

# Tax Risk Management: Evidence from the US

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## Abstract

*Tax risk management is a worldwide phenomenon with growing prominence in the discourse of both revenue authorities and corporate taxpayers. In the US, in-house tax professionals are now subject to unprecedented calls for transparency in terms of their tax risk management strategies and processes. This article discusses the findings of a study of these professionals conducted at a time at which the regulatory environment was becoming significantly more stringent. Overall, the evidence suggests a trend towards a more conservative approach to tax planning generally being adopted. There was also a strong message from the interviewees on the importance of the perceptions around the practice and processes on risk management. Both commonalities and differences are found in comparison with the position in the UK.*

## Introduction

In a previous issue of this Review, Freedman et al<sup>1</sup> discussed, inter alia, tax risk management with their interviewees, primarily in the context of the risk rating approach adopted by Her Majesty's Revenue and Customs (HMRC). This paper presents some similar findings from a study conducted in the US of in-house tax professionals working in US multinational entities (referred to generically throughout as 'companies') in the information technology sector. Specifically, the research study entailed 20 in-depth interview sessions conducted by one of the authors in 2005<sup>2</sup>, involving 26 interviewees in total from fifteen companies<sup>3</sup>. The interviewees are extremely senior personnel in their respective organisations. In addition, views were sought from three professional tax advisers. The purpose of this article is to present and analyse the findings of this study in relation to the way in which tax risk is managed by these companies. The article provides important insights into the thinking of in-house tax professionals at a particularly turbulent time in terms of the changing US regulatory environment.

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<sup>1</sup> J. Freedman, G. Loomer, and J. Vella, "Corporate Tax Risk and Tax Avoidance: New Approaches" [2009] BTR 74.

<sup>2</sup> For a description of the methodology adopted in this study, see Appendix I.

<sup>3</sup> Details of the companies involved are contained in Appendix II.

The need for tax risk management arises in part from the existence of uncertain and inadequate tax legislation. Risk management strategies often reflect how organisations and, more specifically, how in-house tax professionals deal with such uncertainty. A tax professional's 'attitude' to tax legislation and indeed to law in general is important in this context. Some tax professionals are likely to be risk averse and will therefore steer away from what might be termed "aggressive"<sup>4</sup> tax plans. Those who are not risk averse, and are happy to work exclusively within the letter of the law, are more likely to engage in more 'aggressive' tax planning. Arguably, therefore, tax risk management is intimately linked with tax aggressiveness.

There is a substantial literature in the US which examines tax professionals' "attitude" to the law and the extent to which they engage in 'aggressive' tax planning, for example, Schisler<sup>5</sup> and Spilker et al.<sup>6</sup> However, this literature has tended to take as the object of enquiry the work and perspective of tax advisers, and much less research has been conducted into in-house tax professionals.<sup>7</sup> In terms of understanding what determines the level of tax aggressiveness in a firm, Shackleford and Shevlin<sup>8</sup> suggest an interesting question: 'Are growth firms, decentralized firms, and firms led by non-financial Chief Executive Officers (CEOs) less aggressive?'<sup>9</sup> Maydew<sup>10</sup> similarly calls for further research being 'needed to explain why some firms appear to be more aggressive tax planners than other firms'<sup>11</sup>. While these authors, coming from an accounting/economics background, are most likely interested in quantifying aggressiveness, the research reported by them carries a strong sense of the influence of certain individuals (whether it is the CEO, Chief Financial Officer (CFO) or Vice President (VP) Tax) on a company's position on the tax aggressiveness spectrum.

A significant challenge for in-house tax professionals is how to respond to possibly increasingly uncertain tax legislation. This arises due to some finance ministries around the world choosing to deal with creative tax planning by using some 'big power'

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<sup>4</sup> Note the term 'aggressive' in this context arguably originates in the US and is used in the context of tax planning to denote activities that go against the spirit of the law. The term has come into use in the UK without any attempt to clarify its scope, and has been further legitimised by the recent *OECD Study into the Role of Tax Intermediaries* (OECD Study) available at [www.oecd.org/dataoecd/28/34/39882938.pdf](http://www.oecd.org/dataoecd/28/34/39882938.pdf) (accessed 18 September 2009), as noted by Freedman et al. fn.1. at 75.

<sup>5</sup> D.L. Schisler "An Experimental Examination of Factors Affecting Tax Preparers' Aggressiveness--A Prospect Theory Approach." (1994) 16 *Journal of the American Taxation Association*; 124.

<sup>6</sup> B. Spilker, R. Worsham and D. Prawit "Tax Professionals' Interpretations of Ambiguity in Compliance and Planning Decision Contexts." (1999) 21 *Journal of American Taxation Association*; 75.

<sup>7</sup> A recent survey of US and 'non US' companies was conducted using questionnaires: H. Wunder, Tax Risk Management and the Multinational Enterprise, (2009) 18 *Journal of International Accounting, Auditing and Taxation*; 1. Note, however, that significant limitations on the methodology used limit the efficacy of the results of this research.

<sup>8</sup> D. Shackleford and T. Shevlin "Empirical tax research in accounting." (2001) 31 *Journal of Accounting and Economics*; 321

<sup>9</sup> See fn. 8 at p.378.

<sup>10</sup> E.L. Maydew, "Empirical tax research in accounting: A discussion." (2001) 31 *Journal of Accounting and Economics*; 389

<sup>11</sup> See fn. 10 at 397.

strategies<sup>12</sup>. While there is some debate on how effective such strategies are in dealing with “unintended” tax planning opportunities, they have become a reality for many organisations to deal with. In a study conducted in 1995, Porter<sup>13</sup> reports mixed reaction among UK in-house tax directors to the possible introduction of a general anti-avoidance rule. Some managers did not see this rule necessitating any change in the workings or strategy of the in-house tax department. A number of these managers considered themselves to be already cautious in their approach to borderline tax schemes. However, others did see themselves becoming more cautious if a general anti avoidance rule was in place. The US counterpart is the economic substance doctrine which requires the proof of a business transaction’s validity through practice as well as legal form.

Research conducted by Spilker et al.<sup>14</sup> produces findings which are ‘consistent with recent strategic attempts by the Internal Revenue Service (IRS) to frustrate tax professionals’ ability to tax plan by proposing that tax rule ambiguity be increased in certain areas of the tax law’.<sup>15</sup> Spilker et al. conducted experimental research involving tax professionals. Results showed that tax professionals interpret ambiguity aggressively in compliance contexts (considering issues after the relevant transactions have occurred), but relatively conservatively in planning and decision contexts (where advising on structuring transactions to be reflected ultimately in the tax return with an aim to improve their tax situation).

The purpose of this article is to add to a growing body of knowledge about the relationship between tax risk and tax aggressiveness. It also adds to the small but growing body of empirical work that adopts a qualitative and interpretative approach, utilising interviews to gain insights into tax practice<sup>16</sup>.

## **The Importance of Tax Risk Management**

The need to address risk management at all in a tax context arises due to the inherent indeterminacy of tax laws<sup>17</sup>, which gives rise to uncertainty around their interpretation. Where there is uncertainty, there is a risk to be quantified and managed, which ultimately links risk management with degrees of tax aggressiveness and attitudes to the law.

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<sup>12</sup> In the US, for example, such strategies include ‘naming and shaming’ as well as civil prosecutions.

<sup>13</sup> B. Porter, "In-house tax department tax managers' response to current legal and environmental changes: an empirical investigation." [1999] BTR 406.

<sup>14</sup> See fn. 6

<sup>15</sup> See fn. 6 at 76.

<sup>16</sup> See for example Freedman et al fn. 1, L. Oats and P. Tuck, *The Relationship between HMRC and Large Corporate Taxpayers: The Changing Role of Accountants* (ICAEW Centre for Business Performance, London, 2008.), K. Glaister and J. Frecknall Hughes “Corporate Strategy Formulation and Taxation: Evidence from UK Firms” (2008) 19 *British Journal of Management*; 33 .

<sup>17</sup> Freedman et al fn.1 and Freedman [“Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle”](#), [2004] BTR 331 See also S. Picciotto, “Constructing Compliance: Game Playing, Tax Law and the Regulatory State” (2007) 29 *Law and Policy*; 11 – 30; D. McBarnet, “When Compliance is not the solution but the problem”, in Braithwaite, V (ed) *Taxing Democracy*, (Ashgate Publishing, Ashenden, 2003); M. Burton, “Responsive Regulation and the Uncertainty of Tax Law – Time to Reconsider the Commissioner’s Model of Cooperative Compliance?”, (2007) 5 *eJournal of Taxation Research*; 71.

Almost as a direct result of this alone, there will always be some companies (and individuals) who are more aggressive (or perceived to be so) than others and ‘pushing issues to the “envelope”’.

The interviewees in this study were concerned about by what appears to be an increased level of interest in risk management generally by management in a post-corporate-scandals era.<sup>18</sup> This post-Enron environment presents a new risk terrain for these companies, consisting of new regulations (with increased penalties) and specifically, complying with the Sarbanes Oxley 2002 (SOX) reporting requirements as they apply to tax. As noted by one interviewee, ‘Sarbanes-Oxley pretty much ... rules the roost’ and another stated ‘it has changed the world’. Donald T Nicholaisen, Chief Accountant of the US Securities and Exchange Commission (SEC) observed in 2004 that “[t]he accounting and reporting of income taxes has received increased scrutiny by investors, analysts, Congress and others. Your auditor will be asking for more information, and you may have noticed an increased level of scrutiny from the SEC staff. That spotlight is likely to continue. Welcome to the new world.”<sup>19</sup> It is against this regulatory backdrop that the interviews on which this article is based took place. While the impact of SOX is primarily affecting US companies, arguably it has ripple effects throughout the world in terms of the need to tighten up procedures and demonstrate appropriate levels of internal controls. One obvious example is the new requirement to appoint a Senior Accounting Officer in the UK<sup>20</sup> to assume responsibility for ensuring and certifying that appropriate tax accounting arrangements have been established and maintained.

The need for tax executives to keep company management informed of the tax risks to a greater extent than before has become part of internal tax risk management process. This appears to be leading generally to a more conservative approach to tax planning within these companies. Another contributing factor to this conservative approach is undoubtedly the US regulations which were introduced in 2003 to curb abusive tax shelter schemes. These regulations require companies to disclose tax shelters (as defined in the regulations) in their tax returns. Promoters of tax shelters are also required to register transactions with the IRS and maintain lists of participants. These regulations have since been amended<sup>21</sup> and arguably improved upon in response to taxpayer and tax adviser concerns.<sup>22</sup>

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<sup>18</sup> This increased level of interest in risk management is arguably also driven by the Big Four, see for example PricewaterhouseCoopers *Tax in the Boardroom: Tax Risk Management: Key Considerations* 2005 available at [www.pwc.co.uk/pdf/PwC-Tax\\_Risk\\_Considerations.pdf](http://www.pwc.co.uk/pdf/PwC-Tax_Risk_Considerations.pdf) (accessed 18 September 2009).

<sup>19</sup> Quoted in T. Neubig, and B. Sangha, “Tax Risk and Strong Corporate Governance”, (2004) 56 *Tax Executive*; 114.

<sup>20</sup> Schedule 46, Finance Act 2009.

<sup>21</sup> Following the American Jobs Creation Act in 2004 (P.L. 108-357) which included provisions that significantly changed the tax risk calculus in the context of abusive tax shelters for example by imposing more stringent penalties for non-disclosure of reportable transactions, expanding the capacity of the IRS to take civil injunction action, extensions to sanctions for failure to comply with Circular 230 (which governs tax practitioners in the US) and requirements for taxpayers subject to SEC filing rules to disclose tax shelter related penalties.

<sup>22</sup> See R.M. Lipton and Walton “Final Regulations for the Tax Shelter Disclosure Regime: Making the Rules More User Friendly”, (2007) 107 *The Journal of Taxation*; 196, for a summary of these amendments.

Greater interest by management in the stance taken in relation to tax risk is demonstrated by the following comments. One interviewee sees an important part of his job as being to point out to management the impact of being aggressive or conservative, and the risks and rewards: “That’s what makes tax a lot of fun”.<sup>23</sup> Likewise another referred to issues that “you might have left bubbling or you might take a view on, you now need to air and discuss and give guidance to the CEO as to whether it’s appropriate to go with this”. In the context of the increase in documentation now required for risk management purposes (due largely to SOX) A third interviewee said, “you better be able to show that you’ve done this work and that you’re managing that risk and everybody, you know the Board of Directors, the Executive Management want to see it”.

There is evidence here to suggest that the uncertainties around some tax laws, combined with a more intrusive regulatory environment which has resulted in an increased interest in tax by management, has led to a trend towards more conservatism in tax planning generally. One interviewee noted in this regard “I think CFOs generally now are a bit more accepting ... [and they] like to think more conservative.” Another interviewee commented on the changing acceptability of tax plans at a “business, political level”, with the “mindset” of management being narrower than previously.

One interviewee specifically referred to tax plans being “a lot more vetted” now (evidenced by the increase in documentation requirements) whereas in the past “companies may have been a bit more willing to try something...a bit more seat of the pants”. In light of this change he made a presentation to the Audit Committee. He needed to understand where that committee stood on the risk spectrum, and come up with some processes and a list of risks that need to be considered in the present climate. He said in the past there were things like the “Wall Street Journal” test. He now spoke in terms of having something analogous to a spider’s web that would represent the different risks ranging from a public view to technical, to documentation and to the [CEO named] factor. In relation to the latter he stated, “the last thing you want ... one of the richest men in the world feathering his nest with tax shelters, doesn’t really read very well”.<sup>24</sup> He also referred to considering the:

Atmospherics...there’s a lot going on in the atmospherics right now...where judges are reacting very differently to things that are grey...we don’t know what they’re going to be thinking two or three years down the road. The pendulum may have swung back, don’t know, it may have landed in a sensible place.

The position in the US has moved on subsequent to these comments. Concerns over differing judicial interpretations of the economic substance doctrine have led to proposals

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See also A. Granwell and McGonigle, S. “US Tax Shelters: A UK Reprise”, [2006] BTR 170 in relation to the transposition of the disclosure rules to the UK.

<sup>23</sup> Although a few interviewees suggested that ‘the fun’ has gone out of tax.

<sup>24</sup> While a tax shelter usually refers to some method of reducing one’s taxable income, and thereby one’s tax bill, some tax shelters are legal and legitimate but others may be illegal or certainly questionable in ethical terms. It is the latter to which this interviewee was referring in this context.

for its codification.<sup>25</sup> The cyclical nature of tax avoidance patterns and judicial responses is not, of course, peculiar to the US, as noted by McBarnet.<sup>26</sup>

Another interviewee referred in this regard to positioning and posture, “I think that in itself it’s just ...how well you document it, how well you position yourself and your posture. I mean, if you’re looking aggressive then you’re going to be aggressive.”

Uncertainty in itself therefore appears to some extent to result in effective tax policy<sup>27</sup> if the latter amounts to conservative or low risk tax plans. This is subject to debate and represents a “tension” at the economic and political level of analysis. As regards increased regulation, SOX appears to have unveiled (in a new way) a formal authority structure<sup>28</sup> within the companies by pushing tax onto the Boardroom agenda<sup>29</sup>, thereby attaching an increased importance to tax risk management.

When considering the importance of the *perceptions* around the practice of risk management, both within the organisation and externally, procedural legitimacy featured more prominently in the interviews than the exact nature or quality of the practice itself. Being in tune with the “atmospherics” of the situation is an important part of risk management, which includes having one’s ear to the ground, networking, knowing how judges are thinking and so forth.

## **Types of Tax Risk**

Ernst and Young<sup>30</sup> define “tax risk” to include “Any event, action, or inaction in tax strategy, operations, financial reporting, or compliance that either adversely affects the company’s tax or business objectives or results in an unanticipated or unacceptable level of monetary, financial statement or reputation exposure.”

While a number of types/areas of tax risk were specifically identified by the interviewees (as detailed below), many of them spoke of fear of the unknown, of missing something through, for example, not being kept informed. One interviewee described this well:

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<sup>25</sup> Different courts in the US have taken different stances in relation to the economic substance test and its relationship with the business purpose test. The plan announced in Obama’s FY2010 budget is to codify the economic substance test and impose a 30% penalty on understated tax attributable to an undisclosed transaction that fails the test. There is a vast literature in the US on the economic substance test. For a recent addition, see L. Lederman, “W(h)ither Economic Substance” [2010] 95 Iowa L. Rev. (forthcoming).

<sup>26</sup> See fn. 17.

<sup>27</sup> D. McBarnet, “Can tax policy survive the avoidance industry? Analysing Strategies in tax and accounting, in the UK and Australia”. 11th ICAEW Tax Research Network Conference, Nottingham University Business School, 17-18 September(2001); Spilker et al. fn. 6.

<sup>28</sup> N. Fligstein, “The Structural Transformation of American Industry: An Institutional Account of the Causes of Diversification in the Largest Firms, 1919-1979,” in W. W. Powell and P. J. DiMaggio (eds) *The New Institutionalism in Organizational Analysis*. (Chicago, University of Chicago press, 1991).

<sup>29</sup> In the UK, the drive to push tax onto the Boardroom agenda came from HMRC as part of the overall strategy to reduce tax avoidance. In the US it derives from the accounting scandals of the early 2000s.

<sup>30</sup> Ernst and Young (2006) *Tax Risk No Room for Error* available at [www.ey.com/global/assets.nsf/International/TARAS\\_-\\_Sep\\_2006\\_-\\_Talkstarter/\\$file/EY-Tax-TARAS-Talkstarter-Sep06.pdf](http://www.ey.com/global/assets.nsf/International/TARAS_-_Sep_2006_-_Talkstarter/$file/EY-Tax-TARAS-Talkstarter-Sep06.pdf) (accessed 18 September 2009).

The biggest tax risks facing an organisation like [company name] are the ones we don't know and can't assess...what's out there that you don't really have visibility to...it's the great unknown that's the biggest risk. The rest of the stuff we manage.

The primary tax risk areas identified by the interviewees are summarised and discussed below. For analytical purposes, they are classified into two groups, technical and non-technical, by reference to whether the identified tax risk areas relate to aspects of the legislative and other rules by which tax liabilities are determined, or to other aspects affecting the tax function.<sup>31</sup>

### Technical Issues

*Transfer pricing (TP)*: This was referred to by almost every company and for the most part it was first on their list. This is consistent with the findings of the third Ernst and Young Global Tax Risk Survey<sup>32</sup> of tax executives where transfer pricing was specifically mentioned more than any other technical issue as being an important challenge. As evidenced by the following quotes, the companies appear to be “pawns” in the battle for revenue between different tax jurisdictions: “more and more countries are getting more aggressive on transfer pricing and so you have a transaction between two corporations in the group and each tax authority wants their fair share,” “we don't want to pay on the same income twice or three times but you often get two or three jurisdictions who are fighting over the same profit. So to me, to a multinational, that's the biggest issue,” “every government wants to have a bigger piece of the pie,” and “now it's a tug of war around the world and you know you've got to pool the profits and you've got 25 countries all saying we want our share...it's an extreme challenge.”

For one interviewee, transfer pricing underlies the fact that their effective tax rate is driven by “how much profit is booked in the factory in Ireland versus how much is booked in the US and so on”. A related issue mentioned by another interviewee was that foreign audits (as opposed to US ones), especially in Asia, Korea and Japan which are “becoming more aggressive”, and were moving transfer pricing up the tax risk agenda. Similarly, a third interviewee referred to many foreign tax jurisdictions taking “totally unreasonable positions” on transfer pricing and that the number of countries now seeking documentation is growing exponentially (at the time of the interviews, 40 countries require transfer pricing documentation which they categorise as ‘Tier 1’ risk).<sup>33</sup>

*Permanent establishment (PE)* or “a son of transfer pricing,” as one interviewee

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<sup>31</sup> Obviously other classifications are possible and have been used by other commentators in discussions of tax risk management. The Ernst and Young survey for example, distinguishes external and internal risk factors, see fn.30.

<sup>32</sup> Ernst and Young (2008) *Steady Course, uncharted waters*, available at [www2.eycom.ch/publications/items/tax/2008\\_global\\_tax\\_risk\\_survey\\_findings/200812\\_ey\\_global\\_tax\\_risk\\_survey\\_findings.pdf](http://www2.eycom.ch/publications/items/tax/2008_global_tax_risk_survey_findings/200812_ey_global_tax_risk_survey_findings.pdf) (accessed 18 September 2009).

<sup>33</sup> The continued concern with transfer pricing as a key risk issue is reflected in a recent debate documented by the Tax Governance Institute. This body was launched by KPMG in 2007 as a forum to “share knowledge regarding the identification, oversight, management and appropriate disclosure of tax risk”. It has a dedicated website: [www.taxgovernanceinstitute.com](http://www.taxgovernanceinstitute.com) (accessed 18 September 2009).

described it. This category of risk relates to the structure of the company group and the degree of control over actions taken by parts of the organization that are dispersed widely geographically. It also relates to the increasing attention being paid to the categorization of operations as permanent establishments leading to new or increased tax liabilities in other jurisdictions. Interviewees referred to the risk of the subsidiaries doing something that jeopardises the integrity of the tax structure. One interviewee referred to some countries (India was cited) sending conflicting messages to companies; “the countries want them to do business there but then the tax authorities come after them on a PE issue. What did they expect?”

*Tangibles versus intangibles?* The valuation and tax treatment of intangibles is becoming increasingly fraught and is one particular area where there is potential for significant differences of opinion between the taxpayer and the tax authority as to the interpretation of technical rules. One interviewee highlighted the constant risk concerning the inherent nature of their products, identifying in particular that their product (software) does not “fit into a nice mould” so they are “always grappling with the fact that we’re in the grey anyway”.

#### Non-Technical Issues

*Reputational risk.* As pointed out by one interviewee, this is a risk that must be assessed even though it cannot be measured from a “pure tax opinion standpoint”. Not surprisingly, the bosses’ attitude to risk tends to matter here as reflected in another interviewee’s comment, “if the Board of Directors is conservative and we are in line with that, that’s great. So I think it’s more alignment, knowing what the bosses want”. This alignment seems to be more important in the post-Enron environment. The idea of going to tax court came up in this context and this interviewee’s response reflected the company-size factor. His view was that large companies (he cited GE and IBM, neither of which partook in the study on which this article is based) do not mind going to court as they see it “as a cost of doing business” whereas smaller companies would probably prefer not to go to court. These interviewees were also of the view that reputational risk was a bigger issue in the trade area than tax, because of the politics involved (for example, the US losing business to China).

The US Interviewees in this study were very concerned about the role of the media in the context of reputational risk, one noting “we try not to do things that’ll get us written up on the front page of the Wall Street Journal.” Another said “we take a very, very careful look at the risks involved and I guess the guiding principal is would you want this in the newspaper and if the answer is no...you probably shouldn’t do it.” Another interviewee said:

You want to be able to wake up every morning and not see your name in the headlines of the Wall Street Journal as having done something bad. I think that is absolutely the truth with regard to the tax department as well. We feel very strongly that we never want to be the poster child for some bad thing.

Reputational risk; or secondary risk in Power's analysis<sup>34</sup>, is arguably a friction that interferes with the tax planning activities of companies<sup>35</sup>, at both a personal and corporate level. The role of the media in this context was particularly striking; the media is a powerful player and is arguably a subtle catalyst in this apparent trend towards conservative tax planning referred to above. It may well be the media that is responsible ultimately for a change in the attitude<sup>36</sup> of some tax executives to the law, succeeding in a way that numerous tax law changes, including the introduction of "super principles"<sup>37</sup>, have failed in the past. The public, through its interest in the media, in this context may well be having a greater influence on the nature and practice of tax planning than was originally considered possible. Freedman et al<sup>38</sup> note that the relationship between negative publicity in tax issues and share prices, sales and profits is not well understood. Anecdotal evidence, for example in relation to Vodafone<sup>39</sup>, suggests that there is a relationship, but it has not been the subject of systematic academic enquiry to date.

*Changing nature of the business* which brings new risks to be managed which, if not adequately resourced, can become enhanced. Company Five executives spoke of moving into the service industry, while company One executives spoke of moving into retail. These businesses can be very quick to market and may present new areas of risk.

*Compliance risk.* This incorporates completing returns and ensuring the correct amount of tax is being paid (companies do not want to overpay either). Interestingly, one interviewee emphasised that sometimes they knowingly take a compliance risk. This happens due to having minimal tax resources, which means they cannot get to everything.<sup>40</sup> A "business decision" is taken to prioritise what gets done and a calculated risk is taken on the rest. Very importantly, senior management are warned and informed about this risk and he tells them:

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<sup>34</sup> M. Power, *The Risk Management of Everything* (Demos Publishing, London, 2004) (noting that concerns about reputation are becoming more intrusive on organisational decision making than primary, or operational, risks).

<sup>35</sup> M. Scholes, M. Wolfson, M. Erickson, E. Maydew, and T. Shevlin, *Taxes and Business Strategy: A Planning Approach*, (New Jersey: Prentice-Hall Income, 2004). See also D.M. Schizer, "Frictions as a Constraint on Tax Planning," (2002) 101 *Columbia Law Review*, 1312. Schizer expands the notion of frictions beyond those directly connected with tax planning into other areas of the regulatory and institutional environment for example accounting rules (important in light of the disclosure requirements in the US relating to differences between book and tax profits) and risk management policies of securities dealers (which constrain the extent to which new financial products can be devised to satisfy the desire to exploit the tax rules).

<sup>36</sup> See fn. 27

<sup>37</sup> See fn. 17

<sup>38</sup> See fn. 1.

<sup>39</sup> A report in the *Financial Times* observed in 2007 "Vodafone has had its hopes dashed of securing a swift resolution to its dispute with the UK authorities over a potential £2.5bn tax bill... [HMRC] is seeking to impose a tax bill on Vodafone in relation to its Luxembourg subsidiary because it is a holding company for some of the group's UK activities... Vodafone's disclosure of potential tax liabilities of £5bn in November 2005... contributed to a 10% fall in the group's share price at the time..." 9 August 2007.

<sup>40</sup> For example, VAT-specific compliance requirements for which they cannot afford to acquire the expertise to deal with.

I don't have a head count resource so this is being neglected, I do not have the time, the bandwidth or the resources to get to this. You need to know, so that when it comes back around you don't hold me responsible.

If the risk is "significant enough" a reserve will be put in place in the accounts but if it becomes 'chronic' he will argue for more resources and then it becomes a management decision as to how to go forward. One tax Adviser interviewed also referred to the trade-off between the cost of compliance and the risk of sanctions. This type of trade-off seems to be particular to smaller firms for which the cost of compliance can be so significant. Linking this risk with reputational risk, one interviewee said: 'it reflects badly on ... the company as a whole if you're being fined, reported, that sort of thing' for non-compliance.'

*Taxation in other jurisdictions:* Here the concern is less with the application of tax codes than with concerns about the way in which the tax systems are administered and the dynamic nature of the global regulatory environment. A number of interviewees referred to local country issues. One specifically identified some uncertainty around "how a country will take a look at how we should be taxed". Concern was raised by two companies in particular about Japan, China and the Eastern Bloc, "where the tax rules aren't all that worked out and they don't necessarily have a rational way of dealing with these sorts of questions".

Another interviewee, while recognising that movement into other countries is often driven by labour (cost and availability), comments that "tax is the place where you can make the mistake that costs you more than the labour saved you". This is a significant point when companies are looking at longevity of structures. The constantly changing tax laws around the world present tax risks: "what may have been in total conformity with law and regulation at one point in time, due to legislative changes or court rulings and court interpretations, might change".

Foreign tax authorities have been clearly identified as important economic and political level actors, giving rise to many concerns for US tax executives. There are uncertainties around dealing with foreign tax authorities, particularly around the idea of foreign authorities copying already unpopular US tax rules and practices. Transfer pricing and SOX were highlighted as areas within which copycatting of specific policies and regulatory strategies, often a response to uncertainty, at international level, is in evidence or being considered, with associated tax policy implications<sup>41</sup>.

*Financial reporting risks* which incorporate the relatively new SOX reporting requirements, "a brand new risk". Another interviewee observed that "if tax is materially incorrectly reported such that a restatement is required, that can be embarrassing" and "the company's reputation is shot with its analysts, with its investors, with its

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<sup>41</sup> See L. Eden, T. Dacin, and W.P. Wan, "Standards across borders: Crossborder diffusion of the arm's length standard in North America." (2001) 26 *Accounting, Organizations and Society*; 1, on transfer pricing (noting the different historical rates of adoption of US transfer pricing practices in Canada and Mexico).

employees”. This issue is thus linked to reputational risk.

Setting tax reserves in the accounts (a “cushion”) is clearly risk management in action as one Adviser interviewee stated: “The reason companies have tax reserves is because there are risks out there”. The quarterly reserve-setting process has, as a result of SOX, apparently become a painful and extremely heavy administrative burden and is recognised as “a big issue”. Effectively, in this process, the company is being overseen by the auditor, who is being overseen by the Public Company Accounting Oversight Board (PCAOB).<sup>42</sup> The impact of PCAOB was clear, with one interviewee identifying it as now having the most influence in this area. “We do what the people who measure them [the auditors] count and that oversight body can put them out of business, so they do what that body tells them to do.” SOX extends tax risk to processes as explained by one interviewee in some detail who concluded that “you could have the right answer on your reserves but if you have poor processes to get there, then you could have a 404 failure even though your reserves are right on”.

SOX has, according to many of the interviewees, pulled resources from planning and value-add activities to administration and is not very popular among the interviewees. It’s described as “killing a fly with an elephant gun”, ‘the obvious eight hundred pound gorilla in the middle of the room.” SOX and is largely perceived as the consequence of the actions of a few “bold” individuals/companies and the others are “paying for their sins”.

There was certainly some scepticism around whether or not SOX will succeed in what it set out to achieve: One interviewee, extremely annoyed, commented, “it’s not going to stop the larger companies from doing these things, but it is going to be an excessive burden financially on the small companies”. Similarly, another interviewee stated “I am not sure that all the policies and procedures in the world would have stopped some of these major offenders”. Importantly, there was some concern expressed over the copying or borrowing of SOX-type regulations by other countries in which these companies are operating.

Financial reporting risks, largely resulting from SOX-imposed requirements, are evidence of how a company’s auditors, who themselves are overseen by and accountable to the PCAOB, are an important influence on the practice and process of tax risk management. The general consensus certainly is that SOX has given rise to much tension in the various relationships between all the parties involved and its success is viewed with considerable scepticism.

## **Risk Profile**

As noted earlier, the risk stance adopted by an in-house tax executive is invariably linked to, and guided by, the stance adopted by the organisation as a whole. All interviewees

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<sup>42</sup> Some interviewees referred to more changes expected in this process through new Financial Accounting Standard 5 rules also.

were asked to describe the tax risk profile of the company. One company didn't answer the question directly, but the risk profiles were described by the others using the following terms: 'conservative' (4); 'fairly conservative' (1); 'pretty conservative' (1); 'on the conservative side' (1) 'risk averse' (2); 'very ethical and pretty risk averse' (1); 'not hugely aggressive' (1); 'cautiously aggressive' (1); 'at 75 on a scale of 0 to 100 (100 being very aggressive)' (1); and finally, 'aggressive but not slimy' (1).

There are clearly some important and problematic issues around the use of language here. For example, what does "conservative", "aggressive" or "cautiously aggressive" mean in this context? While a detailed discussion on this matter is beyond the scope of this article, it was clear that the interviewees were drawing on the same types of words to describe their companies' risk profiles. There appears to be a recognised and accepted vocabulary around risk profiles. Using these terms therefore (without a detailed discussion on their precise meaning) in this discussion is justified. However, the additional comments on some of the companies' risk positions that follow here do bring some clarification to the various meanings.

One interviewee suggests it is his company's conservative approach that meant he did not (fortunately, according to him) get "on board with some of these ideas that these investment bankers brought through years ago and there are a lot of firms, there are a lot of companies that have been caught by that".<sup>43</sup>

While the company Four executives did describe the company's risk profile as "risk averse", it was very quickly qualified which might lead one to question the appropriateness of the profile descriptor they used:

We take very aggressive positions but then we get rulings to shore those up. So ... when I first came and our prior CFO was here, his attitude was he wanted to set the precedents in Europe, in other countries, not get stuck behind a bad precedent from another country.

When asked if they actually set out to be a leader in that sense, he replied, "Yes, from day one, back in July of 1999". So "risk averse" for this company incorporates what they consider to be "aggressive" tax plans but ones for which they have sought rulings on, which, it seems, no longer makes them aggressive. Not all interviewees might agree with this interpretation of "risk averse". One such interviewee was keen to point out: "to be really frank we're a very conservative company with the highest business ethics on the face of the earth".

On the other hand, another interviewee was happy to describe his company's profile as aggressive but was very anxious to distinguish that from being "slimy". They did not do "very aggressive transactions...when everyone was accused of doing particularly aggressive transactions and we also haven't swung to the other side". He did add that

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<sup>43</sup> This interviewee was referring to potentially illegal tax planning ideas, often referred to as 'off-the-shelf' or "mass marketed" tax plans that have no commercial substance.

they engaged in “sophisticated tax planning”, but expects the IRS to “say hey that’s pretty clever but it’s never slimy.”

So does this align sophisticated tax planning with aggressiveness? These are difficult distinctions to make without clear definitions and examples. Importantly, the reference here to risk management in the context of having a ‘strategy on credibility with government authorities’ highlights the facts that such a ‘relationship’ exists between these companies (through their tax executives) and government authorities and that importance is attached to it.

There was also evidence to suggest that the head of tax brings his or her own personal profile to the table and essentially only stays with a company that has an overall risk culture/profile that matches his/hers. For example, one interviewee, who said his company’s profile was conservative, added that he has been pretty conservative throughout his entire career. He gave the clear impression that he simply would not choose, or certainly would not stay in, a company whose tax profile was aggressive (in his eyes). Therefore, some people “pick” the risk culture that suits them and others try to create or influence a culture towards the one that suits them. The conservative approach taken at his company was also explained in terms of its size and therefore the cost of a mistake: <sup>44</sup> “a two million dollar mistake in [the other named company] is rounding whereas a two million dollar mistake at [my company], I’m fired. Big difference”.

Interestingly, another interviewee introduced a numeric scale to describe the company’s tax risk profile:

I don’t think its tax conservative...I would say you know if you’re from zero to 100 and there’s the aggressive and ... the middle of the road is 50, we’re at 75...when the guy comes in and talks about you know ‘I really want to use Cayman Islands’ with some particular sort of structure with zero tax and ... two guys and a mailbox. I don’t think that’s the type of thing this company would fund, whereas some companies might be very excited and willing to do that.

While the use of such a scale brings some clarity to a company’s risk profile, there are still issues around defining what different points on the scale really mean without more concrete examples. Understandably, the interviewees were not prepared to go into more details on the exact transactions they were entering into and the tax risks attaching to them.

A further interviewee provided some explanation of the term “cautiously aggressive”. Within the constraints of the law this company will “operate to whatever tax benefit we think we should. So we don’t give anything away but we don’t stretch”. Is he an advocate of the “letter of the law” approach but also applies the “smell test”? Company Eleven’s conservative approach comes from the top levels of management who are “very

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<sup>44</sup> There is some evidence therefore to suggest that there is a relationship between company size and aggressiveness, but the full nature of this relationship is difficult to ascertain.

conservative” and don’t want to see [the company’s] name “in a bad way on the front page of the Wall Street Journal”. They have not gone with some of the tax planning techniques they have been approached with over the years; “we just can’t get beyond the look of the smoke and mirrors thing”.

Another interviewee’s comment demonstrates the difficulty associated with the use of language in this context:

I think that it would be more on the conservative side than the aggressive side in that you know if we can come up with good tax plans ... we’d need to be sure that they’re pretty water tight before we’d push the boat out.

To “push the boat out” could, but need not necessarily, be aligned with tax aggressiveness, which may question the appropriateness of using the term ‘on the conservative side’.

These observations demonstrate that these individuals consider their risk profile to be mostly conservative, with a limited number of responses moving into the “cautiously” or moderately aggressive classification. They were all very keen to distance themselves from non-commercially-based tax planning activities. It would be interesting to have somebody else classify the tax risk profiles of these companies, for example the IRS, the auditors or tax advisers. An Adviser interviewee commented generally on what he believed is the stereotypical profile of “tax people” arguably supports the risk profile descriptions revealed in this study. They “tend to be more analytical than your average Joe, so I would think if we threw a dart at the general public, the average person would be more seat of the pants than your average tax person”. The 2006 Ernst and Young Global Tax Survey<sup>45</sup> reported that 54% of respondents experienced an increase in risk aversion in the previous two years, although there were significant regional differences, the percentage being higher for the US. In the 2008 survey, 50% report increased caution, with regional variations again evident, the US being more risk averse than Europe, but outstripped by China and Japan.

These findings address Maydew’s<sup>46</sup> call for understanding differences in levels of aggressiveness in tax planning among firms. Some understanding has been provided here, for example as to why some companies chose to be “leaders”, as opposed to ‘followers’ in terms of implementing innovative — or what might be considered “aggressive” — tax-based structures (albeit on the back of an advance ruling). They consider it in their best interest to set the precedent rather than taking the risk that someone else may set a precedent that doesn’t suit them, a “bad” precedent from their perspective.<sup>47</sup> These companies also find themselves in a particular situation where the products and business environments are changing rapidly and some companies simply do not have the time to

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<sup>45</sup> See fn. 30

<sup>46</sup> See fn. 10

<sup>47</sup> Where there is ambiguity about the legitimacy of a particular tax based structure, once the revenue authorities give their approval, typically that becomes a precedent to be followed or adopted ‘safely’ by other companies and therefore without much risk attached.

wait for others to pursue certain tax-based structures first. In that sense these “leaders” chose to manage their own destiny. The influence of the media was again evident here as a driver of risk profile. The personal risk profiles of the tax executives themselves also play a role. There is evidence that “tax risk clienteles” exist whereby if tax executives do not agree with their companies’ appetite for risk, they either align themselves with it or move on to another company whose appetite for risk matches their own. While many of the companies in this study could be categorised as “growth companies”, there was no evidence to suggest that such companies would be less aggressive<sup>48</sup>.

## Mechanisms of Tax Risk Management

Tax risk management and best practice therein, is arguably a growth industry, with repeated calls by each of the Big Four and other firms to use their services to assist in understanding and implementing tax risk management strategies<sup>49</sup>. A range of mechanisms, practices and processes (identified in italics) are employed by tax executives interviewed to assist them in managing the various tax risks discussed in the previous section. Some companies seek *advance rulings* from the Revenue Authorities, although of course not all jurisdictions offer such facilities. One interviewee spoke of how they took this approach in some large EU countries when they took positions which they described as “contrary to what we call “brick and mortar” positions” and used these rulings as their defence in the smaller countries. They were adamant that they “led the charge in Europe” on some issues and had companies like Google, and PWC/Deloitte partners calling them “to kind of, like, nose around the edges of what we were doing and how we did it”.<sup>50</sup>

Another interviewee referred to engaging in *financial modelling* and obtaining advice from *external advisers*. An Adviser interviewee spoke of the tension between the tax adviser and the client with respect to risk management. At times the client just wants an informal opinion but sometimes they want an “insurance bond”. These *formal opinions* constitute part of risk management practices for some companies whom the client “would intend to rely on if things went wrong and relying on the professional indemnity cover that Big Five or Big Four firms have”.

A further interviewee referred to internal culture and personalities within the organisation driving this need to have back-up from an external adviser. In particular, he suggested it is perhaps to do with:

The conservative nature of the people who are here now, part of it is because of

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<sup>48</sup> See fn. 8

<sup>49</sup> One recent article even suggests ‘brainstorming’ as a means of identifying and managing tax risks, M. S. Beasley, J. G. Jenkins, and R. B. Sawyers, “Brainstorming to Identify and Manage Tax Risk” 2006 *The Tax Adviser*; 158.

<sup>50</sup> This describes well how the organisational field works and how tax plans are diffused. The concepts of organisational field and diffusion are derived from a body of theory referred to as “new institutional sociology”. A useful summary of this body of work can be found in B. G. Carruthers, “Accounting, Ambiguity, and the New Institutionalism.” (1995) 20 *Accounting, Organizations and Society*, 313.

the pain the company had to go through to fix the things that didn't happen years ago, that this is never going to happen again. So we have kind of gone from one extreme to the other.

One interviewee spoke of the importance of *documenting everything* "so that we're not caught unawares if we are on an audit and we have to go back and ... fill in the gaps". SOX requires all controls and procedures to be documented and tested and a further interviewee portrayed this as a positive outcome arising from SOX. Being SOX compliant amounts in part to risk management in practice. Another referred to having *cost studies* to mitigate risks where the concern is not so much with audit but with saving the company from penalties. He needs to be able to show that he used some due diligence on rates and percentages used.<sup>51</sup> Company Nine executives referred to their *meetings with the Audit Committee* to establish their position on risk and agree the various risks to be assessed when considering tax plans. One interviewee has also recently presented to its Audit Committee on risk management, as this committee had heard that tax was putting various processes and procedures in place. Once in place, this company will engage in *Enterprise Risk Analysis*. SOX has to be given credit, he believes, for driving all of this. He emphasised however, that these new procedures will not really change things. Perhaps this exposure to the Audit Committee is a good thing for tax, presenting opportunities and helping to push tax up the corporate agenda. Only a small number of interviewees referred to going to *the Board* itself on risk management within tax. The need for this seems to revolve around the amount of money involved, with one interviewee going to the Board 'for large dollar amounts', maintaining risk and quantum go hand in hand.

One tax executive stated that part of his organisation's risk management strategy is to *follow the leader*.<sup>52</sup> He referred to a small number of large companies that are considered leaders which have "implemented everything that other companies want to implement".

Despite having formal mechanisms in place to facilitate dealing with risk, interviewees referred to the continuing need to apply "judgement", which amounts in many cases to applying the "*smell test*" when dealing with uncertainties around the interpretation of tax laws. This is inextricably linked with debate around abiding by the letter of the law versus the spirit of the law<sup>53</sup>. Interestingly, an Adviser interviewee described essentially a pecking order of approaches to this. The preferred solution is one that:

Meets the client's requirements, that is, within both the purpose and the word of the legislation because it is less likely to be seen as aggressive and less likely to find disfavour amongst the [tax authorities] in whatever jurisdiction.

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<sup>51</sup> While needing to 'show' that some risk management processes are carried out is important, the quality of such processes is less clear.

<sup>52</sup> Which can be viewed as a form of mimetic isomorphism, a process by which organisations mimic each other on the basis that copying successful organisations provides a pathway to further success, see Carruthers (1995) fn. 50.

<sup>53</sup> See McBarnet, (2003) fn. 17; B. A. Porter, "Survey of in-house tax departments in United Kingdom Corporate," [1999]. BTR 32; Picciotto (2007) see fn. 17; and Burton (2007) see fn. 17.

The next level solution could leave one more exposed, with a reliance on a technical interpretation of the law, perhaps involving “contriving” a situation to bring oneself within this technical interpretation, which is at odds with the purpose of the law. The exposure here would be to the possibility of actions against the taxpayer under anti-avoidance legislation. It would be interesting to see if this pecking order still pertains given the recent developments in this regard including the proposed codification of the economic substance doctrine.

The evidence indicates there is a wide range of mechanisms and processes employed by companies to manage tax risk. These range from seeking opinions from external advisers<sup>54</sup>, to applying a “smell test” or perhaps as noted earlier, assessing the “atmospherics” of the situation. Some interviewees referred to “followers” and “leaders” in this context providing general support for PWC’s<sup>55</sup> (2001) position that competitors have a significant influence on acceptable risk and risk management processes. Despite employing the various processes and mechanisms referred to here, it was difficult to ascertain whether such “rational” processes are more about the way risk management is presented to the outside world as opposed to actually reflecting the practice of risk management<sup>56</sup>. Many of the interviewees would argue that risk management per se has not changed, but is just documented better now. In any case it would seem the “smell test” may often best account for (although not articulate nor explain) how a decision is made in an area involving tax risk.

### **Formalisation of Tax Risk Management**

All of the interviewees clearly recognised the importance of tax risk management, particularly in the increasingly regulated post-Enron environment in which they operate, however, rather surprisingly none of the companies have a formalised, documented tax risk management strategy or policy in place. Only one spoke of a corporate-wide risk management formalised policy, with which tax is aligned, being in place. Despite this, all interviewees felt that they have an understanding of the risk profile of the company, and all but one could state what that profile is. For one interviewee, risk management is simply “set really by the tone of the CFO”.

This has significant implications for SOX compliance which requires such sign-offs. Another interviewee admitted not having a risk management policy but added: “you are making me think a lot, maybe we should”. On the other hand, a third interviewee is comfortable with not having a formalised written risk management policy:

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<sup>54</sup> See D. McBarnet, “Whiter than White Collar Crime: Tax Fraud, Insurance and the Management of Stigma, (1991) 42 *British Journal of Sociology*; 323, on the practice of ‘opinion-shopping’ with a view to securing the opinion one wants. McBarnet reprises her “whiter than white” thesis in a subsequent article in which she considers developments subsequent to the Enron case and concludes that while regulatory efforts such as SOX based on ethics and the spirit of the law may create further uncertainty to be creatively exploited, the challenge to the legitimacy of ‘whiter than white collar crime’ through the creation of an environment that makes ‘gaming’ more difficult is nonetheless a significant outcome (D. McBarnet, “After Enron Will “Whiter than White Collar Crime” Still Wash?”, [2006] 46 *Brit. J. Criminol.*; 1091.)

<sup>55</sup> PriceWaterhouseCoopers, *Tax Function* 2001.

<sup>56</sup> See fn. 50.

We may not have a written policy, but we certainly talk about that a lot and we know how we think about it, we talk about what kinds of aggressive tax things we don't want to do and why we might not want to do them.

One interviewee referred to having controls in place around reviews and compliance as opposed to having a documented risk management policy. Interestingly he commented on a recent conference at which he spoke on tax risk management and recalled how far off [his company's] view was from the company represented by the other speaker. His company's goal is to file correct tax returns and have no tax audit adjustments. The other company's view on the tax return filed is that it is "the opening offer to the IRS" and the final position is for negotiation. The other speaker thought this interviewee was out of his mind. This is arguably further evidence of tax risk clienteles of which policy makers should be aware.

Some of the companies just did not see a need to have a formally documented tax risk management policy. For example, in one interviewee's view it would be very difficult to have one. "I think what happens is it gets measured by our reserves."<sup>57</sup> One of the Companies does not have a formal risk management policy in place, nor do its tax executives know of an overall corporate risk management policy being in place. However, there is a checklist of questions they go through which reflects their risk management approach and has probably developed over time through experience. These questions are:

How is it going to show up in the financial statements? How is it going to show up on a tax return? How is it going to look for tax accounting purposes? ...what kind of documentation are we going to have? What advisers are we going to have to talk to? What opinions are we going to have to get? What issues are being raised here?...is it manageable risk? Is it just, a matter of...we pay a little more in taxes if they decide to do this or is it something that is going to create a bigger issue down the line for us?

Exceptionally, as previously noted, one company has an overall company risk policy with which tax aligns itself, which basically indicates that the company will not violate any country's laws, will engage in responsible reporting and so forth.

The interviews suggest that companies have not formalised their tax risk management policies. Importantly however, all of the interviewees do perceive themselves as engaging in tax risk management through various mechanisms, but do not see the need for having a documented, formalised tax risk management policy in place. The CFO, through his or her role in setting the tone in terms of a company's approach to tax risk management (albeit evidently not through formalisation of a tax risk management policy), was clearly

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<sup>57</sup> Another important distinction between the US and the UK regulatory environments is evident here, in particular the requirement in the US to reconcile book and tax profit in a formal statement (M3) to the IRS.

reinforced here as an actor within the tax arena with significant power, the exercise of which is itself an avenue of institutional reproduction<sup>58</sup>.

### **Summary and conclusion**

Tax risk management is clearly important to these companies and their in-house tax executives. This importance is driven in part by the recent increased attention being given to tax by management generally. This latter, in turn, is in response to the increasingly regulated post-Enron environment within which these companies are operating, together with the associated media attention. Continuing uncertainties around some tax laws however ensure a continued need to address tax risk management. Overall, the evidence suggests a trend towards a more conservative approach to tax planning generally being adopted by these companies, which is consistent with the Ernst and Young tax risk surveys. There was a strong message from the interviewees on the importance of the *perception* around the practice and processes on risk management. The interviewees identified specific technical-type areas of risk (for example transfer pricing) as well as non-technical areas (for example reputational risk) that need to be managed. Interviewees described the risk profile of their companies as mostly conservative, with a limited number of responses moving into the “cautiously” or “moderately aggressive” classification. The CFO was identified as a key influencer of a company’s tax risk profile, and some tax executives choose companies who share their own personal philosophy on risk and risk management.

In the rapidly changing business environment within which these companies operate, some interviewees have chosen to be “leaders” or “innovators” of tax planning ideas (albeit subject to advance rulings in some cases), not having time to wait for others to set the precedents. Different mechanisms of risk management are employed by the interviewees, ranging from obtaining advance rulings to the engagement of external advisers. Applying the “smell test” and assessing the “atmospherics” of the situation however remain important less formal risk management mechanisms that are in place. Notwithstanding the importance of tax risk management to the interviewees, they do not have a formally documented tax risk management policy in place and do not perceive such formalisation as important or necessary.

Inherently uncertain tax laws and an increasingly regulated environment have led to a heightened awareness of the need to identify and manage risks around tax planning. The result is undoubtedly a trend towards a more conservative and process-driven approach to tax planning generally, and indeed most tax executives in this study described their company’s tax profile as “conservative” or “risk averse”. Uncertainty in itself results in effective tax policy<sup>59</sup> if it translates into conservative or low-risk tax plans, which are subject to debate and represent a “tension” at the economic and political level of

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<sup>58</sup> W. W. Powell, “Expanding the Scope of Institutional Analysis,” in W. W. Powell and P. J. DiMaggio (eds) *The New Institutionalism in Organizational Analysis* (Chicago, University of Chicago press, 1991); 183-203.

<sup>59</sup> McBarnet (2001) fn. 27; Spilker (1999) fn. 6.

analysis.<sup>60</sup> Increased levels of regulation, such as SOX have pushed tax into the Boardroom agenda, thereby attaching an increased importance to tax risk management within organisations.

Concerns with reputation both within the organisation and as perceived by the ‘public’ with respect to the tax executives’ risk management is clearly very important and is evidence of the different audiences to whom companies are accountable. The role of the media in this context is particularly striking, operating somewhat as a subtle, yet powerful catalyst in changing the attitude<sup>61</sup> of some tax executives to the law, leading to the trend towards conservative tax planning. Uncertainties around dealing with foreign tax authorities featured prominently in the context of risk management, particularly around the idea of foreign authorities copying already unpopular US tax rules and practices. In order to deal adequately with proposed and new tax regulations in non-US countries, many US companies need to address their current US-centric tax organisational structure whereby physically locating tax executives outside of the US may well be necessary, as opposed to desirable, purely from an risk management perspective.

A range of tax risk management mechanisms are employed across companies ranging from seeking opinions from external advisers, to applying a ‘smell test’ or assessing the ‘atmospherics’ of the situation. Competitor and peer company influence are significant in terms of deciding on appropriate and legitimate risk management mechanisms or processes. It is difficult to know however if such “rational” processes are more about the way risk management gets presented to the outside world as opposed to actually reflecting the real practice of risk management<sup>62</sup>. Many of the interviewees posited that risk management per se has not changed, it is just documented better now and perhaps it is a little too soon to comment on whether such documentation is merely ceremonial<sup>63</sup>. The increased level of investment in risk management (in time and money) in response to increased levels of external regulation needs to be evaluated by the regulators. Is it achieving what it set out to achieve, and if so, at what cost? This SOX-type regulation appears to be very regressive and policy makers should not continue to impose regressive regulation without at least assessing its effectiveness.

Power<sup>64</sup> observes the growing prevalence of risk management and risk talk and speculates on the implications for society as a whole, and organisational practices in particular. “This phenomenal expansion of the risk industry reflects a number of different but convergent pressures for change in organisational practices for dealing with

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<sup>60</sup> Arguably, uncertainty itself is therefore a ‘friction’ which may constrain tax planning; see McBarnet (2006) fn. 54.

<sup>61</sup> McBarnet (2001) fn. 27.

<sup>62</sup> Carruthers, (1995) fn. 56.

<sup>63</sup> J. W. Meyer, and B. Rowan, “Institutionalized Organization: Formal Structure as Myth and Ceremony”, in W. W. Powell and P. J. DiMaggio (eds), *The New Institutionalism in Organizational Analysis*. (Chicago, Chicago University Press, 1991.) 41-62.

<sup>64</sup> See fn. 34.

uncertainty”<sup>65</sup>. For Power, “[T]he risk management of everything poses a different agenda of concern, namely that the experts who are being made increasingly accountable for what they do are now becoming more preoccupied with managing their own risks. Specifically, secondary risks to their reputation are becoming as significant as the primary risks for which experts have knowledge and training”<sup>66</sup>.

The 2008 Ernst and Young Global Tax Survey demonstrates the emergence of new categories of risk related to the downturn noting that in “2006 top pressures were increased globalization, regulatory convergence and transparency. Today companies indicate those risks remain a concern – in addition to a wide range of new risks such as economic uncertainty, tightening credit, pressures on cash flows and effective tax rates and increased stakeholder sensitivity to risk overall.” Certainly there is room for more studies of the phenomena of tax risk and its management and the way it is shaping organisational behaviour and relationships between corporate taxpayers and revenue authorities worldwide.

The findings presented in this article differ from those of Freedman et al<sup>67</sup>, for example in respect of the role of the media and importance of reputational risk and the adoption of formal risk management strategies. It would seem that in the UK, while there is increasing talk of reputational risk, there is actually some confusion about what it may mean. The interviewees in this study seem to more clearly articulate the concerns over adverse media coverage, although it can never be assured that it is a real concern or one that is expressed for presentational purposes. One possible explanation for any difference between the two studies in this regard is the different regulatory regimes within which they took place. This signals a need for caution in assuming homogeneity; while there is some evidence of convergence of language, for example in the adoption of the term ‘aggressiveness’ and indeed tax risk management itself, these terms nonetheless take on different nuances in different environments.

Finally, while this article reflects a study undertaken at a time of some turbulence in the wake of SOX, and the introduction of new regulatory requirements, arguably this is part of a continuous pattern of change, reflecting the dynamism of the tax field. Developments subsequent to this study, for example the release of the OECD Study, suggest an increase focus on tax risk management in the intervening period. It is important, however, to understand the heterogeneity of the taxpayer population in terms of their attitudes to risk taking and gamesmanship. There is a danger in adopting ‘one size fits all’ policies and also in assumptions about taxpayer behaviour based on abstract modeling techniques and experimental studies. This article highlights the richness of insights that can be obtained from considering the practical application of the tax regime by talking to the people directly involved in making the tax system work.

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<sup>65</sup> Fn. 34 at 12.

<sup>66</sup> Fn. 34 at 12.

<sup>67</sup> Fn. 1.

## Appendix I

### *Methodology*

The epistemological approach taken in the research that underpins this article is interpretive.<sup>68</sup> This approach is particularly well suited to obtaining insights and understandings about tax risk management in practice as it facilitates “open-ended interaction between the researcher and researched”.<sup>69</sup> In line with this overall approach, the face-to-face interview method was the main research method employed, which facilitated examining, explaining and understanding tax risk management in the context of the social reality of the world within which tax executives operate.

The in-depth semi-structured interview guide approach was adopted which facilitated having a framework of issues/themes around tax risk management, while also permitting some flexibility and spontaneity, and allowing the interviewees “a degree of freedom to explain their thoughts”.<sup>70</sup> Following a detailed literature review, analysis of findings from some preliminary interviews, and in-depth consideration of the potential theoretical underpinnings of this research, an interview schedule was drawn up and used as a guide when carrying out the in-depth semi-structured interviews.

The study focused on tax risk management in US companies. Choosing US companies was a deliberate attempt to seek out companies and individuals engaged in the subject matter being studied. This “purposive sampling” approach is a common technique employed by many qualitative researchers.<sup>71</sup> US companies invest heavily in tax planning activities<sup>72</sup>, which arguably incorporates tax risk management. There is evidence to suggest that this investment is economically worthwhile.<sup>73</sup> Finally, US MNCs are a well recognised and acceptable data base for conducting academic research. Appendix II presents some background facts on all fifteen companies, covering the nature of their business, turnover, number of employees and so forth.

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<sup>68</sup> C. Tomkins and R. Groves "The everyday accountant and researching his reality." (1983) 8 *Accounting, Organizations and Society*; 361. The interpretive research tradition is a broad church that has expanded rapidly over the past 30 years particularly within management and organisational sciences, rather than a single unified approach, and the more influential approaches comprise varieties of social constructionism. For a discussion of the issues of the criteria for evaluating the knowledge produced by this type of research, see J. Sandberg "How do we Justify Knowledge Produced within Interpretive Approaches?" (2005) 8 *Organizational Research Methods*; 41.

<sup>69</sup> T. Ahrens and C. Chapman, "Doing qualitative field research in management accounting: Positioning data to contribute to theory." (2006) 31 *Accounting, Organizations and Society*, 819.

<sup>70</sup> J. Horton, R. Macve and G. Struyven Qualitative Research: Experiences in Using Semi-Structured Interviews, in C. Humphrey and B. Lee (eds), *The Real Life Guide to Accounting Research*. (Elsevier London 2004).

<sup>71</sup> M. B. Miles, and A. M. Huberman, *Qualitative Data Analysis*. Thousand Oaks, California, Sage Publications Inc. 1994.)

<sup>72</sup> Scholes et al (2004) fn. 35.

<sup>73</sup> L., M. Mills, M. Erickson and E. L. Maydew, "Investments in Tax Planning." (1998) 20 *The Journal of the American Taxation Association*; 1.

The study also focussed on one sector, namely the IT sector. Companies operating in the same industry will frequently face similar business and planning issues which have to be managed from a tax perspective and focussing on one industry in this context should, inter alia, provide insights into the commonalities or otherwise of how and why such companies engage in tax risk management.

The study entailed 20 in-depth interview sessions conducted by one of the authors in 2005, involving 26 in-house tax executives in total from fifteen companies. Most of these interviewees were heading up the worldwide tax function within their respective organisations, and the others held senior management positions reporting directly to the head of tax. These interviewees were, therefore, extremely senior personnel in their respective organisations, arguably “elites” in the tax arena, and were well positioned to respond to questions concerning tax risk management in practice. Questions loosely revolved around the types of tax risks facing companies, in-house tax risk management policy and philosophy, changes in tax risk management and the impact of these changes on tax planning practices and processes, and the integration of a company’s tax risk management policy with the overall corporate risk management policy. In addition, interviews were conducted with three tax advisers to US companies. Two of these advisers are senior tax partners with two of the Big Four accountancy practices based in Dublin, Ireland. The third adviser is a US based tax adviser, a partner with a large US legal firm. These tax advisers were well positioned to give the type of information being sought in this study as they specialise in providing tax advice to US companies, many of whom are in the IT sector.

The interviews were taped and transcribed, which, along with post-interview notes and some email correspondence from some of the interviewees, provided a substantial amount of qualitative data requiring detailed and rigorous analysis. It was decided to employ QSR NVivo to assist in data management and to facilitate data interrogation and analysis. Computer aided qualitative data analysis (CAQDAS) is now widely used and recognised within social science and organisational research<sup>74</sup> and provides a form of “audit trail” as well as facilitating data management.<sup>75</sup> NVivo was used primarily as a tool for organising and coding data, but always being mindful that coding does not constitute analysis, sometimes an apparent misconception about CAQDAS<sup>76</sup>. As noted by O’Dwyer<sup>77</sup>, “CAQDAS is merely a tool designed to assist analysis”. Data analysis was still very much the responsibility of the researchers as ‘the researcher still must ask the questions, interpret the data, decide what to code, and use the computer program to maximise efficiency in these processes’.<sup>78</sup> The coding process was very time consuming, and took place through immersion in the data, allowing themes to emerge without much

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<sup>74</sup> N. G. Fielding, and R. M. Lee *Using Computers in Qualitative Research*. (London, Sage 1991).

<sup>75</sup> J. D. Bringer, L. Halley Johnston and C. H. Brackenridge. "Using Computer-Assisted Qualitative Data Analysis Software to Develop a Grounded Theory Project." (2006) 18 *Field Methods*; 245.

<sup>76</sup> A. Weaver and P. Atkinson *Microcomputing and Qualitative Data Analysis*. London, Avebury 1994).

<sup>77</sup> B. O’Dwyer, “Qualitative Data Analysis: Illuminating a Process for Transforming a ‘Messy’ but ‘Attractive’ Nuisance”. In C. Humphrey and B. Lee (eds) *The Real Life Guide to Accounting Research*. (London, Elsevier; 2004).

<sup>78</sup> Bringer et al., fn. 75; 248)

concern for the theoretical constructs. The focus was on allowing the story of the data in its “raw” state to emerge. Following the coding process, the richest and most appropriate quotations were extracted, bearing in mind at all times the purpose of this research. Predominant themes within tax risk management emerged as are presented here.

The qualitative approach adopted in the study, involving interviews with tax executives from fifteen companies means the findings are not statistically generalisable. To achieve the latter however was not the objective. Rather, it was, to explain and enhance our understanding of tax risk management in practice, and to form the basis for theoretical development, which it does. All of the companies involved in this study (apart from the tax advisers) are based in Silicon Valley (SV), California. It is arguably a unique place with a physical concentration of IT companies. It is possible therefore that some of the findings are very particular to SV-based companies, although this is unlikely. As with any qualitative research (and arguably also quantitative research) a limitation arises from the necessary judgement and subjectivity in the analysis of the findings. However, subjectivity is not at the expense of rigour in this study due to the rigorous approach taken to data analysis.

## Appendix II

### Respondent Profiles

Company Code	Business Description	Headquarters	Year Founded	Auditors	Stock Exchange	No. of employees	No. countries (excl. US)	Turnover (\$)
C1	Manufactures computer products and develops software	Cupertino CA	1970s	Big 4	Nasdaq	10,000-15,000	10K*	6,000m-12,000m
C2	Provider of services and equipment for semi-conductor industry	Santa Clara CA	1960s	Big 4	Nasdaq	10,000-15,000	18	6,000m-12,000m
C3	Provides consumers and advertisers with information retrieval products	Oakland CA	1990s	Big 4	Nasdaq	500-1,000	6	Less than 1,000m
C4	Provider of internet Marketplace	San Jose CA	1990s	Big 4	Nasdaq	5,000-10,000	26	3,000m - 5,000m
C5	Technology solutions provider	Palo Alto CA	1930s	Big 4	NYSE	In excess of 75,000	62	30,000m - 80,000m
C6	Semi-conductor manufacturer	Santa Clara CA	1960s	Big 4	Nasdaq	In excess of 75,000	10	30,000m - 80,000m
C7	Manufactures disk drives	San Jose CA	1980s	Big 4	Nasdaq	10,000-15,000	15	3,000m - 5,000m
C8	Developer of network administration and security software	San Jose CA	1990s	Big 4	Nasdaq	1,000-3,000	16	Less than 1,000m
C9	Enterprise software	Redwood CA	1980s	Big 4	Nasdaq	40,000-50,000	58	6,000m-12,000m
C10	Developer of sales and marketing information software	San Mateo CA	1990s	Big 4	Nasdaq	3,000-5,000	31	1,000m-2,000m
C11	Content and network security s/w, it consulting and training	Cupertino CA	1980s	Big 4	Nasdaq	5,000-10,000	30	1,000m-2,000m
C12	Developer of design automation software for integrated circuits etc	Mountain View CA	1980s	Big 4	Nasdaq	3,000-5,000	21	1,000m-2,000m
C13	Manufactures programmable devices and provides design software	San Jose CA	1980s	Big 4	Nasdaq	1,000-3,000	14	1,000m-2,000m
C14	Scientific instruments and vacuum technologies	Palo Alto CA	1940s	Big 4	NYSE	3,000-5,000	15	1,000m-2,000m
C15	Man:storage devices and provides storage related software	Scotts Valley, CA, (Cayman Islands based)	1970s	Big 4	NYSE	40,000-50,000	18	6,000m-12,000m

\* Only Ireland and Japan listed