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Emerging Markets Queries in Finance and Business

Risk management triggers: from the tax risk pitfalls to organizational risk

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Abstract

The advent of Sarbanes-Oxley shed light on fiscal risk. Then, the financial crisis led to the desire to minimize taxation. In order to quantify tax risk, it is necessary to duly weigh risks against return in terms of money, rewards and reputation. A risk intelligence approach should balance value creation with risk generation, while accomplishing income and profit targets between the risk appetite limits. Risk anticipation and the appraisal of rules for mitigating tax lifecycle risks regarding planning, forecasting, compliance and controversy represent genetic information in the chain of corporate DNA. The occurrence of an unforeseen tax risk is capable of creating a domino effect by affecting the other risks. This paper explores the concept of tax risk management with particular reference to the specific risk areas, by using literature and visual representation structure techniques in order to provide clarity and insight for the tax risk management field.

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Keywords: compliance, management, risk, tax

1. Introduction

Any transaction has both an upside part in the guise of opportunities but also a downside part materialized in hazards from the compliance process..

Businesses take decisions by oscillating between a lessened tax liability and the risks assigned to it, and sometimes this entails an overpayment of taxes above the legal minimum. The diversity attenuates risks, the uniformity enhances them, but the one-off, non-routine transactions are committed to an upward risk.

Risk is increasing function of complexity and taxes are seen as a driver for value but also as risk that must

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be controlled and this requires a balance between risk and value. As Carl Ichan said "In life and business, there are two cardinal sins. The first is to act precipitously without thought and the second is to not act at all."

Tax risk is what companies face when they are unsure of having planned their taxes with foresight, accounted for their taxes correctly and complied with all relevant tax laws. For example, risks may arise from the incorrect application of the tax, problems in communication between suppliers and purchasers or a lack of supporting documentation.

Tax risk is measured as money lost due taxes overpayment or penalties incurred as a result of non-compliance or the opportunity cost for not using tax optimization techniques.

A tax risk policy should address terms such as value: the value given by accepting some risk and countervailing the others, cost: the cost saved through risk mitigation and resources in order to benefit from opportunities and attenuate the risks. Tax risk analysis should also be based on emotional factors and should consign to different periods of time even if the longer the time span the more implausible results will be.

This article passes through an extensive literature search and is based on a stringent and detailed presentation of the conclusions unveiled by the analysis of the actual tax environment.

In this conceptual paper we propose some casual loop diagrams to characterize/map the relations between different variables in a fast paced changing environment in order to facilitate the exploitation and development of tax risk management strategies.

A causal loop diagram can be used to quickly capture the hypothesis about the causes of dynamics within a system. It communicates the important feedback structures embedded in the system that are believed to be responsible for a certain problem. As a visual method, a casual loop diagram consists of variables connected by arrows that denote causal influences between consecutive variables that combine to form a system. The arrow between the elements indicates a cause-and-effect relationship and the label attached to the arrow indicates the way the relationship works. S is used for the same direction - increasing one increases the other while the letter O is used for the opposite direction - increasing one decreases the other and vice versa.

In its current form as a conceptual and generic model, causal loop models provide insight into the influences on tax risk.

2. Literature review

Risk management began emerging as an important tool in policy and business literature at the end of the twentieth century and has now entered both private and public sector management thinking to become an organizing concept. (Power, 2004) Even if it was considered that tax risk management is ancillary to risk management now it should be viewed as a separate area of risk management.

Elgood, Paroissien, and Quimby (2005) considered that risk management belongs to multinational companies (with subsidiary operating in multiple countries) by referring to operational risk, compliance risk, and financial accounting risk. Grant Thornton added to those three tax risks identified, the personal tax risk triggered by the unremitted personal taxes withheld and value added taxes.

According to Arlinghaus (1998) tax risk is defined as the likelihood that tax outcome differs from what is expected, due to a variety of reasons, for example, the judicial process, changes in the law, changes in business assumptions, an increased intensity of audits, and uncertainty in the interpretation of the law; and any action emanating from the tax function that subjects the company to adverse publicity.

So, although even if tax depreciation is for certain deductible from taxable profits in the next year, the magnitude of this tax benefit is uncertain due to lack of reliability regarding the tax position of the company or regarding legislative changes which may occur in terms of tax depreciation deduction. The risk involved is not a financial one but an economic and technical tax risk that lead to uncertain financial results.

Suitable with The Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework, tax risk as the sum of all the business's decisions, activities, and operations uncertainties addresses the following areas of tax risk.

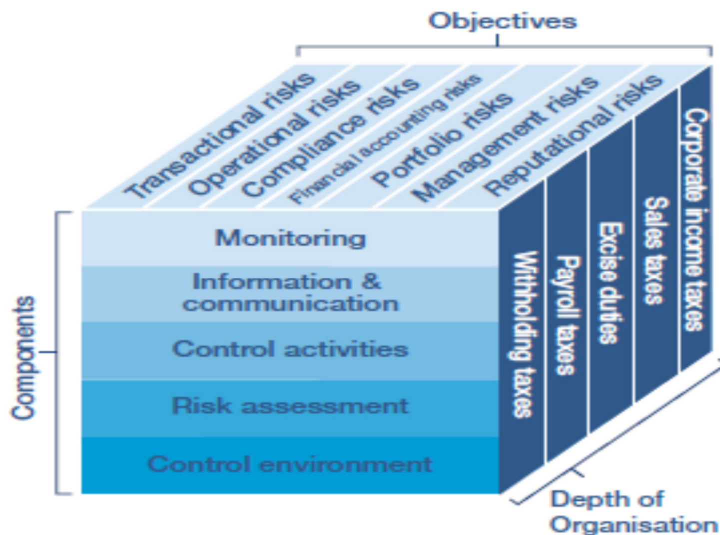


Fig. 1: A tax risk management model equivalent of the COSO model - Source: (Elgood et al., 2004)

Specific risk areas:

◦ Transactional risk - uncertainty in a specific transaction especially in those perceived as with high-risk (e.g., restructurings, reorganizations, cost-sharing arrangements, financing transactions, in-organic growth through acquisitions, mergers; asset acquisitions, sales or disposals).

◦ Operational risk - the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. It also includes the uncertainty in applying tax laws to regular, on-going operations (e.g., new business ventures such as expansion into emerging markets, new operating models, new operating structure, new technology- internet trading). This risk depends on the firm's specificity, local risk and organizational structures' complexity, but also includes financial risk or market risk; economic and business assumption risk, environmental risk and segmented strategy risk.

◦ Compliance risk relates to the preparation, completion and review of an organization's tax returns. We can also refer to legislative risk - the risk that legislation by the government could significantly alter the business prospects of one or more companies, adversely affecting investment holding in that company; legal risk: uncertainty in the outcome from a judicial process; tax technical risk: uncertainty in the interpretation of tax laws by tax authorities and regulatory risk: the risk of not complying with regulatory requirements, regulatory change or regulators' expectations.

◦ Financial accounting/reporting risk - uncertainty in estimates made in the tax accrual and tax related financial statement disclosures.

Generic risk areas:

◦ Portfolio risk (e.g. combination of any of the risks).

◦ Management risk - the risks associated with ineffective, destructive or underperforming management (e.g. changes in personnel, employees' social security contributions and other payroll taxes, new/inexperienced resources, decentralization of decision makers, focus upon short-term metrics).

◦ Reputational risk - the risk that a company will lose potential business because its character or quality has been called into question. It is related to the trustworthiness of business. Moreover, in the above model (figure

1) there must be a fourth dimension towards geographical distribution (different locations) of subsidiaries, business units of a company. A survey indicated that the tax risk exposure is the lowest in the following countries: Ireland, Bermuda, Germany, Cayman Islands, Luxembourg, Netherlands, Singapore, Switzerland, U.K. and France and the highest in countries such as: U.S., China, India, U.K., Brazil, and Bolivia. Tax risk could be tackled from two sides, on the one hand it is a risk of taxes overpayment, the biggest tax risk faced by companies and on the other hand the risk of taxes underpayment, the biggest tax risk faced by governments. Even tax authorities (Australia was an early pioneer of the tax risk management model for tax authorities) approach the tax risk management by designing an enforcement strategy that reflects the behavior of the taxpayer in order to cope with the following risks: (i) register risk (the risk that tax yield is reduced by inaccuracies in tax registration); (ii) filing risk (the risk that tax yield will be reduced by failure of taxpayers to file their returns); (iii) payment risk (failure to pay amounts due); and (iv) declaration risk (where returns are incorrect due to error or deliberate act). (Fiscalis Guide, 2006, p.13)

3. Operational risk

In a 2010 KPMG survey, companies stated that following as the most significant tax risks they were facing: "unintended tax consequences of company transactions" and the "risk of noncompliance with tax laws". "Financial reporting risks", "unsupportable tax positions/audit risk", "poor tax planning/less than optimal tax structure" and "paying too much tax, negative financial impacts of taxes" were ranked on lower positions.

Thus, the lion’s share of respondents indicated the risk regarding uncertainty in applying tax laws to regular, on-going operations. The factors that mostly affect operational risk and that emerge as a consequence of the current economic crisis are presented in the following figure:

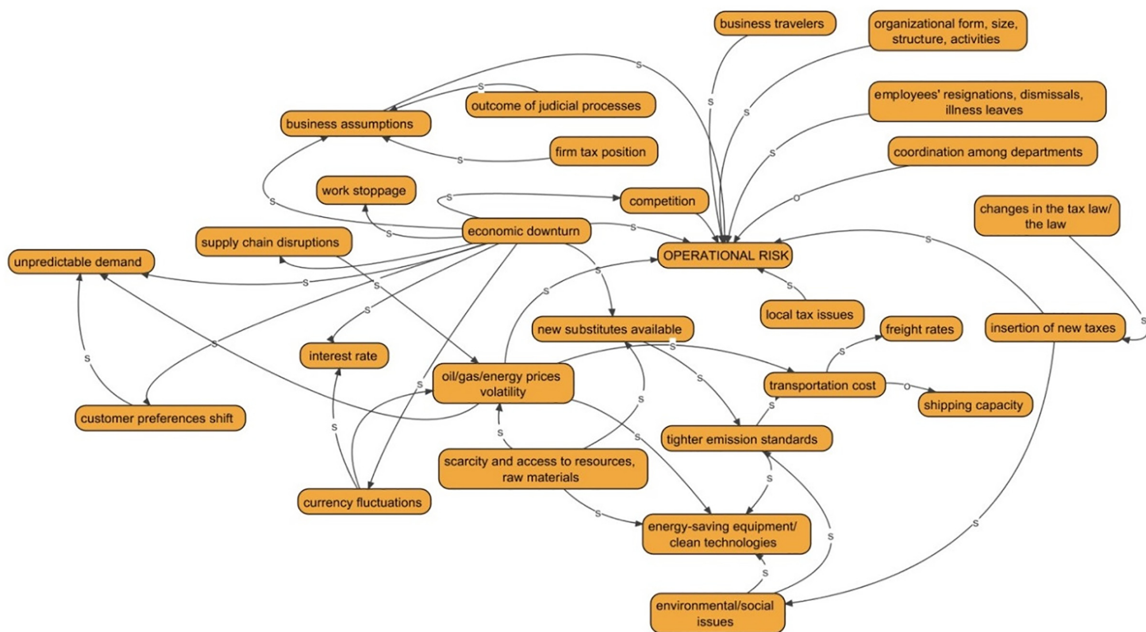


Fig. 2. Operational risk triggers

Recession periods amend consumer behaviour. Therefore, companies must compete in order to come up with new products to meet the new requirements and needs. The oil price was highly volatile due to Lebanon supply disruptions and to the unpredictable demand generated by the economic context. This in turn puts

pressure on energy intensive industries and the chemical industry as it will lead to transfer to energy saving equipment and investment in clean technologies, growth stimulated by tax incentives for such investments. But investments in new technologies are accompanied by shake-ups or can slide into insolvency as a consequence of tax incentives fragility; it is appropriate for solar energy: lower prices for panels and the rollback of government subsidies in some markets.

Another risk is related to the scarcity and the access to resources and raw materials and their price. For example, high energy costs lead to increased transportation costs in the supply chain as a fact that in the last years the global trade has suffered a loss due to a lower demand and an excess shipping capacity and that was as a buffer on imposing strong pressure on the rising of the freight rates.

4. Compliance risk

Even if a company acts only locally, the risk to which it is subject is continental or global. Countries do not act independently in setting regulations and legislation. Thus, in Europe a challenge is the ascertainment of a Common Consolidated Corporate Tax Base (CCCTB) whose legal implementation is still uncertain. Uncertainty about tax policy perspective lessens the ability of an effective tax planning and value creation through tax synergies and tax savings. The risk that tax incentives will be changed or that interest deductions on granted loans will be restricted will affect the fiscal costs of the long implementation projects. The unpredictability of the fiscal policy, which represents an inherent risk, is more loomed by the insertion of new taxes: snack taxes on "unhealthy" food recently introduced in Hungary and Denmark, or carbon taxes aimed at reducing climate change and air pollution (Australia) with the main aim of influencing consumer behavior: Geographical proximity risk can as well lead to harmonization by establishing the same rate for certain taxes (excise) to halt cross-border shopping in the border areas. Fear of uncertainty can be also seen at the government level, such as the recent fiscal dilemma faced by the U.S. in late 2012 following the scheduled expiration of some tax cuts - fiscal cliff (though often temporary provisions were renewed for a further period which led to the identification of certain beneficiaries as "extenders" of those provisions).

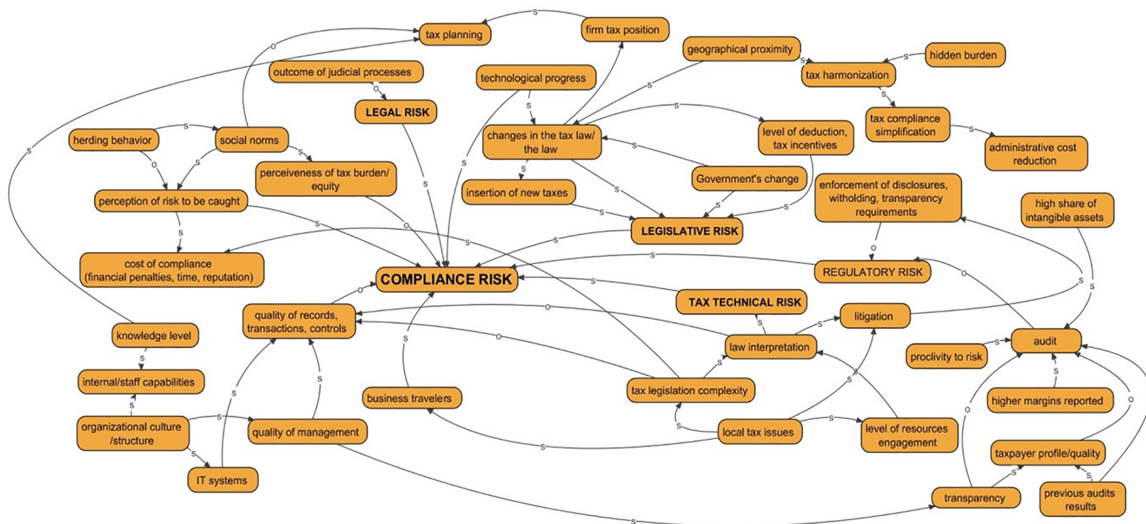


Fig. 3. Compliance risk determinants

Compliance risk is also biased by the technological progress, the convergence between the online environment and the physical one. The appearance of products at the border of classification (in terms of VAT) will lead to litigation and additional compliance costs. For example, different VAT rates for comparable products lead to distortions in taxpayer behaviour (i.e. a printed book is subject to a reduced VAT

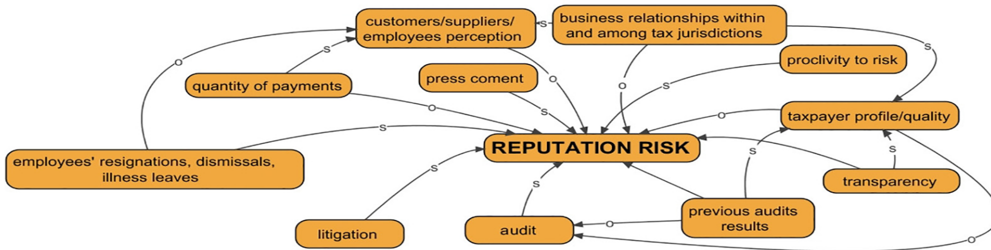
in exchange the same content in the form of eBooks or audio format is imposed at the standard rate) but some countries (Iceland, Luxembourg) neutralized this treatment by imposing the same rate on these products.

Moreover the tax exempt operations infer a tax risk in the form of a hidden VAT burden because the VAT input on goods and services exempt from VAT cannot be recovered (i.e. health care). But also the displacement of VAT reduced rates (food, tourism) or VAT exemption for some products and the adoption of a “single rate circle” in terms of VAT in order to simplify the tax compliance will affect various sectors of the economy (i.e. food processing industry, pharmaceutical, tourism). Other controversies related with VAT comprise: errors due to unreported VAT input and unrecovered in the VAT return, VAT input recovery blocked by the authorities because the supplier has not submitted a valid VAT code etc. A tax controversy may involve reputation. Companies that enter into new markets often face absence of tax treaties, inconsistencies and shortcomings in legislation, doubtful interpretations, lack of legal regulations to settle a tax dispute due to language differences, cultural experience and misallocation of resources for solid local tax knowledge. Therefore, an engagement of qualified people with local experience would be helpful. The risk of compliance is the most manageable risk because noncompliance is not a risk but an acceptance of the “risk of getting caught”. If a tax authority perceives a company as having a high propensity to take risk by reporting higher margins or mainly relying on intangible assets such as pharmaceuticals, IT and the automotive industry or with weak disclosures will scrutinized it thoroughly. So, if a company wants to play the tax authorities it could be the subject of their close examination. To temper the compliance risk special training programs for employees to keep them abreast of legislative updates should be designed.

5. Reputational risk

Every activity or practice of a company could sway the customers, suppliers, or employees’ perception related to the company, so it must be a correlation between the fiscal arrangements and the reputation profile. It could be observed the prevalence of substance over form in the public interest regarding the taxes paid by companies. There are currently self-styled watchdog activist groups whose concern is related to the identification of tax planning techniques by companies. Recently, media has been exhibiting not only the illegal tax activities of companies but also those companies that use tax planning techniques to alleviate the effective tax rates, which erodes both brand and goodwill. The companies’ values and behaviour are under close monitoring by the public so it should be a trade-off between the short-term benefits incumbent by aggressive fiscal techniques and the long-term benefits due to reputational risk. A company’s acceptable behaviour by public is that it "pays off the fair share" for use of resources and infrastructure of the country in which they operate. The quantity of tax payments is a proxy for the quality of a company. Being transparent (a high visibility of local subsidiaries) is a technique which assures an attenuation of the reputational risk and some companies took it into account i.e. Levi Strauss made in 2005 its suppliers and subsidiaries’ list public even this it was considered commercially damaging. Barclays, Vodafone and Starbucks are seen as tax dodgers but they motivate their attitude through the fact that are not interested in “making donations to government” (Williams, 2007).

The term financial risk could be linked with environment among other issues, so a strategy for competitiveness and consolidation of reputation is through pushing the hot-button on environmental, social



issues.

Fig. 4. Reputation risk motivators

6. Tax risk landscape

The economic crisis favoured business travellers or "flying squads" because it is considered that these kind of employees lessen the significant costs of expats, these people leave this country before becoming resident for tax purposes of that location. Business travellers attract tax liability only if they spend more than 183 days in the country visited.

Since many employees work on short term in other countries as business visitors, often companies do not comply with the complicated rules on taxation wages and this entails a higher risk of being audited by the tax authorities (a tax area relatively easy to check by the authorities). A clear classification between employees and self-employed persons has significant consequences for the employers' withholding obligations, as in the case of benefits in kind (fringe benefits) which may involve different tax provisions.

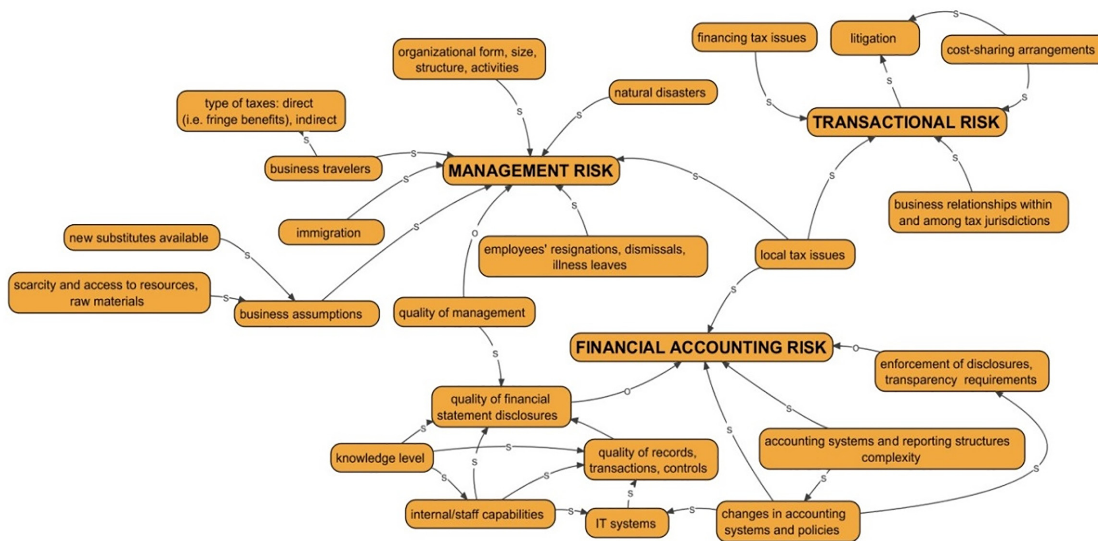


Fig. 5. Interactions between specific and generic risk areas

The immigration risk, the risk of employees return (for those employees who were mobilized in other countries) before concluding the contract, (which involves huge costs, the cost of an employee sent abroad is between 3 and 6 times higher than for maintaining employee in the country) is based on rather personal issues (family reasons, cultural differences, social security issues and less developed infrastructure, low levels of

education, lower housing standards -to compensate for these drawbacks employees are offered substantial financial rewards) than professional ones.

Moreover in some countries an employee mobilized from overseas could be entitled with a local person as a driver, for example in Russia to understand road signs written in Cyrillic and this devolve some extra costs for a company. Risks do not exist in isolation. Enterprises have come to recognize the importance of managing risk interactions. To understand portfolio risk, one must understand the risks of the individual elements in addition to their interactions due to the presence of natural hedges and mutually amplifying risks. As it is pinpointed in figure 4 below, it is an interplay between the triggers of any risk area but also among all the risk areas. One factor could be a tripping spring for a snowball reaction.

7. Conclusions

In these times a tax advantage can be by considering the competitors' fiscal profile in certain transactions because risk is relative, what means risk for some, for others it can be acceptable and the same measures taken for a given risk could bring the success for some and for others could be a failure.

Every firm should establish their own fiscal objectives and properly chose the means for achieving them. Also, the risks a firm is concerned about should be prioritized and further ascertain which are the factors that have a significant impact on the tax risk: changing legislation; tax aggressiveness; size, number of locations and geographic distribution of business activities; management ability of managers; reputation towards the tax authorities / public / shareholders; credit risk and market risk.

But nowadays, companies emphasize more on tax minimization liabilities given by the fine distinctions of black-letter law by devising creative transactions, structures, accounting techniques at the expense of commercial and reputational awareness. In order to respond to risks, either internal or external - systematic risk, manageable or unmanageable, it is necessary to have better information about the source, size and potential impact of each tax risk (both between jurisdictions and years) and to assess them, but also to define the tolerable level of risk and establish the proper strategy: assumption, avoidance, retention, transfer of risk or any combination of them. Thus, in order to simplify a highly complex problem, we incorporate the interactions between the items that affect tax risk and the causal factors in casual loop diagrams. The same risk exposure does not involve the same sensitivity as a fact of companies' specificity, financing sources, customers, assets, history, and culture, which determine the risk adaptation approach.

The attitude towards risk should not be based on too backward looking because will lead to a failure in responding to unpredictable situations. Also the focus and resources should be allocated both to high-risk areas and lower-risk areas, because could be a shift from splitting the high-risk areas into multiple low-risk areas or there could be a substitution from a low level risk activity to another with a higher risk. If a company is seen by the tax authorities as having a low-risk position it could shift to a higher level of compliance risk due to a poor attention given by the tax authorities. Tax risk management "operationalizes" the concepts outlined in the casual loop diagrams. This model, informed by the literature review, could be integrated with information systems and could be applied in the development of tax control methodologies. Business processes need to ensure that taxes are not overpaid, but that legal obligations are fulfilled. The potential tax changes and their possible implications should be constantly appraised, and the dynamics of local tax policies should be correlated with European fiscal policy, with a view to monitor and predict tax policy changes. As Charles Darwin stated, "it is not the strongest of the species that survives, nor the most intelligent, but the one that is responsive to change". Risk is thus a complex adaptive system that in time reacts differently to the same factors. In summary, tax is one area where businesses have to show value-based behaviour.

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