 46, “the SAO of a qualifying company to take reasonable steps to ensure that the company establishes and maintains appropriate tax accounting arrangements. The SAO must, in particular, take reasonable steps to monitor the tax accounting arrangements of the company and identify any respects in which those arrangements are not appropriate tax accounting arrangements.”[176] In practice, for the purpose of this legal requirement, the SAO will be CFO. Introduction of the Senior Accounting Officer institute is certainly one of the most important developments towards better corporate governance practice in tax issues.

The introduction of the SAO has, however, also brought some concerns about its application in practice. The main question includes the possible overlap with Sarbanes – Oxley Act. The SAO legislation does not require the introduction of SOX, however, where a company is required to comply with SOX, the SOX, namely the Section 404 of that Act, provides some comfort to SAO that some requirements stipulated in Schedule 46 are satisfied.[177] Nevertheless, the HMRC estimates are more than optimistic and presume that the institute of SAO will yield to the exchequer of £140 million over 4 years due to the more accurate tax computations.[178]

Another important development in the United Kingdom aligned to the above mentioned HMRC’s risk based approach is the new penalty regime for companies with effect from

[175] HMRC. 2006 Review of Links with Large Business
[176] Ibid.
[177] Ibid.
[178] From http://www.hmrc.gov.uk/budget2009/sao-6450.pdf

periods commencing after 31 March 2008.[179] The new penalty system is so called "behavioural system" based on division of penalties according to the level of deliberateness of the offensive action. Tax payers who deliberately conceal the particular tax offensive behaviour can await the highest penalties. Contrary to that, companies who traditionally have good relationships with HMRC can await a reduced penalty determined by the extent of the disclosure and cooperation of the particular tax payer. Moreover, so called "careless errors" in the tax payer's compliance is suspended from penalties as far as HMRC consider that compliance with condition would help such tax payer avoid further careless behaviour.[180] This new system of penalties is a support for a risk based approach of HMRC and should change the behaviour of tax payers towards the more transparent behaviour.

Recent developments in the UK tax legislation have brought about an increased call for better practice in tax departments. Such developments bring new demands on control processes and involve a higher level of compliance costs. According to MacPherson, the precise nature of upcoming legal standards in the United Kingdom is difficult to predict but some changes in general accounting standards from UK GAAP to IFRS can be expected.[181]

The persisting questions for the HMRC while assessing the certain tax risk profile of particular organization will in connection with the overall corporate governance practice are as follows:

- "What is the customer's attitude towards risk issues?
- What is the nature of the customer's compliance relationship with HMRC - for example, how transparent is its approach to tax risk management; is information disclosed fully and openly?
- What is its tax strategy? Is that strategy documented; does it cover all relevant taxes? To what extent is tax planning articulated in that strategy; how does it impact upon decision-making?
- What are the reporting structures – what reports are required and made to the Board by the customer's tax team? What are the relevant accountabilities?
- Is the tax function adequately resourced?

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[179] Bakker, A.; Kloosterhof, S., Tax Risk Management: From Risk to Opportunity
[180] Ibid.
[181] Ibid.

- How is the tax compliance monitored?”[182]

Companies which are able to appropriately answer those questions will enjoy less scrutiny by HMRC, less charges in connection with non – compliance and consequently the enhanced trust among all involved stakeholders. The main aim of HMRC will be to continuously enhance the role of boards in the tax issues so that the tax will obtain the appropriate level of importance by organizations.

[182] HMRC, HMRC Approach to Compliance Risk Management for Large Business

3.3 Australia

The new era of corporate governance in Australia has come up recently in light of overseas and domestic corporate failures. In general, Australian corporate governance framework "consists of a matrix of legislation, accounting standards which have the force of law, Australian Stock Exchange Listing Rules, and voluntary self – regulatory codes of practice."[183] The overall philosophy is consistent with OECD Corporate Governance Principles.

3.3.1 ASX Principles

In 2002, Australian Securities Exchange (ASX)[184] Corporate Governance Council was formed in order to deliver an industry – wide supportable framework for corporate governance.[185] In its Best Practice Recommendations regarding i. a. the best practice structuring of governance by boards, from March 2003, ten core principles were described. These principles are strictly applicable to ASX listed companies but have also a significant influence on all other companies and organizations. In 2007, the first edition of Principles from 2003 was extended into the revised Corporate Governance Principles and Recommendations. Currently, the Principles are reflected by more than 2000 listed companies which are required to adopt those principles on the basis "if not, why not" reporting.[186]

Principles 4 and 7 of this Corporate Governance Principles are of importance for the purpose of this paper. The principle 4 of that document for example stipulates that "companies have to put in place a structure of review and authorisation designed to ensure the truthful and factual presentation of the company's financial position."[187] CEO and CFO are required to report to the board that the company's financial reporting is fully in accordance with general accounting principles and that it represents a true and fair picture in all material aspects.

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[183] From http://www.treasury.gov.au/documents/178/PDF/ch4.pdf

[184] ASX is on of the world's top – 10 listed exchange groups measured by market capitalisation, for more information about ASX see http://www.asx.com.au/about/asx/index.htm

[185] In ASX Corporate Governance Council, Principles of Good Corporate Governance and Good Practice Recommendations

[186] Ibid.

[187] Ibid.

Moreover, the board is recommended to establish an audit committee which should ensure the integrity of company's financial reporting.

Principle 7 of that Corporate Governance Principles states that companies should establish a well sound system of risk management. As stipulated in the Principle 7, "the company should address risks that could have a material impact on its business (material business risks), as identified by the company's risk management system. The board should regularly review and approve the risk management and oversight policies."[188] Therefore, each company should establish and implement its approach to all business risks. In addition, Principles 7 stresses the importance of the board of directors in managing business risks. As stipulated, "the board should require management to design and implement the risk management and internal control system to manage the company's material business risks and report to it on whether those risks are being managed effectively. The board should disclose that management has reported to it as to the effectiveness of the company's management of its material business risks."[189] Practically, it includes that management of the company is required to report to the board that financial reports made in alignment with Principle 4 are based on the sound system of risk management. Such requirement naturally includes the tax reporting and connected tax risk management.

3.3.2 The ATO's Approach and its "Compliance Model"

"*Management philosophy has now become compliance strategy: each taxpayer category gets the attention appropriate to it.*"

Happé – Beyond Boundaries

The Australian Tax Office (ATO) is "is the Government's principal revenue collection agency. Its role is to manage and shape tax, excise and superannuation systems that fund

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[188] In ASX Corporate Governance Council, Principles of Good Corporate Governance and Good Practice Recommendations
[189] Ibid.

services for Australians."[190] The Australian tax system "is based on self – assessment and voluntary compliance."[191]

In Australia, 45% of corporate tax revenue is generated by the largest 100 companies. Therefore, one of the main strategies of ATO is to enhance and maintain the relationship with these large corporations. In 2003, the former Commissioner of Taxation, Michael Carmody, put in his speech at the Australian Financial Review Leader's Luncheon tax planning at the centre of organizational corporate governance. Moreover, in 2005, Carmody addressed the issue of tax risks and pointed out that there were some positive signs that those were becoming a part of corporate governance. According to Carmody, the boards have to be responsible about the particular tax position and the certain tax risk appetite.[192]

In 2006, Large Business and Tax Compliance Booklet published by ATO has shown what ATO see as a good compliance, its expectations towards large taxpayers, risk assessment methodology, and ATO's demands on the corporate governance policies. In order to build up such mutual relationship, the management meetings with the top 100 Australian companies were established.

In 2008, the Annual Compliance Arrangement (ACA) for the 50 top businesses was introduced by current Australian Commissioner, Michael D'Ascenzo. ACA is built on two concepts. First, "that the taxpayer having sound tax risk management processes and second, that there is a commitment to ongoing disclosure of tax risk."[193] In that respect ACA works as a great tool in enhancing the relationship between ATO and Australian large tax payers. For ATO it is crucial to ensure that managing tax risks is a core for to good corporate governance for companies. ACA is one of the way how ATO supports the tax risk management practice in companies.

These developments have led to the introduction of ATO's so called "Compliance Model" which has become the pioneer in the tax risk management model for tax authorities. The

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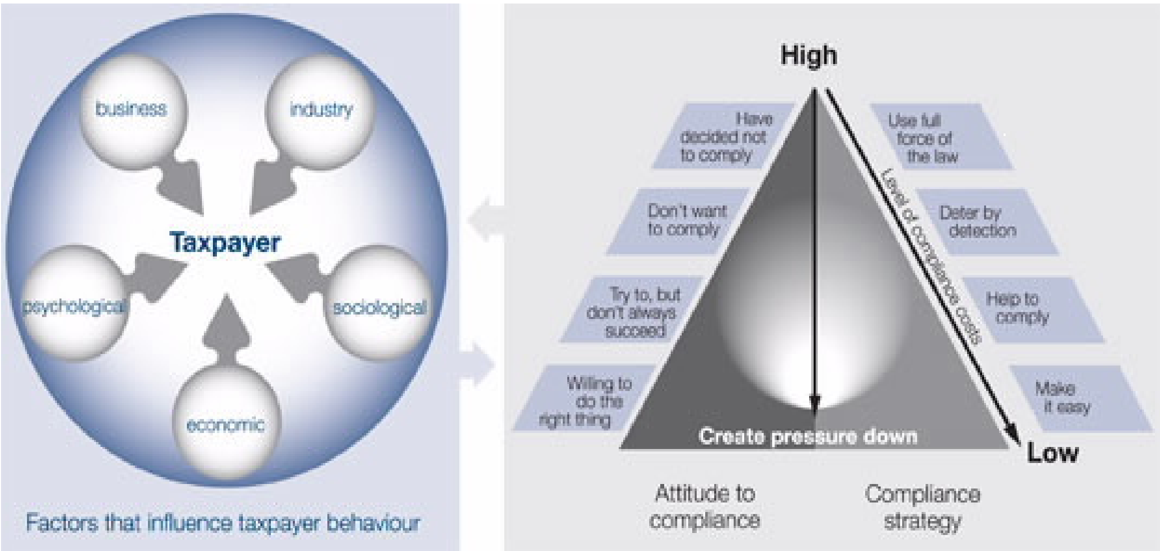
[190] For more information see
http://www.ato.gov.au/corporate/pathway.asp?pc=001/001/002&mfp=001&mnu=39504#001_001_002
[191] In Australian Tax Office, Large Business and Tax Compliance
[192] In KPMG, Tax in the Boardroom : A Discussion Paper
[193] From http://www.ato.gov.au/corporate/content.asp?doc=/content/00167346.htm

following picture is a graphical view of this model.[194] From the tax authority's perspective, the model tries to set a certain appropriate enforcement strategy towards particular type of the tax payer. The particular type of the tax payer is influenced by broad spectrum of factors such as type of business and industry, in which they operate, sociological, psychological and economic factors. The model is based on the precondition that the most tax payers, those at the base of the pyramid, voluntarily comply with the tax system and therefore the compliance strategy should be based on cooperation and trust – so called "make it easy" compliance strategy. Contrary to that, the tax payers on the top of the pyramid are those who are applying the tax evasion methods in decided not to comply in the within the legal framework. In this case, the tax authority should apply the compliance strategy based on the full usage of law enforcement such as penalties, deterrence etc. In the middle of the pyramid there are tax payers who generally might want to comply and but also those who are ready to take advantage of "grey areas of law" and therefore some persuasion compliance strategy by the tax authorities is necessary.



[195]

Based on this model, the main tax risks for the tax revenue authorities arises from the tax payers who are positioned in the middle and on the top of the pyramid. Such tax payers will be therefore on the top of the tax revenue authorities' agenda.

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

[195] From http://www.ato.gov.au/corporate/content.asp?doc=/Content/5704.htm

Moreover, the very uncompromising point of view is represented by Australian Tax Office. The Australian Office suggested the full responsibility of boards in relation to taxation.[196] In addition to this, the Australian Office set a "key governance" questions which should be in the centre of the board's agenda towards tax issues. Answering these questions might be a good starting point while evaluating the level of their corporate governance. Those are:

- "Are you confident that your records and control systems enable your group to meet its tax obligations properly?
- Are the amounts of tax you are paying in line with your business results?
- Is there anything to indicate that your group's business results and tax payments are lower than would be suggested by economic conditions?
- If your group is consistently reporting losses, are these real economic losses and can they be satisfactorily explained in terms of the group's overall performance?
- Are you aware of any material timing or permanent differences in the group's tax effect accounting and, if so, are you comfortable with the reasons for those differences?
- Are there any areas of major disagreement between your group and the Tax Office? If so, are you satisfied with the way they are being handled?"[197]

Above mentioned activities undertaken in United States, Australia, and United Kingdom is where the current practice in tax governance is going. Moreover, such developments are expected to pervade and taxes become an inevitable part of corporate governance practice. From above mentioned examples it is clear that tax administrators have nowadays a vital role in ensuring that corporate leaders are fully responsible for their tax strategies and its outcomes.

[196] For more information see http://www.ato.gov.au/content/downloads/LBI82560.pdf
[197] Ibid.

Conclusion

The paper dealt with the inappropriate tax compliance and introduced the way of how tax compliance can be enhanced. It has been shown on practical examples that consequences of such non – compliance practice are significant mainly due to the fact that tax revenues are in most countries one of the main source of revenue. The paper provided a broad spectrum of theoretical approaches to the topic of tax governance and thereby put tax into the concept of corporate governance. In that respect, it is necessary to bear in mind that such interconnection is still a quiet new phenomena and therefore, there is a space for further research in this field. It has been shown that taxes have to be perceived as one of the corporate governance topic since the main corporate governance issue, the agency theory, is also largely relevant in this connection. Moreover, it has been shown that good corporate governance practice is one of the way how tax compliance can be enhanced. If taxes are well governed, the undesirable tax avoidant and evasive behaviour will be mitigated.

Tax risk management particularly is one of the methods of how good governance in tax can be achieved. It seems that current move towards better governance and tax risk management is inevitable. Both tax payer's perspective and the tax revenue authorities' perspective of tax risk management have different aims but both are subsequently creating better tax governance practice. Such practice leads to better tax compliance which have positive effects on both governmental revenues and corporations itself. From corporate tax payer's perspective, it has become clear that tax, as a significant part of corporate costs, has to be perceived more as a strategic issue rather than an administrative obligation. The way of how corporations manage their risks and are able to communicate them with their stakeholders remains the main challenge for organizations. The consequences of broad spectrum of risks arising from inappropriate tax compliance can be irrecoverable. Therefore, CEOs and Boards particularly are increasingly considering tax as a strategic issues rather than administrative issue. Every tax strategy and policy should be aligned to the wider corporate strategy. Moreover, such consideration is even more important in current uncertain economic environment where business risks in general need to be transparently brought into the light.

Last section of the paper described the current international experience in promoting the better governance in tax. Mainly, tax authorities in Anglo – American world are the ones who are pioneers in enhancing the tax governance. IRS in the United States and its compliance assurance process, the HMRC in United Kingdom and its risk assessment methodology, and ATO in Australia and its compliance model are great examples from practice towards which direction the current tax revenue administrators will go. In such environment where tax authorities concentrate their resources according to the riskiness of the profile of particular tax payer, it is particularly important to implement policies where tax risks are managed well and effectively. In addition, there is one common denominator in all above mentioned countries – the pressure on enhanced relationship between tax revenue authorities and corporate tax payers. Only such relationship can consequently lead to better tax compliance and to mitigation of tax avoidant and evasive tax behaviour. It is necessary to mention that these developments are expected also in other well developed countries where principles of corporate governance have already become an inevitable part of everyday business life.

Changes and developments in corporate governance legislation and practice reinforced the whole approach to taxes. Corporations and tax revenue authorities have recognized the importance of good corporate governance in tax function. Tax risk management as a part of corporate governance is the way both tax authorities and corporate payers have to go in the future.

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