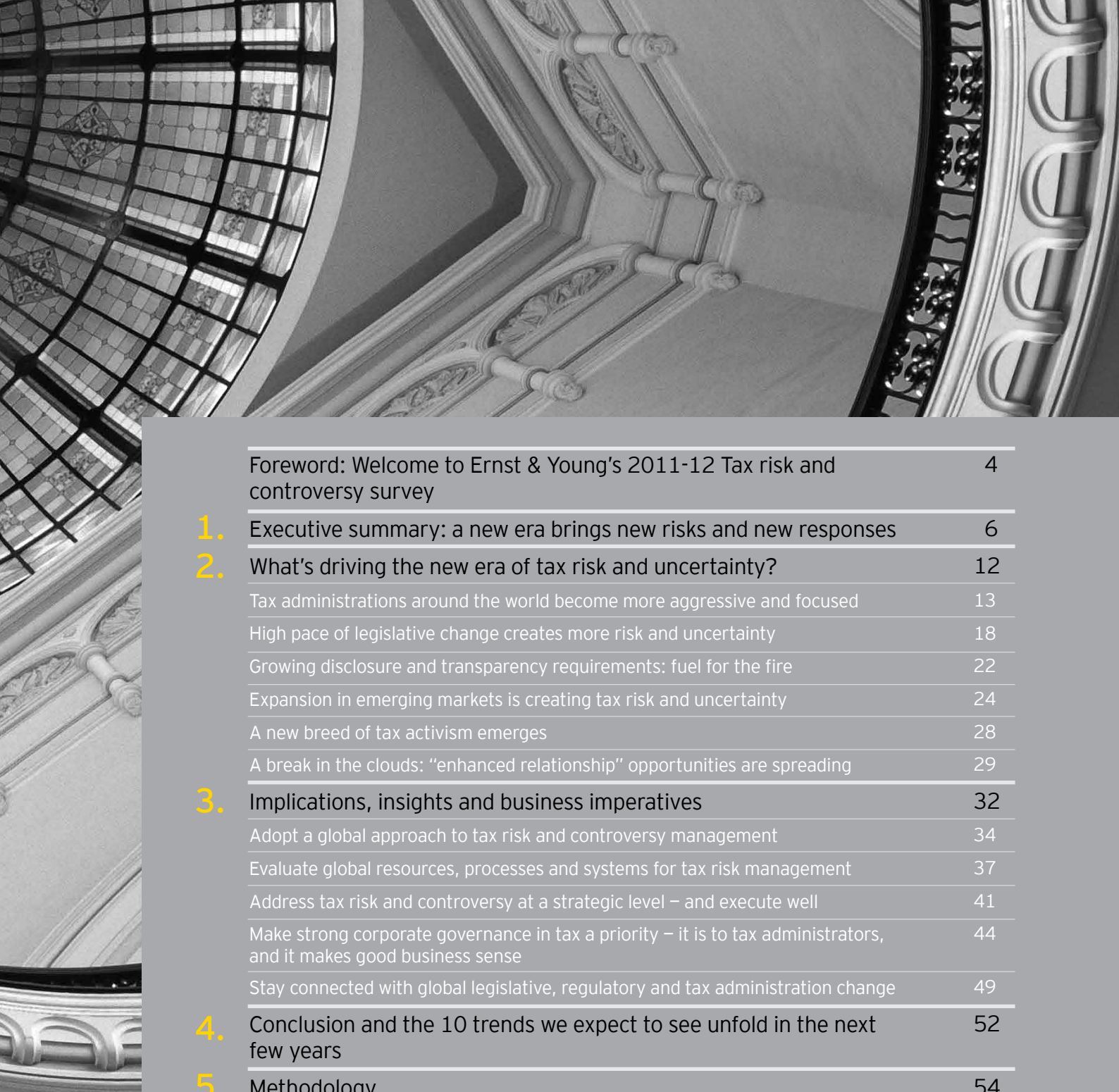


"Just managing how aggressive the tax authorities have become is probably our number one tax risk."

– Survey respondent

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Foreword

Welcome to Ernst & Young's 2011-12 Tax risk and controversy survey





We are pleased to present Ernst and Young's 2011-12 Tax risk and controversy survey, our fourth on this subject. This report examines how greater uncertainty in these areas is posing new financial and reputational risks for leaders of global businesses. The survey indicates the risks are imminent and growing in volume and complexity. Some risks are unpredictable and others unavoidable; now is the time to plan a course of action to manage them.

We turned to the leading stakeholders navigating in the tax arena to get the broadest possible perspective. For the business view, we consulted 541 chief financial officers and tax directors as well as 100 audit committee members. We interviewed tax policymakers and tax administrators for the government mindset.

Their combined responses tell a compelling story about current challenges and future trends. Our survey respondents stand united in their view that the tax risk and controversy environment has become more challenging than ever. They also tell us they believe that it will be even more demanding in the years to come.

This report will take you on a journey through the biggest challenges companies say they face, including the most contentious issues in the most challenging countries and other related risks. It will also share where tax authorities believe they should be focusing, and highlight their issues, initiatives, and enforcement strategies. We will also draw from insights by our extensive global Tax Policy and Controversy network and our dealings with many of the world's leading businesses to share how company leaders can proactively manage tax risk related to controversy.

We hope that the survey results and knowledge provided in this report will help you lead your business successfully in the "new era of global risk and uncertainty."

Mark Weinberger
Global Vice Chair – Tax

Deborah Nolan
Americas Tax
Controversy Leader

Rob Thomas
Director – Tax Policy &
Controversy

1.

Executive summary: a new era brings new risks and new responses

Rarely have tax function leaders, tax administrators and tax policy-makers been in such agreement: a convergence of trends has created the ripest environment for tax controversy in years. Audits are more frequent and aggressive, and thus more costly to defend or litigate; assessments and penalties have now entered the realm of billions of dollars; and companies face unprecedented scrutiny and reporting of their tax affairs by advocacy groups and the news media, often hurting brand reputation and – in the worst cases – shareholder value, even when such coverage is unwarranted or inaccurate.



Tax executives, tax administrators and tax policy-makers have perhaps never been in such agreement: converging trends have created the riskiest environment for tax controversy the world has experienced in years.

We surveyed all three parties in July and August 2011, and their responses form the basis of this 2011-12 Tax risk and controversy survey.

541 corporate executives and **100** audit committee members were interviewed across **18** geographic markets.

30 tax administrators and **16** tax policy-makers provided input.

The world has changed dramatically in the space of just a few years. Globalization, moves from west to east and north to south, and demographic shifts have brought opportunities in new markets, more complex supply chains and rapid growth in the importance of intangibles, royalties, service fees, intra-group financing and intellectual property.

At the same time, the economy continues to move through the different phases of a global financial crisis. The effect on tax policy has been startling, overshadowing longer-term tax trends and the convergence of accounting standards.

Companies are doing all they can to capitalize on change. They are expanding market and customer reach and increasing their search for efficiencies, both in effective tax rate and business operations. They are driving dramatic changes in their business models with restructuring, finance transformation, outsourcing and centralization.

And tax authorities have become significantly more assertive in examining cross-border activities. The volume of tax information exchange agreements has increased by more than 1,000%, and joint and simultaneous tax audits have gone from concept to reality.

Tax administrators and legislators, under pressure to generate more revenue to balance debt-laden budgets and fund infrastructure and social programs, acknowledge that they are more committed than ever to enforcing existing tax law and creating new enforcement mechanisms. They are demanding more disclosure from taxpayers, strengthening or creating economic substance doctrines and imposing criminal sanctions where they believe willful tax evasion has occurred. A new era has begun.

Seventy-seven percent of respondents in our 541-company survey said managing tax risk and controversy will become even more important to them in the next two years.

“Hostile and aggressive”

Tax executives tell us that the harder line taken by many tax authorities is causing significant levels of stress. “We are seen as guilty rather than innocent until proven guilty,” said one survey respondent, describing an interaction with the tax authority in a major European country. Another executive cited, “increasingly hostile and aggressive tax authorities” as the company’s top tax risk today. Seventy-five percent reported that tax audits are becoming more aggressive.

Because of these changes, 77% of respondents in our 541-company survey said managing tax risk and controversy will become even more important to them in the next two years, and this figure increases to 88% for large companies with annual revenues of more than US\$5 billion. The increasing focus on managing tax and controversy is mirrored by what tax directors tell us about their future appetite for risk – 92% say they will either stay the same or become more risk averse in the next two years.

But chief financial officers have a different perception – and tolerance – for these growing tax risks. They are expanding within fast-growing emerging markets, the same places that 73% of tax directors tell us they face increased tax risk or uncertainty. We think this difference of opinion warrants further investigation to be sure tax is given due attention in such a rapidly changing environment.

A new era starts

By all accounts, the next five years will likely be every bit as volatile and evolutionary as the last half-decade. Seventy-eight percent of the world’s largest companies – those with revenues of US\$5 billion or more – say they are already experiencing greater risk or uncertainty around legislation, and this figure increases for those in emerging markets. Tax policy-makers tell us they foresee even more change ahead as they seek to protect the tax base and raise revenue from an evolving mix of taxes. In fact, 69% of tax policy-makers surveyed expect to generate more revenue from indirect taxes in the future, and these taxes have certainly been used as a tool of choice in those countries adopting austerity measures. They also tell us that they foresee increased revenue from personal income taxes, environmental taxes and property taxes. These policy changes come as revenue agencies are equipped with legislation designed to increase levels of compliance and enforcement, such as anti-avoidance statutes, disclosure requirements, demands for greater transparency, and increased information reporting and withholding. It’s a lot to manage.

The enforcement landscape echoes the changes foreseen in tax policy; 97% of tax administrators say they expect to increase their focus on international structures and cross-border transactions in the next few years. And 81% of corporate tax executives expect more disclosure and transparency requirements in that same time frame, with 84% of policy-makers and 76% of tax administrators concurring.



Tax risk management models that were effective just five years ago may no longer provide adequate protection for companies today or in the future. Our survey indicates that companies increasingly realize this and are starting to take a more global and strategic approach to managing tax risk and controversy.

Transfer pricing remains a leading source of controversy, and indirect taxes, the migration of intangible assets and permanent establishment issues are all becoming sources of intense focus for taxpayers and governments alike, reflecting the continuing path of globalization. All these issues will likely be major sources of dispute in the future, with many respondents reporting that some tax administrations increasingly seem to be taking positions that are overly aggressive or without merit. In many cases, they also report that treaties or dispute resolution processes (other than litigation) are not available. The new world of tax risk is short on safety valves.

Forging a response: how leading companies are adapting

The spectrum of change that companies must manage is staggering: globalization, changing business models and a hugely uncertain global economy; shifts in taxation trends; unprecedented change in local tax legislation and more aggressive tax enforcement. All bring unique challenges to the tax department.

As a result, tax risk management models that were effective just five years ago may no longer provide adequate protection to companies today or in the future.

Our survey indicates that companies increasingly realize this and are starting to take a more global, strategic approach to managing tax risk and controversy. They are redeploying their resources to where they are most urgently needed, refreshing their tax risk management processes and putting in place technology systems to increase overall levels of visibility. The number of companies applying greater internal audit scrutiny of tax controls and processes, for example, has increased by nearly 30% since 2006. Companies also told us they are embedding tax risk management more prominently within their corporate governance approach, opening more lines of communication with their board and audit committee and tax policy-makers and tax administrators. This is a crucial step in an era when tax issues have moved to the forefront of perceptions of corporate citizenship; 72% of companies say they are pursuing a more open and collaborative relationship with a tax administrator.

These tactics help companies improve their responses to tax disputes, reducing the threat of unexpected assessments and penalties and achieving greater certainty and flexibility in their ability to plan. The leading companies also tell us that good risk management allows them to reduce the size of the tax provision and lower their overall costs of compliance, freeing up resources for more innovative pursuits. And importantly, they can reduce the overall threat of reputational risk from both consumers and the tax authorities with which they engage.

In this report, we share more insights on how tax risk and uncertainty are unfolding, how we see these leaders forging their response and how we think these global trends may develop. We think a new paradigm of tax risk is here. The leaders indicate that the time to act has arrived.

6 issues tackled in 5 steps

Understanding key drivers in the new era of tax risk and uncertainty

Tax administrations around the world become more aggressive and focused

75% of companies say they have experienced a rise in the volume or aggressiveness of tax audits.

97% of tax administrators reported that they will increase their focus on tax risk related to international structures and cross-border transactions in the coming three years.

57% of tax administrators identified transfer pricing as being their leading tax risk focus area in the next 12 months. Transfer pricing was also the leading risk focus area for companies.

Indirect taxes are another key risk focus, with more companies identifying indirect tax compliance as their second leading tax issue.

94% of tax policy-makers predict some or significant growth in general anti-avoidance rules (GAAR) and other similar measures in the next three years.

65% of tax administrators believe the incidence of double taxation will stay the same or increase. Only 35% believe it will decrease.

High pace of legislative change creates more risk and uncertainty

75% of tax directors in the largest companies (those with more than US\$5 billion in annual revenue) report heightened risk or uncertainty around tax legislation. This figure rises to 78% for BRIC-based companies and 83% for US-based companies.

However, only **57%** of CFOs report that they feel heightened risk or uncertainty around tax legislation.

81% of tax policy-makers see growth in GAAR and other anti-avoidance legislation in the next three years, while 94% see new legislation in the area of disclosure and transparency.

81% of tax administrators see increased disclosure and transparency requirements ahead.

Emerging markets is cited as the source of greatest risk related to legislative change.

Growing disclosure and transparency requirements: fuel for the fire

78% of companies report that they have experienced an increase in disclosure and transparency requirements made upon their company in the last two years.

99% of company respondents believe disclosure and transparency requirements will either stay the same or increase in the coming two-year period.

76% of tax administrators expect to focus on enforcing these requirements in the next three years.

94% of tax policy-makers expect to see some or significant growth in the area of transparency and disclosure in the coming three years.



Expansion in emerging markets is creating tax risk and uncertainty

92% of China-based and 62% of Brazil-based companies confirm that they have experienced a rise in the volume or aggressiveness of tax audits in the last three years.

85% of India-based companies and 88% of China-based companies have experienced growth in disclosure and transparency requirements in the last two years.

78% of BRIC-headquartered companies reported greater risk or uncertainty around legislation, compared to 67% of all companies globally.

73% of respondents feel that entering into or operating in emerging markets significantly increases their levels of tax and tax controversy risk. But that view was shared by only 50% of CFOs.

A new breed of tax activism emerges

57% of tax directors surveyed reported that the threat of a negative media article about their company was somewhat or a significant concern, with 40% reporting it was not a concern.

58% of tax directors from the largest companies (those with annual revenues in excess of US\$5b) reported that the threat of negative media was somewhat of a concern or significant concern.

A break in the clouds: "enhanced relationship" opportunities are spreading

75% of tax administrators reported that they are reinforcing the enhanced relationship and moving their organization further in that direction.

21% of tax administrators told us they do not believe that taxpayers or tax authorities can achieve the enhanced relationship over the next three years.

48% of tax administrators report they plan to actively seek opportunities to expand their pre- and post-filing dispute resolution toolset in the next three years, while 44% say they will encourage greater use of existing tools.

Execute a five-step approach to manage your organization's tax risk and controversy:

Adopt a global approach to tax risk and controversy management

Evaluate global resources, processes and systems for tax risk management

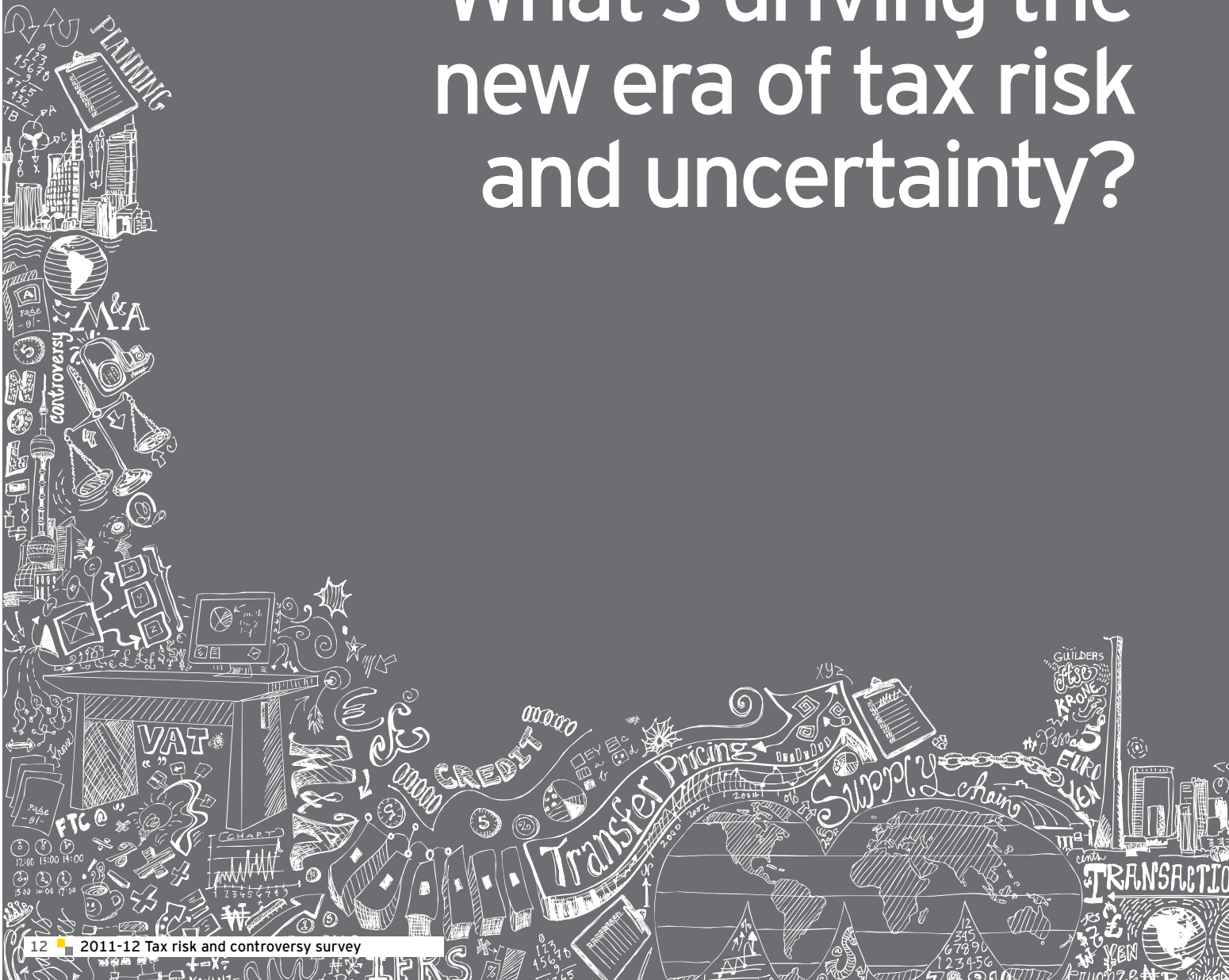
Address tax risk and controversy at a strategic level – and execute well

Make strong corporate governance in tax a priority – it is to tax administrators, and it makes good business sense

Stay connected with global legislative, regulatory and tax administration change

?

What's driving the new era of tax risk and uncertainty?





► Tax administrations around the world become more aggressive and focused

In 2008, as the worst days of the global financial crisis were unfolding, everyone involved with taxes speculated on what it might mean for tax policy and tax enforcement. It was a given that countries would do everything they could to jump-start their struggling economies, including offering significant stimulus via the tax system. They extended more generous write-offs for corporate losses. Headline corporate tax and value-added tax (VAT) rates were reduced temporarily. Incentives to encourage investment such as accelerated depreciation and enhanced research incentives proliferated worldwide. And most of these initiatives were financed with budget deficits.

While these stimulus activities were clear and concrete, we could only predict their effect on the enforcement landscape once governments pivoted to recovering the revenue they sacrificed. It was only a matter of time before they began scrutinizing taxpayers more closely in pursuit of funds. Our survey indicates that time has arrived.

Although the unfolding phases of the crisis may bring yet more future tax policy and enforcement change – and risk – we can now more clearly identify and categorize the enforcement effects of earlier phases. The range of responses we have seen from government policy-makers and tax administrators alike has been staggering.

Tax directors and CFOs:

75%

of companies say they have experienced a rise in the volume or aggressiveness of tax audits.

85%

of tax directors in companies with more than US\$5 billion in revenues reported that they had experienced an increase in international focus by tax authorities in the last two years.

77%

of companies “agree” or “strongly agree” that tax risk and controversy management will become even more important to them. However, only 50% of CFOs subscribe to that same viewpoint.

57%

of tax administrators identified transfer pricing as being their leading tax risk focus area in the next 12 months. Transfer pricing was also the leading risk focus area for companies.

Indirect taxes are another key risk focus, with more companies identifying indirect tax compliance as their second leading tax issue.

94%

of tax policy-makers predict some or significant growth in GAAR and other similar measures in the next three years.

97%

of tax administrators reported that they will increase their focus on tax risk related to international structures and cross-border transactions in the coming three years.

65%

of tax administrators believe the incidence of double taxation will stay the same or increase. Only 35% believe it will decrease.

“I think the biggest challenge we have is the approach of the tax authority, and the relationship we have there can make things a lot harder or a lot easier – we are seen as guilty rather than innocent until proven guilty. It’s that relationship that causes difficulties.”

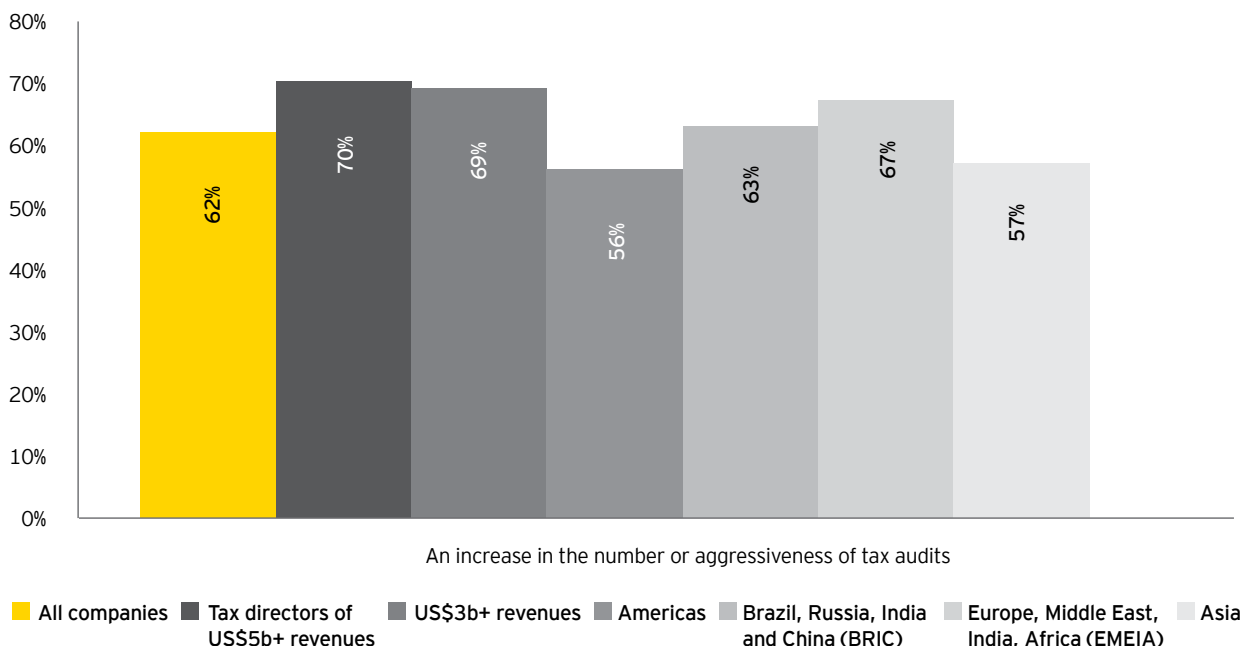
– Tax manager at an automotive company

Strength in numbers

The speed with which the world’s tax administrations joined forces is startling. They are now sharing taxpayer data and information at unprecedented rates while simultaneously developing and adopting leading practices in a number of key tax enforcement areas. Multilateral tax enforcement collectives such as the Joint International Tax Shelter Information Centre (JITSIC) have grown. Bodies such as the Organisation for Economic Co-operation and Development (OECD) Forum on Tax Administration, the Intra-European Organisation of Tax Administrations (IOTA), the Study Group on Asian Tax Administration and Research (SGATAR), and the Centro Interamericano de Administraciones Tributarias (CIAT) have strengthened and expanded their membership, sharing more leading practices among one another.

The African Tax Administration Forum (ATAF) has been created and is already demonstrating growing influence. The role of the OECD has grown meteorically in the wake of the financial crisis, on both tax policy and tax enforcement issues. Tax administrations everywhere are acting more boldly with the firm support of bodies such as the G20. In some cases – particularly in the emerging markets – they are challenging long-established norms, alarming multinational companies that fault a perceived lack of tax administration experience and sophistication for what they regard as an overzealous stance. These trends are likely to continue as 79% of tax administrators reported that they will see either new enforcement requirements come into being or stronger enforcement of existing requirements in the next three years.

Figure 1. Companies: Have you experienced an increase in international focus by tax authorities in the last two years?





Key enforcement focus areas emerge

In terms of enforcement risk areas, transfer pricing remains a leading tax risk – and therefore tax audit focus – for government tax policy-makers, tax administrators and taxpayers. Fifty-seven percent of tax administrators and 48% of the largest corporate taxpayers identified transfer pricing as their leading area of tax risk in the next 12 months. This was mirrored by transfer pricing being the leading risk issue for all companies, securing 40% of the 541 responses. For tax administrators, transfer pricing polled almost three times as many responses as global restructuring, their second-highest tax risk focus area.

While transfer pricing has long been an area of contention, our survey shows that indirect taxes are emerging as a potential flashpoint. Tax policy-makers said they expect indirect taxes to be their leading source of new revenue over the next decade, while tax administrators and taxpayers view indirect taxes as a key source of risk in the coming one- and three-year periods. With the US facing serious fiscal challenges over the next several decades, the tax reform debate has triggered a discussion of a value-added tax as a possible source of revenues. Any reform of this manner in the US will have a breathtaking effect on companies and tax administrations alike.

Tax administrators also tell us that they will be focusing heavily upon international structures in the future. Eighty-five percent of tax directors in companies with more than US\$5 billion in annual revenues reported that they had experienced an increase in international focus by tax authorities in the last two years, with 97% of tax administrators telling us they plan to increase their focus on the international structures in the next three years. This focus has not been lost on the largest corporate taxpayers, 57% of whom report that they have recently carried out a risk assessment of existing international structures.

This increased focus has been especially prevalent when holding company structures have been disposed of via another offshore holding company, leading to a gain that the local taxing authority believes is taxable. High-profile cases involving this type of transaction are certainly becoming more common, and in some cases – such as the Australian Tax Office's probe dispute with Texas Pacific Group (TPG) – local taxing authorities have attempted to secure payments against assets held outside their local jurisdiction.

Figure 2a. Companies: Which of the following tax types or issues represent the highest tax risk for you?

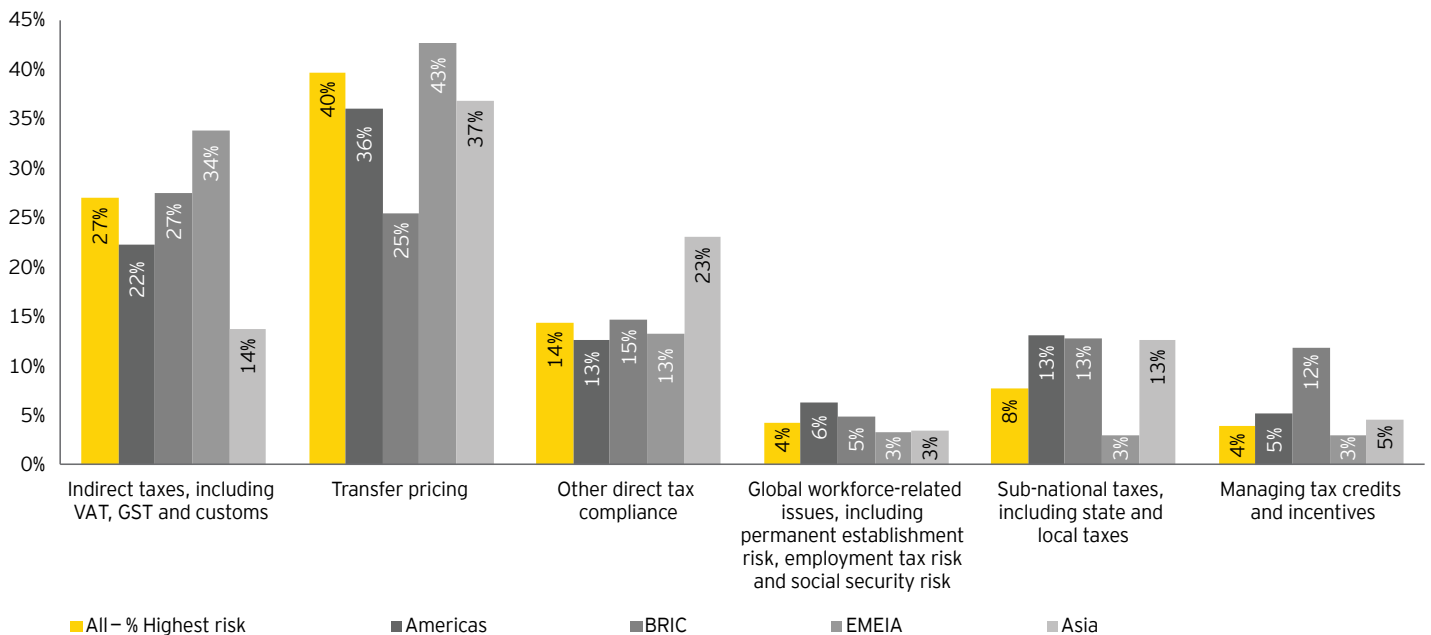
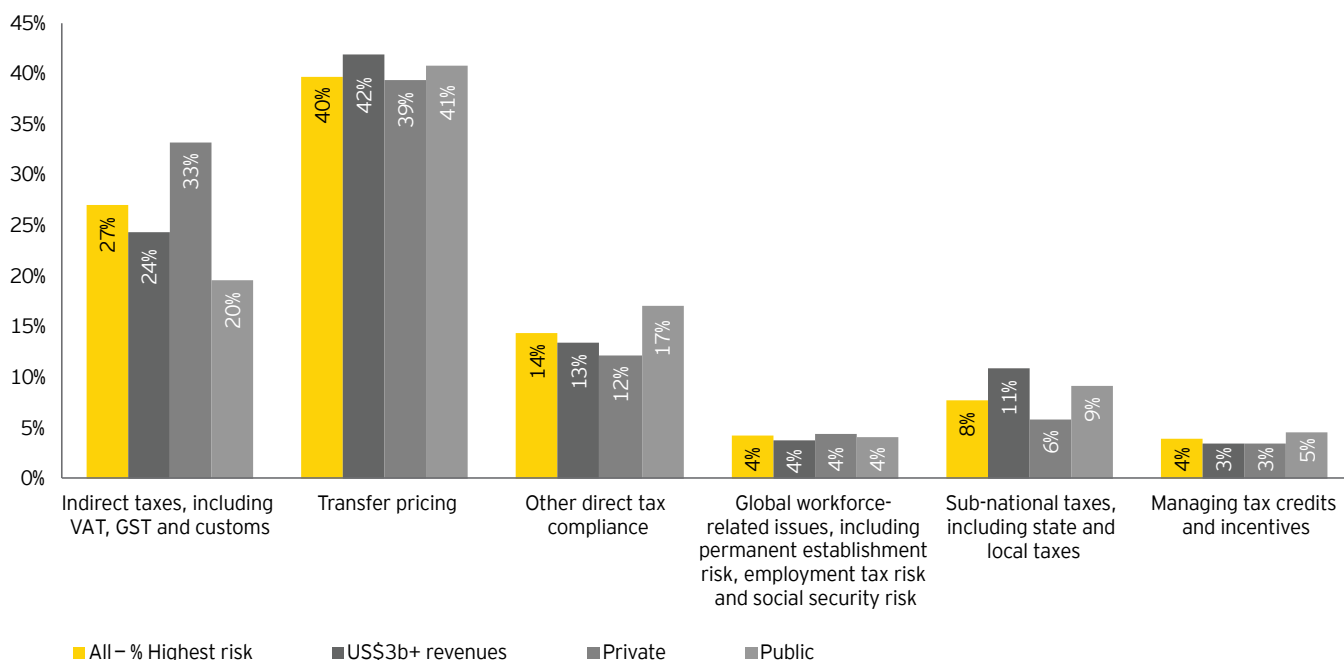


Figure 2b. Companies: Which of the following tax types or issues represent the highest tax risk for you?



A growing wave of controversy

On these key tax issues and others, a number of characteristics illustrate the rapid and tangible rise in enforcement. For example, tax audits have increased in volume and aggressiveness: 75% of tax directors in large multinationals (those with annual revenues exceeding US\$5 billion) confirm that they have experienced a rise in the volume or aggressiveness of tax audits. This figure rises to 69% for Americas-based companies and to 79% for US companies with revenues under US\$3 billion. In some cases, we have actually seen countries exhibit behavior that can be described as “competitive enforcement,” such as offering a seemingly low settlement amount but with the attached caveat that the company agrees not to invoke the Mutual Agreement Procedure (MAP) with the country on the other side of the transaction. The removal of such pressure valves creates not only increased costs overall but also increased complexity in managing relationships with tax administrators on either side of the transaction.

Joint audits are born

The past year also marked the global birth of joint tax audits, a long-standing goal of the OECD. While joint audits have been a relatively long-standing practice in the European Union (EU), it was only late 2010 which saw the release of more global guidelines for joint and simultaneous tax audits. The number of joint tax audits is still low overall, but their increasingly global reach is becoming evident. In regions such as the Americas, for example, the CIAT Secretariat stated in a 2011 interview with

Ernst & Young that work proceeding on a proposed multilateral tax agreement will facilitate joint audits in the region.

Tax authority respondents to our survey tell us they expect to focus heavily on building their capabilities in this area over the next three years. According to this group, the primary goal of new collaborative efforts with their peers is to share more taxpayer information. This is followed by participating in a higher volume of joint tax audits. Of course, these two developments go hand in glove.

Information as fuel

Various disclosure and transparency schemes have also fueled the rise in tax enforcement and show continued growth potential. Such schemes cover both the reporting of uncertain tax positions at the time of filing a tax return and the required disclosure of tax planning schemes classified as supporting tax avoidance. Likewise, the number of Tax Information Exchange Agreements (TIEAs) and Double Tax Conventions that meet the requirements of OECD’s Article 26 on information exchange have rocketed, providing the “fuel” for increased levels of enforcement. In fact, from a baseline of just 44 TIEAs in late 2008, more than 500 TIEAs were in place globally when this report was written.¹ Perhaps more interesting is the fact that, in addition to this rapid growth of TIEAs, we have also recently seen a change to the OECD Multilateral Tax Convention on Mutual Administrative Assistance in Tax Matters, which changed the convention

¹ OECD Exchange of Information portal: <http://www.eoi-tax.org/>

“Governments have signed more than 700 agreements to exchange tax information. These agreements have already yielded €14 billion in additional revenues, to 20 countries, from more than 100,000 taxpayers who had hidden assets offshore. We can expect to see multiples of this €14 billion collected over the years to come.”

– Angel Gurría, OECD Secretary-General, 25 October 2011

from a bilateral instrument into a multilateral one, effectively creating the global web of taxpayer information that leading tax administrations have sought for so long. In May 2011, when the OECD opened the convention up to non-OECD countries, the global, multilateral reach of the convention was complete.²

While the majority of information exchange growth falls under the umbrella of tax treaties or TEIAs, a more recent trend has been for many individual countries to forge ahead and broker one-off arrangements with one another. Recent examples include arrangement that both Germany and the UK (and perhaps soon, Italy) have made with Switzerland.

What the future might hold

Looking ahead, our survey results provide additional interesting insights into potential enforcement trends we expect to see continue to grow:

- ▶ GAARs and other anti-avoidance measures will continue to proliferate and may have a catalyst effect on tax disputes. Ninety-four percent of the tax policy-makers we surveyed predict some or significant growth in this area in the coming three years.
- ▶ The sourcing and sharing of taxpayer information will continue to grow rapidly, allowing more tax authorities to leverage information shared by a peer in order to drive enforcement. It is also reasonable to expect that the increased information flow may lead to a higher volume of joint tax audits and that these will start to involve a wider range of countries, moving beyond the traditional “big players” from the OECD.
- ▶ As tax administrations drive their enforcement efforts more strongly, 68% say they believe the incidence of double taxation will stay the same or increase. Only 32% believe it will decrease.
- ▶ Alongside an intense focus on cross-border structures, transfer pricing and indirect taxes, new OECD projects and reports such as the document on the aggressive utilization of losses will continue to provide an early warning system of how tax administration focus may shift, highlighting the importance of monitoring not just country policy and legislation but the work of supra-national bodies such as JITSIC, CIAT, CIOT, ATAF and the OECD's FTA.

For large multinational companies, 88% “agree” or “strongly agree” that tax risk and controversy management will become more important to them. But with only 50% of CFOs subscribing to that same viewpoint, there may well be a rocky road ahead. With the quantum of tax payments, penalties and interest now reaching into the billions of dollars for the first time, leading companies will likely address this divergence sooner rather than later.

Figure 3. Companies: Have you experienced an increase in the number or aggressiveness of tax audits in the last two years?

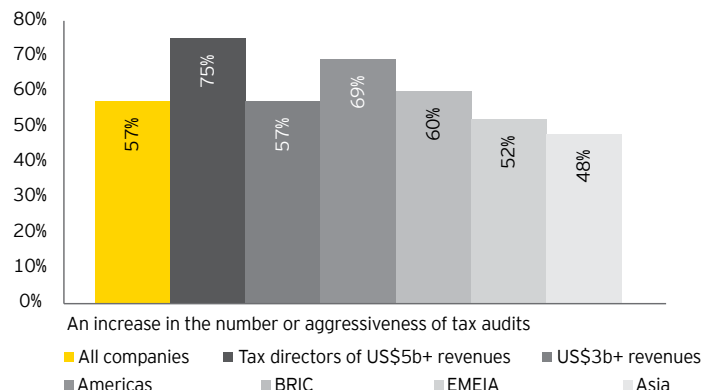
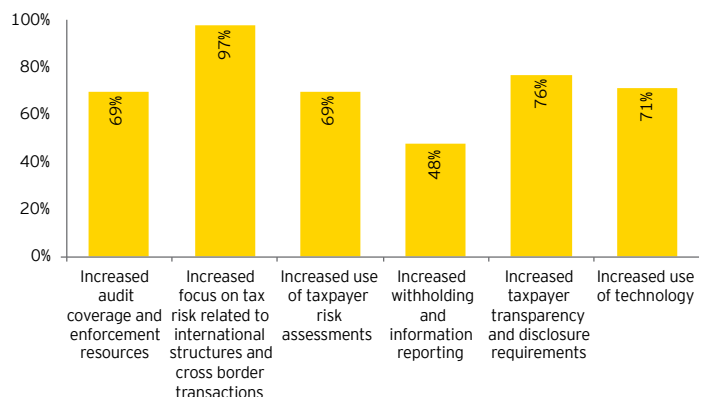


Figure 4. Tax administrators: Which tax administration enforcement strategies and trends do you expect to focus on during the next three years?



²See [http://www.ey.com/Publication/vwLUAssets/TPC8_MultilateralConvention_8Sept2011/\\$FI/LE/TPC8_MultilateralConvention_8Sept2011.pdf](http://www.ey.com/Publication/vwLUAssets/TPC8_MultilateralConvention_8Sept2011/$FI/LE/TPC8_MultilateralConvention_8Sept2011.pdf)

► High pace of legislative change creates more risk and uncertainty

Alongside the clear message that “tax enforcement is becoming more aggressive,” companies tell us with a single, resounding voice that the pace, volume and complexity of tax policy, tax legislation and tax administration change is a source of more risk and more uncertainty than ever before.

With the landscape continually changing, companies say effective planning has become more of a challenge and that complying accurately with the wide array of global tax and regulatory filing requirements is consuming more and more resources. As a vice president of tax at a consumer products company put it, “You can’t plan; there’s just too many changes going on. The risks are huge because you could set up something for today, but it could just turn around. There’s really no way to plan for that. And it’s not only in the US; it’s everywhere that’s changing. It’s very difficult to keep up.”

This change has not been confined to any single jurisdiction, specific area of tax or even a single direction of development. It has been completely pervasive and unrelenting and, at times, may even have seemed contradictory. Take two countries which share a border, for example: France and Germany. Within 24 hours of one another in early November 2011, these two countries announced a five percentage point corporate tax increase and a €6bn set of tax cuts respectively. These are unprecedented times of inconsistency and uncertainty.

The swinging pendulum of policy

Tax policy worldwide in the last three years has been characterized by a rapid swing from stimulus to austerity. During the course of 2009 and 2010, countries everywhere used their tax systems to deploy unprecedented volumes of fiscal stimulus to combat the global financial crisis. But stimulus is designed to be temporary, and tax legislation today reflects a newer, equally urgent set of concerns. Many countries have swung to deficit-fighting austerity and, in many cases, have reversed earlier stimulus measures, leaving corporate tax functions with much to monitor and assess and little time in which to do it. And yet others continue to mull over potential stimulatory measures, demonstrating the inconsistency of the global landscape.



Tax directors and CFOs:

75%

of tax directors in the largest companies (those with more than US\$5 billion in annual revenue) report heightened risk or uncertainty around tax legislation. This figure rises to 78% for BRIC-based companies and 83% for US-based companies.

However, only **57%** of CFOs report that they feel heightened risk or uncertainty around tax legislation.

56%

of tax directors in the largest companies report that they have “little or partial” visibility on local tax deadlines and filing status around the world. Only 40% felt they had full visibility.

Tax policy-makers and administrators:

81%

of tax policy-makers see growth in GAAR and other anti-avoidance legislation in the next three years, while 94% see new legislation in the area of disclosure and transparency.

81%

of tax administrators see increased disclosure and transparency requirements ahead.

69%

of tax policy-makers see simplification of the tax system as an objective of its own right. The remaining 31% see it as a “nice to have.”

“A lack of up to date information on frequent changes in legislation is probably our top tax risk right now.”

– Chief accountant at a midmarket company

In addition to keeping track of a myriad of stimulus initiatives, companies have had to monitor and assess the effect of other longer-term, underlying tax policy trends on their business. Governments, seeking to remain attractive to increasingly mobile capital, have continued to refine their corporate tax regimes by lowering rates. They also have continued to shift from worldwide to territorial tax regimes, often pruning expenditures to broaden the corporate tax base. Many governments have strived to lure inbound investment with new incentive mechanisms, including “patent” and “innovation boxes,” which reward companies who locate their intellectual property in one particular location.

Country pressure points

Companies tell us that the emerging markets are the source of the greatest tax risk related to legislative change. But interestingly, many respondents – whether US-based or from other countries – also say that the lack of certainty regarding US tax policy outlook reduces their ability to effectively carry out tax planning.

Some countries have issued legislation supporting their aggressive enforcement of international issues. China has continued to build out the enforcement of Circular 698 through the last 18 months, extending it to non-resident individuals.³ Similar high-profile cases in the Indian tax system have been chronicled with some regularity in the media. And Australia is likely re-assessing its approach in this area as a result of the TPG case.

³ See [http://www.ey.com/Publication/vwLUAssets/TPC8_China_7_Sept_2011/\\$FILE/TPC8_China_7Sept2011.pdf](http://www.ey.com/Publication/vwLUAssets/TPC8_China_7_Sept_2011/$FILE/TPC8_China_7Sept2011.pdf)

Indirect taxes

An inexorable shift to a higher consumption tax burden has further clouded the tax environment for global corporations. As tax policy-makers pledge to continue developing consumption taxes, corporations are beginning to recognize that these levies in many cases effectively make them unpaid tax collectors. A large company can ultimately handle a throughput of indirect taxes totaling many billions of dollars, making errors costly and cumbersome. As a result, the management of tax risks (and growing number of controversies) related to global indirect taxes has become a core focus for many companies.

Countries are not acting alone in issuing legislation and regulation. Supranational bodies have gained influence as a result of the financial crisis and are exerting their will on the tax landscape in a more robust way.

The shift toward the taxation of carbon continues apace as well, with companies needing to assess both the opportunities (a new range of sustainability incentives) and the consequences (new taxes, which as yet are uncoordinated and disparate).

Not just country policy

Countries are not acting alone in issuing legislation and regulation. Supranational bodies, gaining in influence as a result of the financial crisis, are having a bigger influence on the tax world. They continue to unveil a barrage of taxes, regulations and codes of conduct that large taxpayers must assess and comply with. In Europe, the Common Consolidated Corporate Tax Base (CCCTB) arguably represents one of the most fundamental changes in corporate taxation attempted within the EU and, alongside efforts to implement an EU-wide financial transaction tax, demonstrates that tax policy is not just a local issue anymore. Likewise, the OECD transfer pricing guidelines saw an upgrade in 2010, and more change is highly likely as bodies such as the UN and the ATAF push for the increasing influence and political capital of a strengthening emerging market.

The rapid pace of change on the policy and legislation front has continued into 2011, mirroring the next phase of the financial crisis – a sovereign debt crisis. This has created an environment where some countries are losing their ability to formulate and execute their own tax policies and administrative strategies.

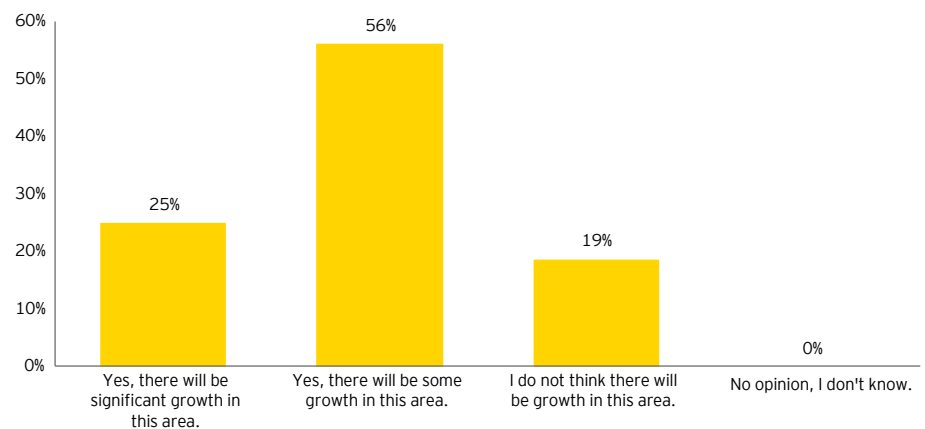
As well as tax policy and legislation, the last three years also demonstrate how

important it is to simultaneously monitor the unprecedented changes occurring in tax administration from the perspectives of both challenge and opportunity. The OECD's FTA is a key example. Its guidance is not in any way binding, but the FTA work provides a useful benchmark for what tax administration processes and programs may emerge within individual countries.

Among other things, the OECD has prompted additional information sharing between countries; the "White," "Gray" and "Black" lists of countries; a recent set of guidelines in relation to conducting joint tax audits; a code of conduct for banks and revenue authorities (which continues to see traction and should thus be watched carefully) and a series of reports covering issues such as tax planning disclosure schemes and the aggressive utilization of losses.



Figure 5. Tax policy-makers: Do you see an increasing use of principle-based legislation in your country in the next three years such as GAAR and other specific anti-avoidance legislation? (Single answer)



Keeping pace

All of these individual trends and changes represent a flow of information of unprecedented magnitude that corporate tax executives must identify, understand, assess and communicate to their people around the world. Yet many of them tell us that they worry they will fail to keep up with the pace of change or misinterpret one of the thousands of changes they must absorb.

Some 67% of companies worldwide report they are experiencing this heightened risk or uncertainty around tax legislation. This figure rises to 78% for BRIC-based companies and 83% for US-based companies. Only 57% of CFOs, however, report that they feel heightened risk or uncertainty around tax legislation, perhaps illustrating that they are simply not aware of or don't fully appreciate the massive scope of change that is occurring.

And it's not likely for this uncertainty and risk to be resolved any time soon. Tax policy-makers tell us that they anticipate a growth in many areas of legislation ahead. For example, 81% see growth in GAAR and other anti-avoidance legislation, while 94% see new disclosure and transparency legislation.

As we set out, it is not just on the tax policy side that staying up to date is an imperative. On the enforcement side of the coin, tax administrators also foresee significant change ahead. Eighty-one percent anticipate increased disclosure and transparency requirements, and the same proportion (81%) predicts either new information reporting and withholding requirements or the stronger enforcement of existing disclosure requirements. We think that the likelihood of continued change and complexity should require a major change in behavior for the tax function.

“The constant modification and complexity of international tax regulations is probably our key risk. We just can't keep up with how much change there is.”

– *Financial director at an industrial products company*



► Growing disclosure and transparency requirements: fuel for the fire

Around the world, the increase in tax enforcement has been accompanied by a broad range of new requirements for business taxpayers to disclose more information to the taxing authorities. And in some regards, these requirements may fuel future controversy. The objective of such requirements is clear: they drive efficiencies in tax administration, enabling the enhancement of risk assessments and targeting activities.

For companies, the requirements bring both challenges and opportunities; while meeting the requirements can be an arduous task, they do bring companies the opportunity to approach government and tax administrations and ask for clearer guidance. And at the tax position level, companies can choose to be proactive, preparing robust and contemporaneous documentation or securing pre-filing agreements, or they can be more reactive, preparing for audit on a case-by-case basis.

Uncertain tax positions

So far, the United States and Australia have demanded that companies report their uncertain tax positions (UTPs) when they file their returns. Others countries have launched programs that require the mandatory disclosure of avoidance transactions in addition to other statutory reporting requirements aimed at increasing transparency.

The genesis of the requirement to report UTPs can be found in the 2006 Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48).

These types of requirements provide tax administrations with a dramatically increased volume of information regarding tax positions, which may result in additional tax revenues if they are not sustained upon examination – in other words, a red flag for tax examination.

The Internal Revenue Service's (IRS) January 2010 announcement requiring the reporting of UTPs is widely expected to be replicated by other countries around the world, most likely starting with the countries making up the OECD's FTA. Under the US requirements, affected corporations include both domestic and, in some cases, foreign companies.⁴

Australia is the first FTA member to introduce a similar program, with a pilot scheme requiring corporations to reveal "reportable tax positions" (RTPs) for years commencing 1 July 2011.⁵ The pilot scheme will be applicable for all "notified higher consequence taxpayers," a type of risk rating approach used in Australia. While the United Kingdom, another leading country within the FTA, has not yet announced similar measures, it seems likely that it will.

⁴See www.ey.com/uncertaintaxpositions

⁵See www.ey.com/tpcquarterly



Tax directors and CFOs:

78%

report that they have experienced an increase in disclosure and transparency requirements made upon their company in the last two years. US-based companies report 83%, China respondents 85% and Brazil-based respondents 88%.

99%

of company respondents believe disclosure and transparency requirements will either stay the same or increase in the coming two-year period.

Tax policy-makers and administrators:

76%

of tax administrators expect to focus on enforcing these requirements in the next three years.

94%

of tax policy-makers expect to see some or significant growth in the area of transparency and disclosure in the coming three years.

Ninety-nine percent of our tax executive respondents believe disclosure and transparency requirements will either stay the same or increase further in the coming two-year period.

Assessing the effects

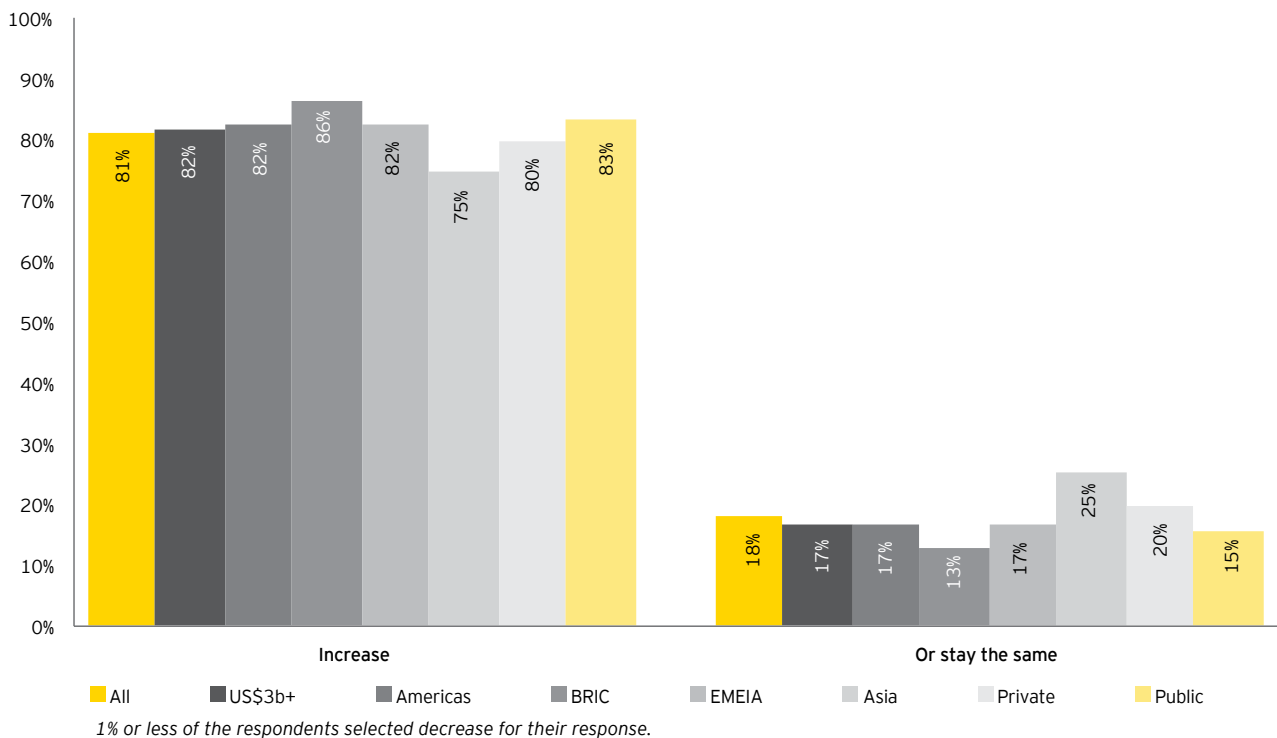
The effects of such disclosure requirements on corporations are two-fold. First, complying with the new and complex forms to report UTPs is onerous. Second, and perhaps more seriously, it is widely understood that these programs have prompted and will continue to prompt tax audits. And as tax administrators around the world strengthen their global "taxpayer information web," there is good reason to believe issues with one country's tax auditor can quickly grow into controversy in other nations.

Of our 541 corporate tax executive respondents, 78% report they have experienced more disclosure and transparency requirements made upon their company in the last two years. That percentage is elevated in some of the world's biggest and most rapidly growing economies. Eighty-three percent of US-based

respondents experienced increased disclosure demands. In China, 85% of respondents reported them, and in Brazil, the figure was 88%. From an industry sector perspective, the financial services sector faces the most additional scrutiny, with 84% reporting that disclosure requirements had increased. Technology firms were a close second at 83%.

Ninety-nine percent of our tax executive respondents believe disclosure and transparency requirements will either stay the same or increase further in the coming two-year period. This view is shared by tax policy-makers and tax administrators alike: 76% of tax administrators expect these requirements to grow in the next three years, while 94% of tax policy-makers expect there to be either some or significant growth in transparency requirements for large companies.

Figure 6. Companies: In the next two years, do you think you will see a change in disclosure and transparency requirements?



► Expansion in emerging markets is creating tax risk and uncertainty

Emerging markets present the ultimate dichotomy for the tax director who needs to support and enable overall business strategy while facing the thought of “entering the unknown” – with all the risk it brings.

It is clear that the global financial crisis has accelerated the pace of globalization, and companies are forging ahead into fast-growing markets to increase their market share. While these markets may once have been seen as attractive only for their natural resources or as a source of cheap labor and low-cost manufacturing, they are now viewed as promising markets in their own right. Rapid population growth, sustained economic development and a growing middle class are making many companies look at emerging markets in a new way.

The emerging markets led the global economic recovery in 2010, particularly in Brazil, India and China. Their strength is set to continue. Estimates show that 70% of world growth over the next few years will come from emerging markets, with China and India accounting for 40% of that growth. Adjusted for variations in purchasing power parity (PPP), the ascent of emerging markets is even more impressive. The International Monetary Fund (IMF) forecasts that their total gross domestic product (GDP) could overtake developed economy GDP as early as 2014. They also forecast that the BRICs will remain the driving force behind growth in emerging markets over the next 10 years and that, by 2020, BRICs are expected to account for nearly 50% of all global GDP growth.⁶

The OECD reports that the size of the middle class is expected to increase from 1.8 billion people in 2009 to 3.2 billion by 2020 and 4.9 billion by 2030. Roughly 85% of this growth will happen in Asia. By contrast, the size of the middle class in North America will remain constant. This expansion of a global middle class with greater income represents a significant opportunity for businesses from all sectors.

Yet as exciting a picture as this paints, our survey respondents tell us that operating in emerging markets is a leading source of tax and controversy risk. Because they are dealing with such rapid growth in inbound investment, the emerging market countries tend to experience large volumes of tax policy and tax administration change as they develop the laws and processes to secure what they feel are the right levels of tax revenues from those capital flows and transactions.



Tax directors and CFOs:

92%

of China-based and 62% of Brazil-based companies confirm that they have experienced a rise in the volume or aggressiveness of tax audits in the last three years.

85%

of India-based companies and 88% of China-based companies have experienced growth in disclosure and transparency requirements in the last two years.

78%

of BRIC-headquartered companies reported greater risk or uncertainty around legislation, compared to 67% of all companies globally.

85%

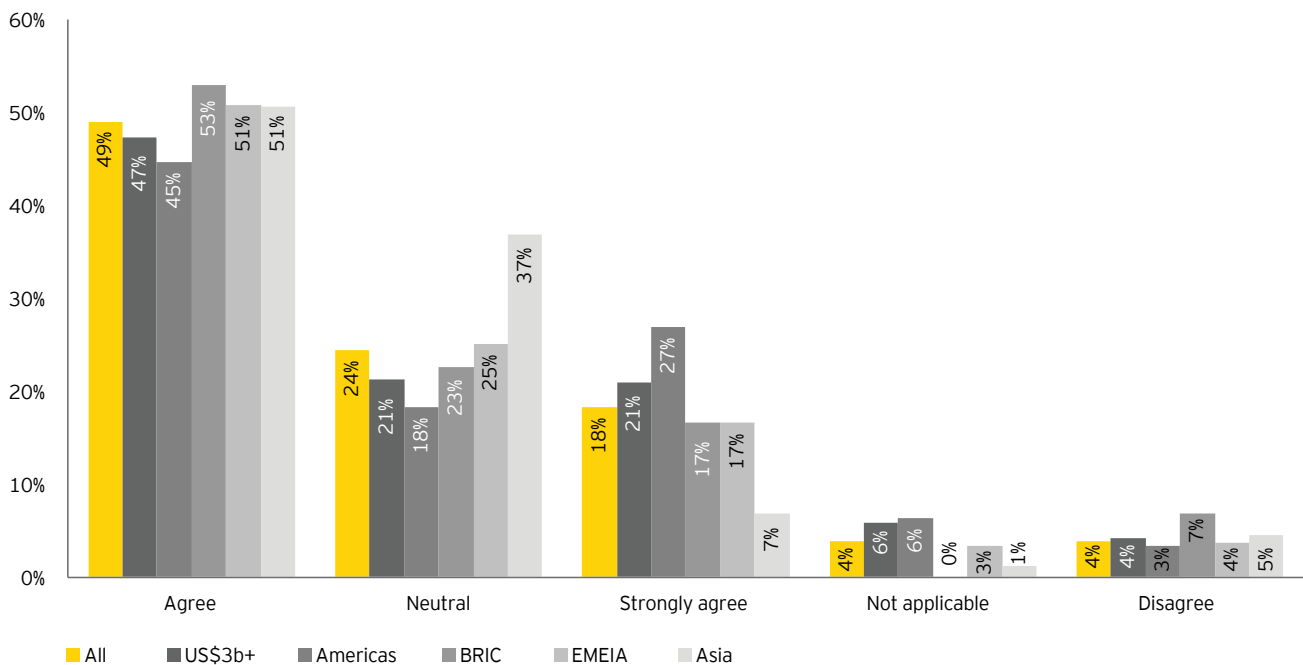
of China-based companies tell us that they feel the Chinese tax authorities have increased their international focus in the last two years.

73%

of respondents feel that entering into or operating in emerging markets significantly increases their levels of tax and tax controversy risk. But that view was shared by only 50% of CFOs.

⁶World Economic Outlook Database, International Monetary Fund, October 2010

Figure 7. Companies: To what extent do you agree with the following statement: "Entering into or operating in emerging markets significantly increases levels of tax and tax controversy risk?"



1% or less of the respondents selected strongly disagree for their response.

Long road to maturity

It can take many years for a tax regime unaccustomed to policing cross-border commerce to mature, so some key nations rely on existing legislation and processes that globetrotting taxpayers may view as unsophisticated, complex and, without doubt, culturally different. But as emerging market countries become more confident in their own right, they are increasingly challenging commonly applied international standards. This has proven particularly true in transactions involving foreign-based companies, where some emerging markets are increasingly levying taxes on events that may previously have failed to trigger taxation. This phenomenon is becoming especially pronounced in the taxation of indirect capital gains and in the area of transfer pricing.

Unfortunately for the business community, as these same tax administrators move quickly to enforce new laws and deal with anti-abuse regulations, coupled with other revenue-raising or

cost-cutting efforts, there may be no administrative dispute resolution processes, or they may be immature. The result is a long, often contentious, expensive road to achieve certainty.

When it comes to managing tax function activities, the frustrations of entering into or expanding in an emerging market are enormous. Companies typically have no dedicated resources with strong local tax knowledge or cultural experience, and the tax policy, legislation and tax administration processes can change rapidly as the country develops at warp speed. In fact, companies in our survey say they frequently experience cases where there are no tax treaties in place, inconsistencies in legislation, ambiguous interpretation and, in many cases, a lack of clear judicial and administrative guidelines about how to resolve a tax dispute, assuming a cultural approach supporting collaboration exists in the first place. Language differences and the lack of a long-standing relationship between taxpayer and tax administration may also further compound the difficulties of managing these tax issues.

“Because those countries offer a facility for attracting you to them in the first place, they then want the returns to remain in country and not to flow to other countries. They use all kinds of measures to prevent this – in other words, taxes and tax enforcement.”

– Tax director at a real estate company

Survey respondents also tell us that they feel tax authorities in the emerging markets tend to be more aggressive overall in their enforcement efforts: “It’s ultimately about the revenue authorities in different countries wanting to tax as much as possible. In that respect, double taxation is the result,” said a Tax director at a European multinational company when asked about emerging markets risk. Another reported: “I would say the greatest risk is that everyone is looking for money, so they’re getting more aggressive and trying to figure out how you owe each jurisdiction more” – Tax director at an industrial products company.

In another recent Ernst & Young survey,⁷ tax directors reported that carrying out mergers and acquisitions (M&A) transactions in emerging markets carried a particularly high level of tax risk, even to those with many years of similar experience. Echoing the results of this survey, respondents noted that, among other issues, uncertainty of how tax legislation and practice will be applied to a particular transaction step (93% of respondents) and a heightened risk that the tax system or tax incentives will change (87% of respondents) were their leading challenges.

A majority of respondents in this Tax risk and controversy survey – 73% – told us that they feel entering into or operating in emerging markets significantly increases their levels of tax and tax controversy risk. Notably, only 50% of CFOs we surveyed felt the same way. This divergence is interesting because CFOs are more likely to initiate expansion plans. It could be that they have great faith in their tax technicians to navigate the tax landscape; it’s also possible that CFOs don’t fully grasp the tax implications of their ambitions. Any company with expansion plans should consider addressing this difference in views.

Survey respondents based in the BRIC countries reported far higher levels of uncertainty and risk around legislation than elsewhere in the world: 78% of BRIC-headquartered companies reported greater risk or uncertainty around legislation, compared to 67% of all companies globally. If it is difficult to manage taxes in those markets as a native company, managing taxes for non-natives must be even more difficult, which is no surprise when you consider that:

- ▶ Brazil possesses an indirect tax system that taxpayers say is overly complex and has massive tax reform to come
- ▶ Transfer pricing in Russia is undergoing significant change
- ▶ India is rapidly ramping up enforcement levels, resulting in the largest tax disputes in history
- ▶ China continues to level the playing field, both raising the tax burden on foreign-owned enterprises and ramping up the enforcement of Circular 698, recently extending its reach to non-resident individuals

“Our leading tax risk is that there is a disconnectedness within our organization, because we run a decentralized model. We tend not to have a lot of bench strength, so it's almost an impossibility for us to send experienced operating people into the local emerging markets in order to implement company standards and practices and to transmit data back to headquarters.”

– *Vice president of tax at an automotive company*

As China enters a new phase, policy changes by the State Administration of Taxation (SAT) is reflected in the 85% of China-based companies that tell us they feel the tax authority has increased their international focus in the last two years.

Companies in these markets also tell us they face higher disclosure and transparency requirements than survey respondents elsewhere in the world. Against a global benchmark of 78%, 88% of Chinese respondents tell us that they have experienced a growth in disclosure and transparency requirements in the last two years, with Indian companies reporting an 85% score in the same category.

More growing pains are likely as emerging markets transform their taxation approach to more closely match economic realities. The transformation from “emerging” to “developed” market is not a quick one, not least where tax policy, legislation, tax administration processes and culture are concerned. A key message to tax directors can only be to fasten their seat belts: the ride will not be smooth and getting the governance, policies, systems and processes in place to manage emerging markets risk will be key – as will the ability to tap into local knowledge and cultural experience.

“The tax environment in Brazil is not as mature and transparent as in Europe and the USA; there seems to be constant alterations and changes to the law, in addition to the high number of taxes. I think this must happen in other emerging markets too.”

– *CFO at a Brazilian multinational company*



Tax administrators:

75%

of tax administrators reported that they are reinforcing the enhanced relationship concept.

55%

of tax administrators believe that some corporate taxpayers have embraced the concept and are exhibiting the behaviors that are conducive to the enhanced relationship.

21%

of tax administrators stated that they do not believe that taxpayers or tax authorities can achieve the enhanced relationship over the next three years.

48%

of tax administrators report that they plan to actively seek opportunities to expand their pre- and post-filing dispute resolution toolset in the next three years.

44%

of tax administrators say they will encourage greater use of existing tools and processes.

Tax directors and CFOs:

34%

of companies make use of pre-filing rulings.

21%

of companies report that they are part of a real-time auditing process in one or more countries.

49%

of companies with revenues larger than US\$5 billion make use of Advance Pricing Agreements (APAs). Seventy-two percent plan to expand their use in the next two years.

► A break in the clouds: “enhanced relationship” opportunities are spreading

So far, the picture of the tax enforcement landscape would appear somewhat negative, simply because there are so many dramatic changes occurring. It is worth noting that the uncertainties created by the increasingly negative backdrop take their toll on governments also. As a result, many governments have less appetite for tax litigation because of the costs, time and drain on resources they cause. Instead, many (but not all) tax authorities are now looking for new ways to open up a channel for business taxpayers to interact with them, to resolve issues before they reach controversy and also to end disputes in ways that are quicker, less costly and more efficient in the long run.

Enhanced relationship model is born

A key result illustrating this changing approach is the birth of the enhanced relationship between taxpayer and tax administrator, which finds its roots (like many tax administration changes) in the OECD's Forum on Tax Administration. The approach, though not adopted by all countries globally, is increasingly being demonstrated by a majority around the world. Some 75% of tax administrators reported that they are reinforcing the enhanced relationship and moving their organization in that direction. Twenty-one percent told us that they do not believe that taxpayers or tax authorities can achieve the enhanced relationship over the next three years, while 14% voiced the opinion that large corporate taxpayers generally are not transparent and collaborative in a way that defines the enhanced relationship.

The physical elements of the enhanced relationship approach are two-fold. First, more countries are now starting to adopt real-time auditing arrangements that cover the entire tax return (such as Horizontal Monitoring in the Netherlands or the Compliance Assurance Process [CAP] in the US). There are currently relatively few examples of these arrangements, and most are pilot programs that have been adopted by only a small number of multinational companies. Only 21% of the largest companies in our survey (those with annual revenues in excess of US\$5 billion) reported that they have entered such a process to date.

Transparency and cooperation

These arrangements require transparency and cooperation on the behalf of taxpayers throughout the year and a highly collaborative approach between the taxpayer and the tax administrator. As such, they can be characterized as a form of voluntary disclosure: the taxpayer promises actively to notify the tax authorities of any issues with a possible or significant tax risk and to disclose all facts and circumstances regarding the issues without hesitation or reservation. In return for full disclosure, the tax authority endeavors to provide timely advice on significant positions, taking into account real commercial deadlines when doing so. That approach to service provides the taxpayer with increased timeliness and certainty.

So does the “enhanced relationship” only apply to comprehensive contemporaneous processes like CAP or horizontal monitoring? No, the basic concepts could apply to the pre-filing agreements for one issue or equally to the post filing audit process.

Alongside certainty and timeliness, the successful participation in processes can also provide fungible results, such as a reduction in the size of the tax provision. As the group tax director of a multinational logistics company told us, “Each year, if we plan our request to the tax authority properly, we generally have an answer before we close the books. That’s an outstanding result for us because if I do something that is beneficial because it reduces the amount of tax we owe, it hits the P&L immediately. We need less provision for uncertain tax positions than we had before.”

Evidence suggests that the creation of such enhanced relationship processes covering the whole tax return are growing outside of the early adopters of Australia, the US and the Netherlands. Some tax administrators in Europe and Asia-Pacific are reported to be working on developing similar pilot schemes through the increased sharing of leading practices within groups such as the OECD. South Korea, for example, is currently running a three-year cycle of a new Horizontal Compliance Program (HCP) that shares many characteristics of the Dutch process. We expect to see many countries join this trend.

So does the enhanced relationship only apply to comprehensive contemporaneous processes like CAP or horizontal monitoring? No, the basic concepts could apply to the pre-filing agreements for one issue or equally to the post-filing audit process. Based on a set of guiding principles and behaviors on the part of taxpayers and the tax administrator, the enhanced relationship is intended to drive fairness and efficiencies for both.

Expanding the dispute resolution toolkit

In order to focus their resources more efficiently, tax administrators are increasingly improving their entire range of dispute resolution tools. This allows them to reduce the volume of time their most experienced resources spend on managing (and litigating) complex disputes. This same resource efficiency is also available to the taxpayer. Pre-filing processes enable taxpayers to reduce the potential effect of a tax position prior to filing their return. Although approaches vary between countries, the key concept is that pre-filing provides a mechanism to give taxpayers certainty that, once an issue has been resolved, the position will not be challenged by the tax administration during the audit process. Many pre-filing opportunities exist, and tax administrations tell us they are actively building more.

Forty-eight percent of tax administrators reported that they plan to actively seek opportunities to expand both their pre- and post-filing dispute resolution tools, versus 44% who said that they would encourage greater use of existing tools and processes. Of those planning an expansion, the creation or addition of these pre-filing processes, such as APAs, agreements and rulings, was the leading focus area. The second-highest area of focus was around legal or administrative guidance that would apply to a broader group of taxpayers.





The use of APAs was reported by 49% of tax directors of companies earning US\$5 billion or above in our survey, and 72% of them said they plan to expand their use in the next two years, cementing the APA as a key controversy management tool. In fact, when asked about how they plan to expand their cooperation and collaboration among their peers, the second choice of tax authorities (after increasing their overall levels of international information exchange) was to increase their use of bilateral or multilateral APAs.

Post-filing resolution: still some work to do

Of course, not every company will want (or be able) to resolve disputes prior to filing their return, and not every tax administration embraces the approach. Although post-filing processes are conducted after a return is filed, the overall objective is similar to the pre-filing approach. In cases where a dispute arises during the examination process, taxpayers can enter into a constructive dialogue with the tax authorities in an attempt to reach agreement without reverting directly to a legal process. The expansion of post-filing resolution mechanisms such as appeals, mediation and arbitration has been a significant focus area for tax administrations in the last few years, but it does not seem to have (yet) fully captured the attention of tax directors. We think this is an area worthy of consideration by business taxpayers.

“I would say that in a couple of the major jurisdictions in which we do business, we have entered into these enhanced relationships, which are delivering significantly greater certainty and, I would say, also significantly reduced cost. I do think there is a shared view on the parts of companies and tax administrations that we have to be more efficient. There are opportunities to achieve greater certainty on both sides at a much lower cost and with much greater speed, provided that there is a better understanding of the key commercial factors that are driving decisions being made by the multinationals.”

– Tax director at a multinational oil and gas company

3.

Implications, insights and business imperatives





Managing tax risk and controversy is, at its heart, about managing uncertainty. And the new era of tax risk is more uncertain than ever. Leading companies understand this. They are putting in place global, strategic approaches to managing tax risk and controversy that rely on the redeployment of resources, the updating of processes and the use of technology as an enabler. They are increasing their levels of tax corporate governance, and they are actively assessing how the shifting landscape affects their business.

Tax directors are now simultaneously managing changing business models, a shifting economy, complex and fast-paced legislation, and an approach to tax enforcement that is evolving rapidly. Taking into account the harsh financial and reputational penalties that can result from a major tax controversy, the leaders realize that successfully and proactively managing uncertainty is a key imperative.

The very nature of uncertainty makes it difficult to quantify what success or failure in managing tax risk and tax controversy actually looks like once the issue has finally been resolved. The results are rarely clear-cut, and one person's success may well be another person's failure. It is clear, though, that those who achieve the greatest success in managing today's uncertain tax environment are those who are better informed and act on that knowledge. Better information on the source, size and potential impact – both multijurisdictional and multiyear – of each tax and controversy risk can be set and measured against a clearly defined risk tolerance level, allowing better decisions to be made. The leaders also realize that success is not solely about being a master technician; it is increasingly reliant upon managing a new, complex set of stakeholder relationships inside and outside the company.

In this section, we set out a five-step, enterprise-wide approach to tax risk and controversy management, detailing the many different characteristics we are seeing leading companies around the world put in place as they strive to protect themselves in a rapidly changing world:

- ▶ Adopt a global approach to tax risk and controversy management
- ▶ Evaluate global resources, processes and systems for tax risk management
- ▶ Address tax risk and controversy at a strategic level and execute well
- ▶ Make strong corporate governance in tax a priority – it is to tax administrators, and it makes good business sense
- ▶ Stay connected with complex, voluminous and fast-paced change

▶ Adopt a global approach to tax risk and controversy management

We think a global approach to tax risk and controversy management should be adopted, because tax administrators tell us loud and clear that they are increasingly taking a global view of companies. Viewing risk and potential controversy from a bilateral or multilateral perspective can help companies mitigate risk and prepare to engage tax administrations who say they are looking to increase their international focus and levels of information sharing, using this information to facilitate unilateral, bilateral or even multilateral tax audits.

A global approach to documentation – and not to mention improving its consistency overall – becomes increasingly important as tax administrations ramp up their information exchange protocols and capabilities. The eyes of multiple tax authorities may be analyzing facts and law related to different sides of a transaction. Companies therefore need to make sure each position is assessed and managed within a framework that provides for assessing of all angles of each transaction or position.

Internal risk factors to consider

Of course, not all taxes are managed at the headquarters, or even the regional level. As companies strive to increase their overall levels of control in the management of taxes, we are certainly seeing that global compliance and reporting seems to be at a tipping point. The combination of evolving business models, transforming finance functions and an increasingly complex regulatory landscape has demanded that a global business reevaluates its approach to compliance and reporting.

More and more companies are striving for a more centralized control of tax operations (whether at the global or regional levels or via a series of country “clusters”), and in the leading companies, we are seeing tax risk and controversy management processes either embedded into this transformational process or addressed as a global need in and of itself. We think that adopting this global approach is rapidly becoming a leading practice.

What success looks like

- ▶ A global vision and strategy for tax risk and controversy management is developed.
- ▶ The current state of tax risk and controversy management is assessed.
- ▶ A business case for tax risk and controversy management is developed, setting out resource, process and technology needs against the current state.
- ▶ An assessment is made of whether opportunities exist to globalize the tax risk and controversy management as an element of an existing or forthcoming finance transformation.
- ▶ Global tax risk and tax controversy management policies are developed and put in place, including framework approaches for operational execution on an ongoing basis.
- ▶ Externally, opportunities to enhance relationships with tax administrators are assessed in key jurisdictions.
- ▶ Internally, ensure tax controversy and risk management “thinking” is embedded in all aspects of the business lifecycle.
- ▶ Processes are put in place to improve levels of understanding of country.
- ▶ Processes are put in place to understand the risk assessment systems of tax authorities and what the company tax risk profile is in relevant jurisdictions.
- ▶ Assessment is made of the available programs that may provide a way to lower the company risk profile.
- ▶ Interaction is made with tax authorities in a way that is more transparent, collaborative and responsive.



In those companies where a global compliance and reporting function either exists or is in the process of being created, a recent Ernst & Young survey⁸ reported that tax controversy management was one of the core activities to be included for 80% of companies, the same percentage as income tax compliance and three percentage points ahead of completion of the tax provision.

If one considers areas such as the identification of tax issues possessing the potential to trigger future controversy or the management of tax audits, it certainly makes sense for the tax function to have visibility of these issues as early in their developmental lifecycle as possible.

This is also true of issues such as indirect tax management, where compliance is being rapidly moved into shared service centers, raising overall risk levels. It therefore makes a lot of sense to identify and manage such issues globally.

External factors to consider

Once a company commits to adopting a global approach to managing tax risk and controversy, the resources, processes and enabling tools that make up the framework approach should be put in place internally. This framework – due to the very nature of tax – means that a number of external factors, relationships and processes must also be considered and acted upon.

Companies should continue to engage directly with tax administrators, who are also actively sharing, leveraging and adopting their own leading practices, including processes, technical positions and legal interpretations. We think building a genuine and mutually respectful relationship can help companies gain a better understanding of the effect that tax administration processes and focus changes will have on them and create an “early warning system” that anticipates future risk areas.

Relationships with tax authorities are becoming more important. As tax administrations develop and share new processes for dispute resolution, they also can provide better service to taxpayers who desire earlier certainty and are willing to take a collaborative approach that will facilitate a positive outcome. As governments implement new transparency policies and procedures – such as leveraging tax transparency for financial

accounting for UTPs – others are likely to follow suit. Companies need to have a clear understanding that, regardless of the type of risk assessment system in place in a particular jurisdiction (or whether there is a formal system in place at all), tax authorities are increasingly risk rating business taxpayers, and they are applying more scrutiny to those with higher risk profiles and rewarding those with lower risk profiles. This often will result in a reduction in the cost of compliance and more mechanisms to achieve certainty sooner through accelerated issue resolution approaches and tools.

“As part of our overall approach to tax risk management, we are putting in place a global tax controversy framework which is supported by the right people resources to support it. The fundamental objective of the framework is to ensure that we adopt consistent corporate policies and procedures related to tax controversy. Our goal is to develop a global network that shares information, insights and leading practices on a timely basis and facilitates our engagement with key tax authorities. Where litigation is in prospect, the objective is to manage that process so as to optimize our global tax position whilst preserving and, where possible, enhancing our relationships with tax administrations.”

– Global tax risk officer of a Fortune 500 financial services company

⁸Seizing the opportunity in Global Compliance and Reporting – Ernst & Young, 2011. www.ey.com/gcrsurvey

Risk ratings rising

This focus by tax authorities on risk rating provides companies that want to invest in an open and transparent relationship with an enhanced opportunity to reduce exposure to controversy, penalties and interest payments, while freeing up valuable resources. A strong risk assessment takes into account the aggressiveness of tax positions taken on the return, adequacy of internal controls and processes, and overall approach to tax governance. Behavioral factors, such as responsiveness to requests for information and documents, transparency and collaboration should also be considered. This is especially true in the countries that have adopted (and continue to rapidly embrace) the OECD's concept of the enhanced relationship. Taxpayers that are more transparent, collaborative and responsive may be granted a number of benefits that include:

- ▶ A more impartial approach to assessing tax positions
- ▶ A willingness to work together to seek the appropriate conclusion related to tax treatment
- ▶ A willingness to listen objectively to create a better understanding or "commercial awareness" of the factors that drive business decisions
- ▶ An approach to tax examinations that can result in a resolution at the earliest appropriate time and level

This can help taxpayers get to the final answers more quickly, with fewer resources expended, and it is becoming increasingly attractive to taxpayers; 72% of tax executives in our survey said that their company is pursuing a more open and collaborative relationship with one or more tax administrations. From the perspective of tax administrators, 79% reported that they felt business taxpayers have embraced the concept and demonstrate the behaviors that are conducive to the enhanced relationship.

Other ways to engage

In addition to dealing with tax authorities on specific positions or matters regarding controversy, business leaders now have increasing opportunities at the global, regional and country levels to participate in forums and joint meetings with tax authorities that seek an external stakeholder view of their processes or guidance for particular issues. We think active participation in these types of settings across all key jurisdictions will help inform both tax administrator and taxpayer, creating a better understanding of one another's interests and business objectives to find the win-win solution.

We think active participation in these types of settings across all key jurisdictions will help inform both tax administrator and taxpayer, creating a better understanding of one another's interests and business objectives to find the win-win solution.

► Evaluate global resources, processes and systems for tax risk management

All companies want to reduce tax risk. Many strive to ensure that when a tax risk or tax controversy arises, they have the right framework of systems, processes and resources in place to identify, track, report and manage the issue in order to minimize any resulting financial and reputational damage.

Creating, implementing and operating a framework approach of this nature is a formidable challenge for any tax function, however well-resourced and well-intentioned. For large multinationals, the approach ideally needs to be global in scope, have the right governance and controls in place, be effectively resourced and be aligned with other tax function processes.

On the “input” side of the equation, the framework must parse and assess shifting tax legislation on one side of the coin and a rapidly evolving business strategy on the other, which can create reams of different data points across hundreds of tax returns. On the “output” side, it must be supported by the right tools and enablers that allow for the aggregation and reporting of all potential risks and controversies wherever they appear. This is a real challenge when set against the backdrop of trying to manage day-to-day tax function operations in a complex, shifting world.

People

Managing tax risk and controversy has clearly become more of a focus – and additional burden – in the last few years. The companies we surveyed tell us the time they spend on managing risk and controversy has grown by around 20% since 2008. Indeed, 75% expect tax risk and controversy to become more important to them in the next three years. In terms of proactive tax risk and controversy management, 81% of all companies reported that there was a readily identifiable individual who has overall responsibility for managing tax risk within their company (down from 88% in 2008), but the role was fully dedicated in only 46% of all cases. This intense resource strain within the tax department has prompted many large companies to create a tax controversy officer role, with this role tightly aligned to the responsibilities of the tax risk officer.

What success looks like

- ▶ The proper corporate governance is in place over tax risk and controversy management, illustrated by the existence of aligned and complementary tax risk policy and tax controversy policies.
- ▶ Underlying and supporting the effectiveness of the policies, a global framework approach or “Tax Charter” is in place, detailing all processes, controls, roles, responsibilities and tracking protocols.
- ▶ The right talent and resources to deal with controversy and risk management – across a matrix of leadership, geographic and technical dimensions – is obtained, retained and appropriately trained on an ongoing basis.
- ▶ Processes and procedures are in place for tax risk management across the entire tax lifecycle of planning, compliance, provision and controversy, and those processes are embedded as far upstream in the decision-making process as possible.
- ▶ Tax risk and controversy considerations are embedded in all aspects of business activities that have tax compliance implications.
- ▶ Tracking technology is in place, with issue identification and reporting protocols operating in close alignment and interconnectivity to any global compliance and reporting tool or platform already in place.
- ▶ Processes and procedures are constantly reviewed and tested by the internal audit group. Opportunities for efficiency and improvement are constantly sought.
- ▶ Global connectivity of those responsible for controversy management is in place via regular calls, meetings and knowledge-sharing measures.
- ▶ All resources are knowledgeable about tax administration practices and procedures in key jurisdictions and have protocols in place to share information and collaborate.

“You have to preserve the robustness of tax risk management, whatever the economic climate, and that is what we regard as one of our two key pillars of what we do in our tax function. So I think it is important to make sure that even when costs are under pressure you have appropriate resources to manage risk properly.”

– Global tax director of a FTSE 100 company

Thirty-seven percent of the companies we surveyed acknowledged that a lack of time contributes to their levels of tax and controversy risk, up from 23% in 2008. When asked to identify their leading source of tax risk, responses such as: “Implementation of processes; our teams are not currently sufficient in terms of their level of resources and quality, so there’s a danger of failing to control all risks” were common.

Companies also struggle to train the people they have and keep them up to date with shifting legislation. Managing resources overseas, particularly in emerging markets, presents particular challenges. A global company often needs to consider either hiring suitable skilled and experienced people locally or engaging an external adviser where the appropriate skills, relationships and cultural understanding may not already exist. For companies struggling with time and resource constraints, it is often not just a question of the right skills but whether those skilled team members are sufficiently focused and have the time and knowledge to execute on strategy.

Processes

Ideally, companies should have processes in place to identify and evaluate the risk of the tax positions they take before tax returns are filed. This means designing, embedding and maintaining controls and procedures as far upstream in the decision-making process as possible and not treating tax risk and controversy management as a separate or distinct activity within the tax function.

The four major tasks of the corporate tax function embodied in the tax lifecycle – planning, provision, compliance and controversy – occupy about 90% of the tax function’s time and so provide opportunities to proactively manage tax and controversy risks. In order to effectively manage these risk issues across the enterprise, many leading companies have adopted an approach that considers the entire tax lifecycle as an integrated process. Before making a strategic or tactical decision on any type of tax, the decision’s effect across each phase of the tax lifecycle is considered.



Tax directors and CFOs:

20%

more time is being spent on managing tax controversy, compared to 2008.

A lack of time was viewed by survey respondents as being the leading barrier against implementing effective tax risk management.

77%

expect tax risk and controversy to become more important to them in the next three years.

81%

of companies report they have a readily identifiable individual who has overall responsibility for managing tax risk within their company.

However, that role was fully dedicated in only 46% of all cases.

87%

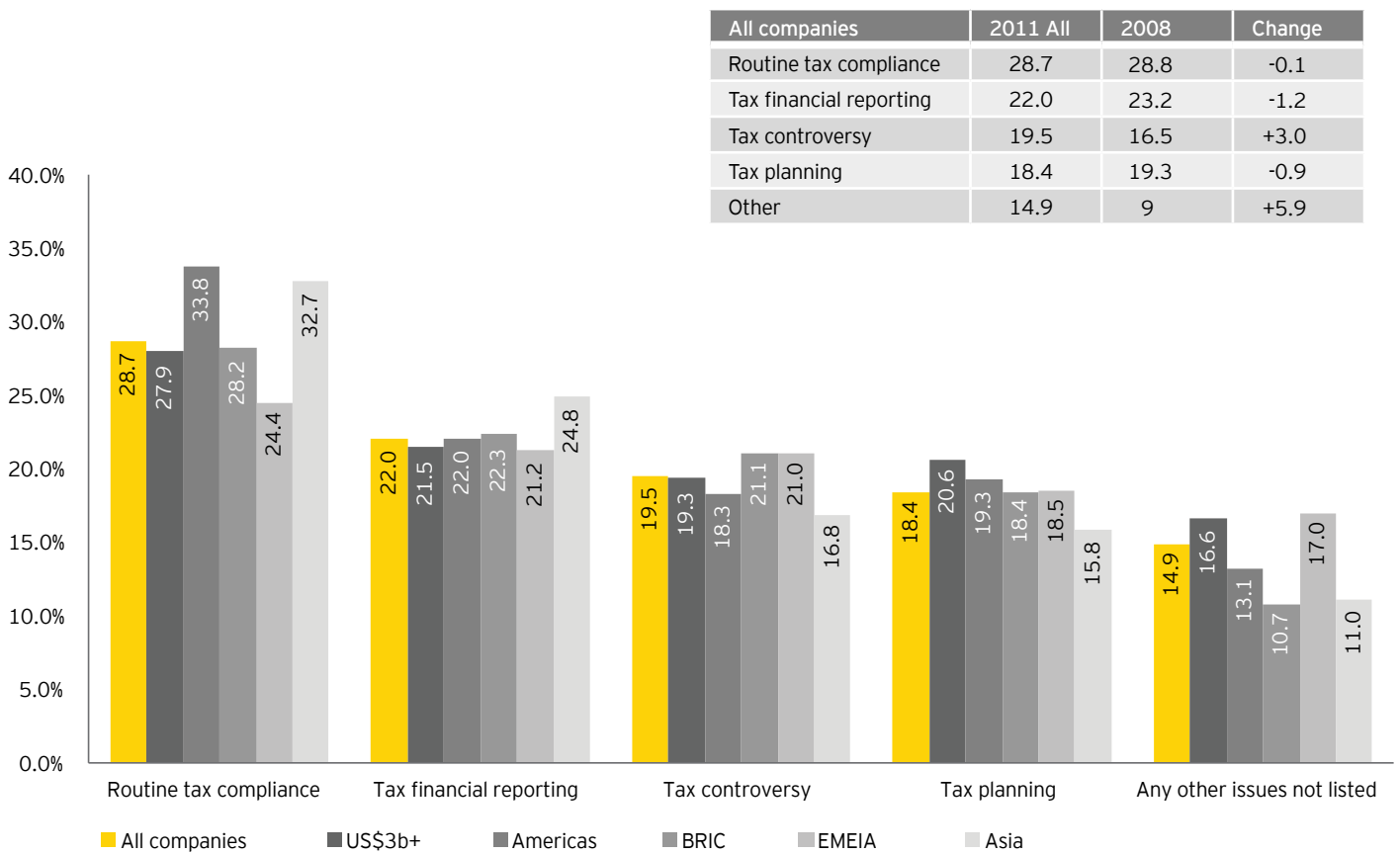
of tax directors felt that the tax function involvement in the general business planning and strategy process was either significant or adequate, while 27% of CFOs felt the tax function involvement was insufficient.

Only **38%** had a process improvement program in place designed to integrate the tax function more closely with the wider business.

66%

use internal audit to regularly test and review their tax processes.

Figure 8. Companies: What percentage of your overall tax function time is spent on each of the following issues?



Aligning with the business

To have the ability to identify these strategic or tactical decisions, the tax department must maintain the closest possible relationships with those responsible for general business planning. Our survey, however, shows a distinct divergence between the views of tax directors and the company CFO: 87% of tax directors felt that the tax function's involvement in the

general business planning and strategy process was either significant or adequate, while 27% of CFOs felt the involvement was insufficient. Only 38% of all respondents reported having a process improvement program in place designed to integrate the tax function more closely with the wider business, suggesting the tax director's necessary focus on managing the shifting external environment may come at the expense of opportunities to play a more proactive role in advising the wider business.

Testing

Processes and procedures to manage tax risk and tax controversy are only as good as the organization's ability to measure, test and, if necessary, refine and improve them. To be truly objective, such measurement and testing must be carried out by different individuals than those responsible for their initial design, implementation and operation. These oversight duties are increasingly and steadily falling to the internal audit function. Sixty-six percent of respondents reported using internal audit services to regularly review and test tax positions in the survey, up from 56% reported in prior versions of the same survey in 2008 and 47% in 2006. Interestingly, whether tax risk processes were tested by internal audit or by the tax department itself, only 42% of respondents reported that such testing identified any weaknesses all of the time. A larger proportion – 54% – believed testing identified weaknesses just some of the time.

Of course, alongside the measurement and testing itself, the most effective processes and procedures tend to follow the mantra of process improvement. Through constant feedback to the right individuals, corrective action can be implemented upon those processes deemed to be operating at a sub-optimal level.

Technology to manage risk and controversy

The rapid development of web-based technologies is helping tax directors manage their risks by providing new ways to identify, track, store and report on different tax activities across multiple locations. Global workflow and tracking platforms are an imperative to navigate the incredibly diverse and challenging compliance and reporting obligations companies increasingly face. With so many filing and reporting obligations to be managed through the year, accurate identification, tracking and exception reporting can provide some degree of comfort that obligations are being met.

The leading companies are also taking the same technologies one step further and using them to identify, track, aggregate and report tax risks and controversy. This approach takes many forms and includes the tracking UTPs around the world, alongside a range of other tax “triggers” that may result in future controversy if left unmanaged. These programs also allow companies to catalog and manage individual controversy issues through information and documentation request, tax audits and dispute resolute resolution, whether through administrative resolution processes or via litigation.

Alongside workflow and tracking capabilities, many leading tax departments are also rapidly investing in knowledge management capabilities designed to help source, categorize, store and expose vast volumes of content and information. This content and information can be explicit, such as information available from content vendors, professional services firms and from government and tax administrations detailing change that must be factored into decision-making processes, or it may be implicit. Implicit knowledge represents the collective insight and experience of your own people inside and outside the company on how an issue may be dealt with most effectively. The leading companies realize that the highest value lies within molding implicit and explicit knowledge together into a single reference system with a clear taxonomy.

► Address tax risk and controversy at a strategic level – and execute well

Developing wide-ranging, global tax risk and controversy management strategies – and then executing them well – can reap significant benefits for a company beyond basic financial savings. A strategic approach to tax risk and controversy management isn't just about managing active controversies. It also helps companies anticipate potential controversy issues, avoid disputes before they occur and effectively mitigate the effect of any conflicts that do arise. This reduces financial, resource and reputational risks and provides opportunities to remediate and secure the enterprise against future reoccurrences.

Focus where tax administrations are focusing

A strategic approach to managing tax risk and controversy should differentially focus on exactly those issues that tax administrators are focusing on. According to the tax administrators we surveyed, those leading issues were transfer pricing, indirect taxes and international structures. The growing focus by policy-makers and tax authorities merits close inspection and action by companies. Controversy related to indirect taxes is growing at a quick pace and is increasingly causing companies to adopt a global approach to indirect tax management.

What success looks like

- ▶ Criteria are developed and put in place for the proper identification of those business transactions that should be managed proactively to avoid or mitigate controversy.
- ▶ An inventory of current controversies is developed and processes are put in place to actively update the inventory and report on status to key stakeholders.
- ▶ A process is put in place to identify those business transactions and decisions that may result in future controversy. The process is supported by key reporting, communication and tracking protocols or technology.
- ▶ A priority order for jurisdictions that have significant or potentially significant issues is developed, alongside analysis of the countries that may have shared interests in these issues.
- ▶ An analysis is made of the legislative and regulatory environment, policies for exchanging information and strategic direction in which the tax administration is headed in key jurisdictions.
- ▶ For each key jurisdiction, a technical risk assessment of tax return positions is carried out that takes into account existing documentation and enforcement activity.
- ▶ For each issue, an assessment of the potential multiyear and multijurisdictional effect of both the issues and the means by which they are resolved is in place.
- ▶ A review and assessment is made of opportunities to use resolution tools and administrative processes that may facilitate closure of disputes and resolution of issues.
- ▶ A focus is in place on developing and improving the relationships with local tax authorities in key jurisdictions by demonstrating appropriate behaviors of transparency, collaboration and accountability.
- ▶ Tax controversy risk management protocols and processes are built into tax planning and compliance processes.

These disconnects merit close attention, particularly as tax administrators and tax policy-makers alike tell us that indirect taxes will be more important to them in the future.

The very complexity of VAT lends itself to future controversy. Errors mean that VAT charged by and paid to suppliers is not reported and recovered on the VAT return; recovery of input VAT may be blocked by tax authorities because the supplier's VAT invoice is invalid, and VAT may be recovered by the business when it is not entitled to do so. These are just a few examples of the many potential sources of controversy related to VAT.

This rising importance of global indirect taxes stands in stark contrast to a historic pattern of "benign neglect" of indirect tax management among most global corporations. Most global companies' central finance, tax and legal departments had, until recently, accepted the idea that they did not have (or need) full global visibility and control over the wide range of indirect taxes, particularly in jurisdictions outside their home country or in emerging markets.

Managing indirect taxes

Although companies in our survey reported indirect taxes are their second leading area of tax risk, they also reported that these taxes were managed by the finance or accounts department more of the time (48%) than they were managed by the tax department (44%). They also reported that a global indirect tax officer was resident in the tax department of only 21% of companies. Interestingly, this percentage fell to just 12% in the largest companies (those with US\$5 billion in annual revenues or more), indicating that the larger the company, the less likely they were to have a dedicated indirect tax officer. Looking forward, increasing the number of resources focused on indirect tax in the next two years was foreseen by only 30% of companies. These disconnects merit close attention, particularly as tax administrators and tax policy-makers alike tell us that indirect taxes will be more important to them in the future.

Looking back, looking forward

A robust approach to tax risk and controversy management will cover all time phases; identification and management of prior year positions and returns already filed with the authorities needs to be considered, as do processes to identify and manage positions that may trigger future controversy. Past, present and future events all need to be considered.

For positions that are reflected in tax returns that have already been filed, companies should identify, quantify and evaluate potential tax risks and exposures in light of existing documentation levels and the enforcement approach occurring in the filing jurisdictions. Larger companies are making it a leading practice to create such a global, collaborative space within which to carry out this task. These platforms also provide the companies with comprehensive reporting capabilities and a true sense of global visibility.

Covering the bases

Clear identification of issues in this manner provides the opportunity to mitigate the risks associated with the areas of exposure, such as by enhancing documentation and considering dispute resolution options or voluntary disclosure opportunities.

Geographic dimension must also be considered, of course. While it may be tempting to embed risk management processes at the local level, elevating oversight responsibility to the global or regional level provides higher levels of visibility and accountability. Whichever approach is chosen, it is critically important to put in place the right tracking, communication and reporting protocols. Like any management exercise, good decisions can only be made if they are informed by timely and accurate information.

Specific response mechanisms for each jurisdiction should be put in place to ensure consistent information is provided to all taxing authorities involved. This is especially important in an era where taxpayer data is routinely exchanged among tax authorities, often at the press of a computer key.

Managing examination requests, tax audits

A tax audit in a single jurisdiction typically involves managing a number of moving pieces, but navigating tax audits in multiple jurisdictions can be even more challenging. This is especially true when competition between countries for revenue from the same dispute heightens the possibility of double taxation, particularly if relevant treaties are not available. Again, whether managed centrally, regionally or locally, companies should establish protocols for responding to examination requests and documenting the existing status of tax audits. Specific response mechanisms for each jurisdiction should be put in place to ensure consistent information is provided to all taxing authorities involved. This is especially important in an era where taxpayer data is routinely exchanged among tax authorities, often at the press of a computer key. Quickly and efficiently sharing the same information inside your corporation across geographies is the logical response when tax authorities are doing the same. It's also important to be able to quickly access shared knowledge of the facts behind any positions under review to better respond to or defend positions with the tax authorities.

How hard to push the issue

The relative merits and weights of issues that advance to the controversy stage should be analyzed. In addition to evaluating the tax position being challenged, a corresponding analysis should be made of the merits of disputing each issue with the tax authority or tax authorities. This research involves understanding how the authorities have treated similar issues in the past, as well as gleaning broader insights into their cultural approach to enforcement generally, including how they handle post-filing resolution through processes such as appeals, mediation and arbitration.

This multifaceted analysis enables better-informed decisions about the right way to settle any disagreements. Within this process, it is worth emphasizing that particular attention should be given to the available dispute resolution options. Tax authorities are increasingly relying on alternative mechanisms to make tax administration more efficient, and in many cases, a compromise settlement may be worth more to them than a protracted dispute with no guaranteed outcome.

Managing bilateral and multilateral issues

Where an issue is cross-border in nature, be sure to consider how a settlement or adjustment in one jurisdiction may affect other jurisdictions. The approach to issues such as the Mutual Agreement Procedure in both countries should be actively understood, and modeling the impact of various settlement scenarios may be helpful to make sure the right overall settlement is achieved from a global perspective.

Making use of dispute resolution processes

Tax administrators will have different means to prevent or resolve disputes. These can range from the issuance of broad guidance, which can help taxpayers avoid controversy by following those directions, to individually negotiated agreements on how to treat a specific issue for a specific taxpayer that might otherwise result in controversy or audit.

Just like taxpayers, most tax administrations have finite resources and are increasingly seeking their own efficiencies. Many are even genuinely interested in reducing burdens on compliant taxpayers, and so many of these same efficiencies can be leveraged to the benefit of the corporate tax function. Leading companies will actively review the ever-developing variety of pre-filing opportunities to obtain greater certainty across key jurisdictions, freeing managerial time and resources that can be redeployed to more value-added areas.

We think that successful tax risk and controversy management requires both a strategic plan and tactical delivery in an extremely complex and ever-changing environment. Operating in multiple countries with different tax authorities, tax laws and processes make the necessary expansion and refinement of resources, processes and systems increasingly challenging.

► Make strong corporate governance in tax a priority – it is to tax administrators, and it makes good business sense

Tax controversy today can result in larger financial effects than ever before. And the potential for a tax risk or a tax controversy to become a reputational risk has grown significantly. Companies are on the defensive due to a combination of generally negative public perception and media commentary about their tax affairs that is amplified by social media tools able to globally spread messages – even false ones – within seconds.

Given these two risk factors, it is no surprise that our survey respondents indicated that improving corporate governance in tax has been a key focus in the last three years.

Jeffrey Owens, Director of the OECD's Centre for Tax Policy and Administration argued in *Good Corporate Governance: The Tax Dimension*⁹ that "It is a striking fact that while taxes often represent a very significant portion of a company's profits and potentially huge risks (tax adjustments may sometimes lead a company to bankruptcy), there is generally, in practice, limited involvement of the board and even more limited involvement of the shareholders in the management of a corporation tax strategy."

Companies hear the call to action

We think that picture has changed significantly. While the push by tax administrations to elevate tax strategy up the boardroom agenda has been strong and the global financial crisis has had a catalyst effect, we believe that companies are rapidly increasing their levels of corporate governance in tax simply because it makes good business sense to do so.

The tax function wants the board and audit committee to understand that the tax risk environment has shifted. Likewise, the board and audit committee don't want to read about their company's tax affairs on the front page of a newspaper or have to respond to unexpected calls for funds.

Leading companies have put in place robust, regular connectivity and communications between tax executives and their boards and audit committees. This communication is two-way, keeping the tax function up to date on key strategic moves and related transactions. But interestingly, both company CFOs and the audit committee members indicate that they are not feeling the same heightened levels of tax and controversy risk that tax directors report. Has the tax function perhaps done too good a job at promoting corporate governance in tax by convincing their superiors the situation is under control? Or is their message that the environment is more dangerous missing the mark?

What success looks like

- ▶ The board and audit committee receive regular reports regarding the tax implications of specific business decisions.
- ▶ This communication flows both ways so that the tax function actively receives information on strategic direction and tactical transactions.
- ▶ The board and audit committee have a good understanding of the structure, processes and policies related to tax controversy and risk management within the company.
- ▶ The board and audit committee have a good understanding of how the enforcement landscape is changing and what tax authorities are focusing on.
- ▶ The board agrees on what constitutes an appropriate response to any negative media coverage relating to taxes.
- ▶ The tax function is prepared for board-level inquiries related to tax risk management strategies as well as inquiries related to specific transactions and issues.
- ▶ The risk tolerance of the company is aligned and communicated to any external advisers.

⁹ *Good Corporate Governance: The Tax Dimension*: OECD: 2006. <http://www.oecd.org/dataoecd/21/36/37207911.pdf>



Governments increasingly expect corporate boards to understand their responsibilities with regard to their tax strategies and outcomes in order to fulfill their wider corporate governance responsibilities. The tax administrator community has a clear agenda: it wants to use corporate governance in tax as a lever to increase compliance levels and to reduce tax avoidance.

As a result, corporate tax executives increasingly need to act as “tax diplomat,” managing a dynamic set of relationships, including other stakeholders in the corporate governance structure and the tax authorities themselves. Some tax administrators have engaged CEOs and CFOs, as well as corporate boards, in dialogue regarding tax risk. In the United States, IRS Commissioner Douglas Shulman acted to ensure company CEOs fully understand the gravity and implications of entering into the recently formalized CAP, while the Canadian Revenue Agency (CRA) has recently been questioning large business taxpayers on their approach to corporate governance in tax issues. Australia’s tax authority has expanded this model to take their view of a company’s tax corporate governance capabilities into account when risk rating the company, while the United Kingdom Senior Accounting Officer (SAO) certification takes a slightly different angle, pinpointing responsibility for tax reporting onto a single individual.

“I am suggesting that you, the leaders of your organizations, should have a mechanism to oversee tax risk as part of your governance process – the audit committee needs to know and influence what tax posture the tax planners are taking.”

– *Dave Hartnett, HMRC Permanent Secretary for Tax – United Kingdom*

“By being transparent, accountable and engaging constructively with us, you demonstrate good corporate citizenship and lower your tax risk profile, with the benefits to reputation that follow. Our experience with corporate governance and relationship-based products – such as our annual compliance arrangements – show that better relationships with large businesses lead to fewer audit interventions and improved certainty for both of us.”

– *Australian Taxation Office: Large business and tax compliance booklet – August 2011*

Questions for the board and audit committee to consider

- ▶ Are you confident that your tax processes and controls enable your group to meet its tax compliance and reporting obligations?
- ▶ Are you comfortable that the level of tax you pay in all jurisdictions is in line with your business results? Could it be construed otherwise, and if so, how do you feel about it?
- ▶ Are there indicators that suggest your company's tax payments are lower than current economic conditions suggest they should be?
- ▶ Are you comfortable that the tax function has clear and close input into major transactions and business plans?
- ▶ Are you aware of any material timing or permanent differences in the group's tax effect accounting, and if so, are you comfortable with the reasons for those differences?
- ▶ Are there any areas of major disagreement between your company and a taxing authority? Are you satisfied with the way they are being handled?
- ▶ Have any potential additional tax liabilities been adequately provided for?

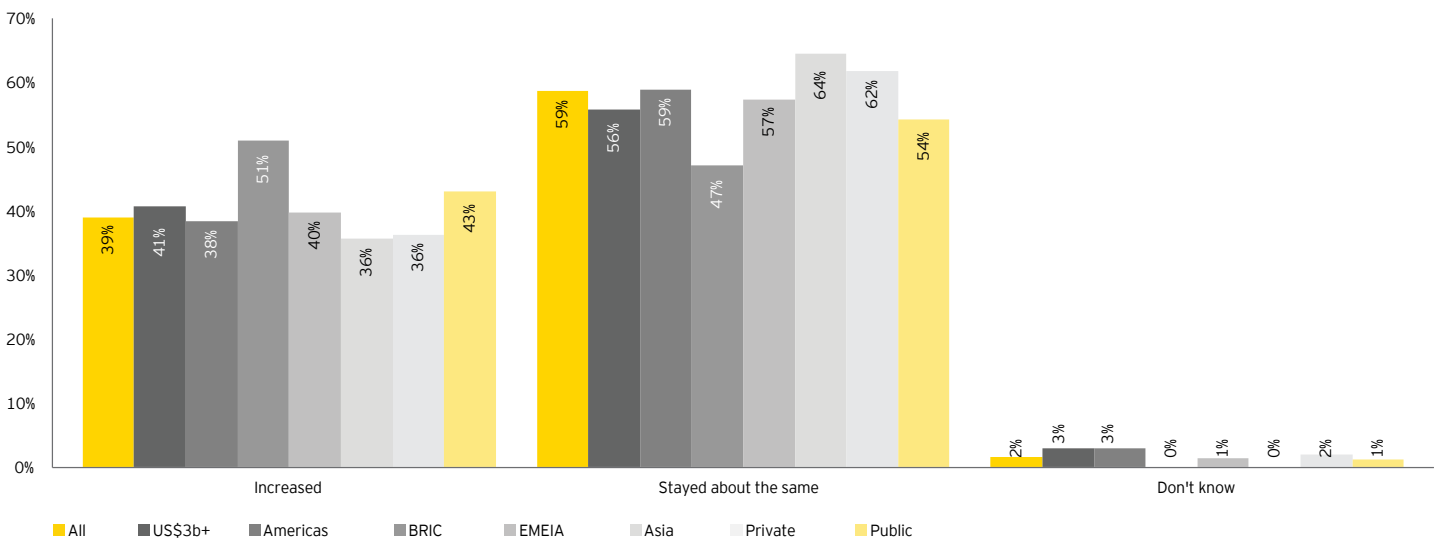
What corporate governance in tax looks like today

So what does corporate governance in tax look like? Tax directors in our survey clearly feel that their boards are supporting them. Only 9% reported that a lack of board support was an impediment to successfully managing tax and controversy risk, down from 13% in 2008 and 17% in 2006. Some 98% of all respondents reported that internal oversight of tax matters has either increased or stayed the same in the last two years. Board-level oversight also increased more markedly in companies based within BRIC countries, reporting some 12 percentage points above the average score for all companies globally. Some 66% of respondents globally reported that they felt their audit committee has a sufficient grasp of the key issues related to tax risk.

The audit committee agrees

This feeling that the audit committee “gets it” is certainly borne out by audit committee members themselves. Tax was reported as a top five risk by 60% of audit committee respondents, and 94% reported their overall focus on tax issues had either stayed the same (41%), grown (39%) or grown significantly (14%) in the last two years. Only 4% reported a decrease in focus during that same period. Eighty percent agreed or strongly agreed that the audit committee on which they sit has a good understanding of the level of tax risk that is acceptable to the company, with only 6% disagreeing or strongly disagreeing. Some 70% agreed or strongly agreed that the audit committee understands the processes that management uses to identify, measure and oversee various categories of tax risk, while 61% agreed or strongly agreed that the audit committee plays a strong governance role in the company’s tax affairs and tax strategy.

Figure 9. Companies: Over the past two years, has your company CEO’s and/or board of directors’ oversight relating to tax risk and controversy management increased or decreased?



1% or less of the respondents selected decrease as their response.

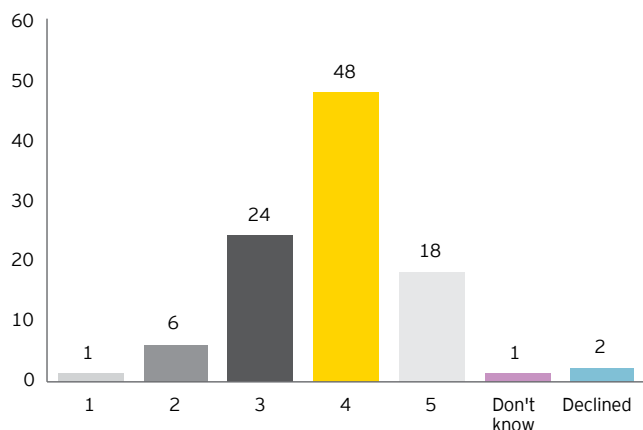
"I agree that oversight of tax issues needs to occur at the boardroom level. How a company manages tax risk can affect its financial performance and reputation, and CEOs and boards of large businesses are increasingly considering tax risk management as part of their overall corporate governance."

– Linda Lizotte-MacPherson –
Commissioner and Chief Executive
Officer, Canada Revenue Agency¹⁰

Audit committee members also told us they felt well-served by the level and quality of communication from the tax function. Fifty-nine percent receive regular updates from their tax executives on issues related to tax risk specifically (although it's perhaps worrisome that 41% don't). On a scale of 1 to 5 (with 5 being the most positive response), 66% of audit committee members scored the appropriateness of information received as a 4 or a 5.

While the picture painted by audit committee members seems to be positive, it is perhaps again a concern that company CFOs do not feel the same levels of heightened risk as their tax directors. CFOs, for example, do not seem to fully appreciate how much more risk averse their tax directors have become in the last three years – and how risk averse they foresee themselves being in coming years. Fifty-one percent of tax directors felt they had become more risk averse during the course of the last two years, while only 40% of CFOs felt their company had become more risk averse. With 76% of tax directors feeling that their level of risk tolerance is unlikely to change in the coming two years and as CFOs bravely forge ahead to drive market share increase, all parties must make sure that this disconnect does not occur to the detriment of strong corporate governance in tax matters.

Figure 10. Audit committee members: On a scale of 1 to 5 (with 5 being the most positive response), how would you rate the tax information the audit committee receives in terms of appropriateness?



¹⁰Interview with Ernst & Young. See www.ey.com/tpcquarterly

► Stay connected with global legislative, regulatory and tax administration change

Companies tell us with a resounding voice that the pace, volume and complexity of tax policy, tax legislation and tax administration change have become a larger source of risk and uncertainty than ever before. At the same time, having the ability to identify, communicate and assess the effect of these changes can provide a business with many advantages. Compliance risks can be reduced. High-quality, accurate knowledge can support tax planning activities. And the general business planning agenda can be supported with knowledge of the tax policy environment into which you may be investing. In that regard, it is important to clearly differentiate between what has happened – which can be achieved simply by monitoring newly published legislation – and what might happen in the future, which requires highly specialized and insightful monitoring of the direction of tax policy.

Identifying opportunities for policy development

In such a quickly changing global economy, new tax legislation around the world is impeding the successful execution of commercial decisions with greater frequency, often in ways unintended by the policy-makers passing the laws.

Actively monitoring and assessing the effect of changing tax policies can provide a valuable contribution to the business planning process. Extending this monitoring to identify opportunities to engage with government on collaborative policy development can have additional benefits, and many countries demonstrate a willingness to work with taxpayers – either individually or as part of some form of consortium or industry grouping – to develop policy alternatives.

Developing tax authority intelligence

It is also highly beneficial to monitor the development and effect of new programs, processes, guidance and focus areas by tax authorities themselves. This “tax authority intelligence” enables companies to both refine and improve their tax risk and controversy management strategy, increasing their levels of pre-controversy protection and identifying opportunities to increase certainty for the business.

What success looks like

- ▶ All major tax areas for potential tax policy, legislative and regulatory change, and tax administration focus areas in key jurisdictions are closely monitored, and change is integrated into tax risk planning.
- ▶ The local dynamics of potential tax changes, alternative policy designs and ways in which the changes link to global tax policy trends are all understood.
- ▶ The implications of potential change upon business operations are constantly assessed.
- ▶ Clear lines of responsibility, lines of communication and some form of knowledge sharing is put in place among all those who are responsible for monitoring and anticipating tax policy and legislative change.
- ▶ The tax information and insights provided by outside providers is fully leveraged and shared within the organization.
- ▶ Active engagement is considered with policy-makers over sources of business impediment or future controversy.

The growth of alternative dispute resolution processes being developed, shared and adopted around the world provides a good opportunity to do this. These tools, which are available to support both pre- and post-filing activities, often drive an improved relationship with the tax authority, an earlier sign-off on the annual tax return and higher levels of certainty.

People, processes and technology must all be considered and must all operate seamlessly together.

It is not just country monitoring that is important

It is equally important to monitor the activities and recommendations of global or supranational bodies such as the European Union, IMF, OECD and World Bank. Doing so allows tax harmonization efforts to be identified, captured, shared and assessed long before they are implemented. Issues developed through these bodies tend to take a long time to come to fruition, providing companies with substantial opportunity to model the effects against current tax strategy and business decisions.

Initiatives driven by bodies such as the OECD's FTA and other collective institutions (such as JITSIC, CIAT in the Americas and CIOT in Europe) should be similarly monitored and assessed because they also provide an early warning system of what may be to come at the local level. The regular OECD Current Tax Agenda¹¹ publication, with issues spanning the entire spectrum of tax types, taxpayers and tax administration processes, provides some good examples of their activities. Most recently, these groups have focused on high net worth individuals, taxpayer codes of conduct, losses, offshore disclosure schemes and VAT, among other areas. The OECD agenda is constantly rolling, and so close monitoring is an imperative for multinational companies. Staying in touch with more regional bodies such as CIAT and CIOT is harder but not insurmountable. Indeed, the secretariat of each body welcomes the close involvement of business and will typically have in place relationship management protocols.



¹¹OECD Current Tax Agenda: see www.oecd.org/tax

Leading practices to consider

Successfully identifying, capturing, storing and sharing the varied types of knowledge that support your business and tax strategy requires the same overall approach as the successful operation of that very tax strategy. People, processes and technology must all be considered and must all operate seamlessly together.

People

From a personnel perspective, it is more critical than ever to place the right people with the right technical skills in the right locations. Individuals will need to be nominated as technical knowledge specialists, and they should be measured and rewarded on those competencies, alongside their other responsibilities. This means recruiting outsiders in cases where those people are not already present within the company. In addition, leading companies will forge stronger relationships with information technology personnel to build or purchase proper systems to store and re-access the accumulation of knowledge.

Processes

There are three key issues to consider from a process standpoint. First is determining what processes are already in place to identify, source, store, share and then maintain knowledge on an ongoing basis. Does the company have a knowledge council with either dedicated or rotating resources that are tasked with staying on top of specific tax technical issues? And how does the business ensure the knowledge assets being developed and stored are proactively shared and communicated across the tax function rather than simply pushed into a database to languish forever?

The second step is to ensure the appropriate processes exist to apply that knowledge to active tax positions, planning activities, transactions and compliance, and reporting obligations and to ensure that they are functioning properly. Just as knowledge is only useful if it is stored and shared, it is only useful when it is correctly applied to the relevant real-life situation.

The third, perhaps most important issue to consider in terms of process is that when it comes to understanding taxation, only a portion of the required knowledge – typically the legislation that has already passed – can be described as explicit and therefore readily available from multiple sources.

It is important to consider that in the cases of tax policy and tax administration processes and approaches, much of the required knowledge is implicit in nature – it is not reflected in data or hard facts but instead gained through experience and relationships. A monitoring process that leverages the experiences and insights of people who have previously operated in key government or tax administration positions is a leading practice. Developing such relationship-based knowledge networks increases the chances of receiving a deeper level of insight while also creating the opportunity to challenge the assumptions and perceptions of network members on an interactive basis.

Technology

From a technology perspective, the choices are relatively simple: does the business build a platform, buy one or leverage something that already exists from an external service provider? Whatever the choice, it is important to consider that even the most advanced, function-rich technology platform will wither and die if the right people and the right processes are not in place to support it.

Looking forward

We expect tax policies to continue to develop and evolve at a pace equal or higher than what we have seen in recent years, and that is confirmed by both tax policy-makers and tax administrators. These changes will likely continue to have major effects on decision-making, especially if tax reform comes to fruition in the United States or if efforts to harmonize tax policies in the EU are implemented. A clear and early perspective on potential changes can provide many benefits to companies. Changes in tax policy and legislation tend to foreshadow future controversy as tax administrations seek to understand and test the operation of new legislation. Governments and tax administrations are cooperating more closely; companies need to make sure they are too, not only to manage risk but also to identify opportunity.

4.

Conclusion and the 10 trends we expect to see unfold in the next few years





That the tax world has entered a period of greater risk and uncertainty is clear, with news of dispute and controversy arriving daily – and not just in the financial pages. In turn, our survey respondents see a lot more uncertainty and heightened enforcement activity ahead of them.

Tax policy and legislation are more difficult to predict than ever before. As many countries move to austerity measures, still others are considering a return to stimulus. But without exception, countries are either reforming existing tax regimes or introducing new legislation at an unprecedented pace. Tax administration without borders has become a reality. Against this backdrop, companies are increasingly putting the cash on their balance sheets to work, expanding their footprint – and adding to their portfolio of risk.

However, leaders always emerge, as do leading practices from which others may learn. With the benefit of the short time that has passed since what were – hopefully – the worst days of the financial crisis, we now have a clearer picture of exactly what these leading practices are. We think companies will continue addressing tax risk and controversy globally and strategically, redeploying their resources where they are most needed and refreshing their tax risk management approach and processes. These steps are the right way to reduce risk, increase certainty and enhance overall levels of operational agility.

As tax authorities sharpen their focus and capabilities, it will not be just the largest, most global companies who will be in their sights. Every company needs to prepare for increasing tax risk and consider how they will address the 10 trends we expect to unfold. The time to act has indeed arrived.

- 1** More countries will launch disclosure and transparency programs that are similar in nature to requirements in Australia and the United States.
- 2** The pace and scope of information exchange will increase, and companies will become aware more often of how their information has been shared between two or more jurisdictions.
- 3** New information reporting and withholding requirements will proliferate as countries look outside their own borders for leading practices they can adopt in order to drive higher levels of compliance.
- 4** More countries will leverage improved technology capabilities in a number of different areas of tax administration, including risk assessment processes.
- 5** The shift toward a range of indirect taxes will continue, and will fuel a wave of both planning opportunities and controversies.
- 6** The occurrence of double taxation will continue to rise for many differing reasons.
- 7** The emerging markets will increasingly have their voice heard, and the result will be the integration of many of their requirements into globally accepted transfer pricing guidelines.
- 8** The concept of enhanced relationships will rapidly spread outside the largest OECD countries, with more and more real-time auditing programs becoming available.
- 9** Strong corporate governance in tax will be rewarded by tax administrators in more countries.
- 10** There will continue to be an intense focus on the tax affairs of companies by the media and social justice activists.

5.

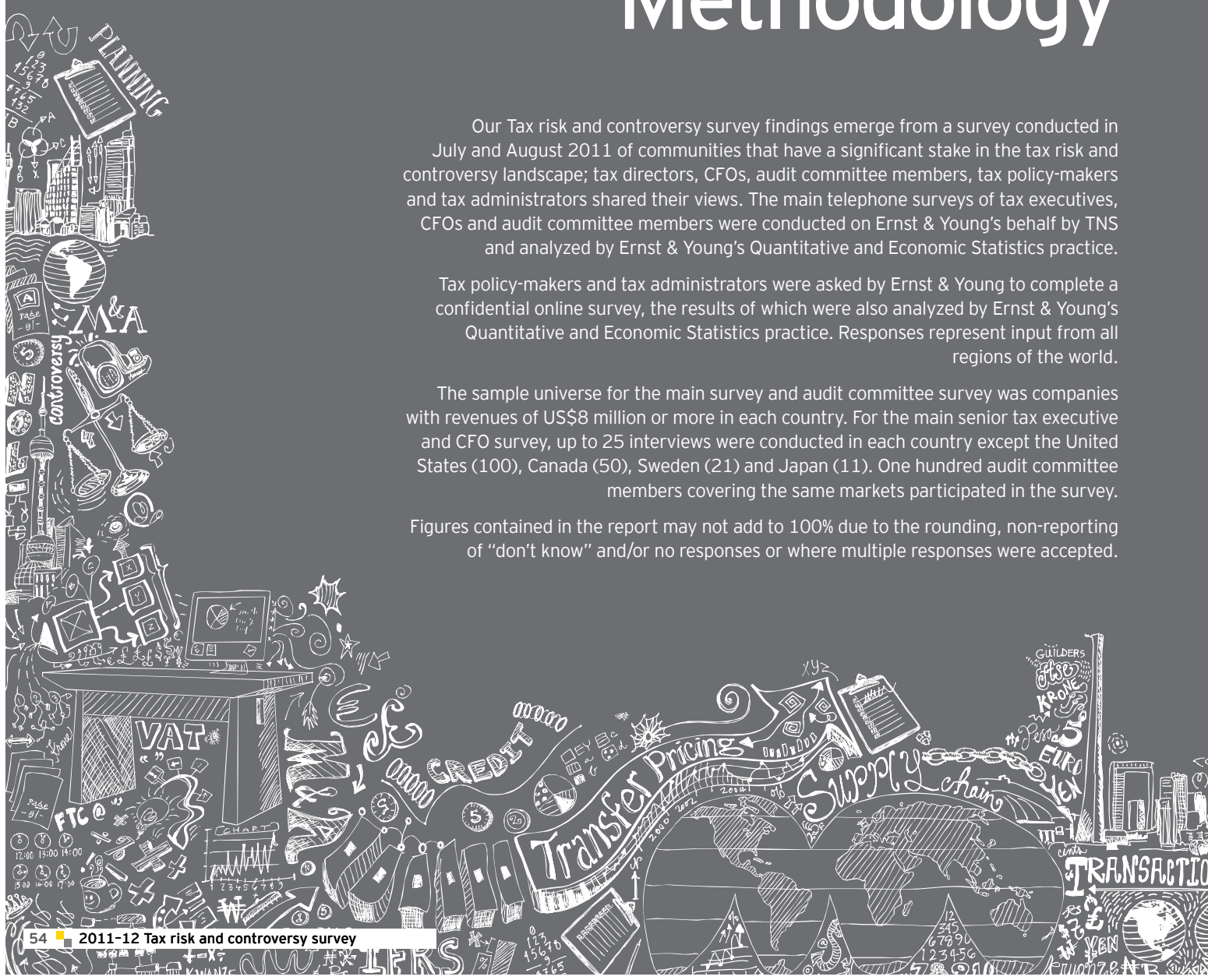
Methodology

Our Tax risk and controversy survey findings emerge from a survey conducted in July and August 2011 of communities that have a significant stake in the tax risk and controversy landscape; tax directors, CFOs, audit committee members, tax policy-makers and tax administrators shared their views. The main telephone surveys of tax executives, CFOs and audit committee members were conducted on Ernst & Young's behalf by TNS and analyzed by Ernst & Young's Quantitative and Economic Statistics practice.

Tax policy-makers and tax administrators were asked by Ernst & Young to complete a confidential online survey, the results of which were also analyzed by Ernst & Young's Quantitative and Economic Statistics practice. Responses represent input from all regions of the world.

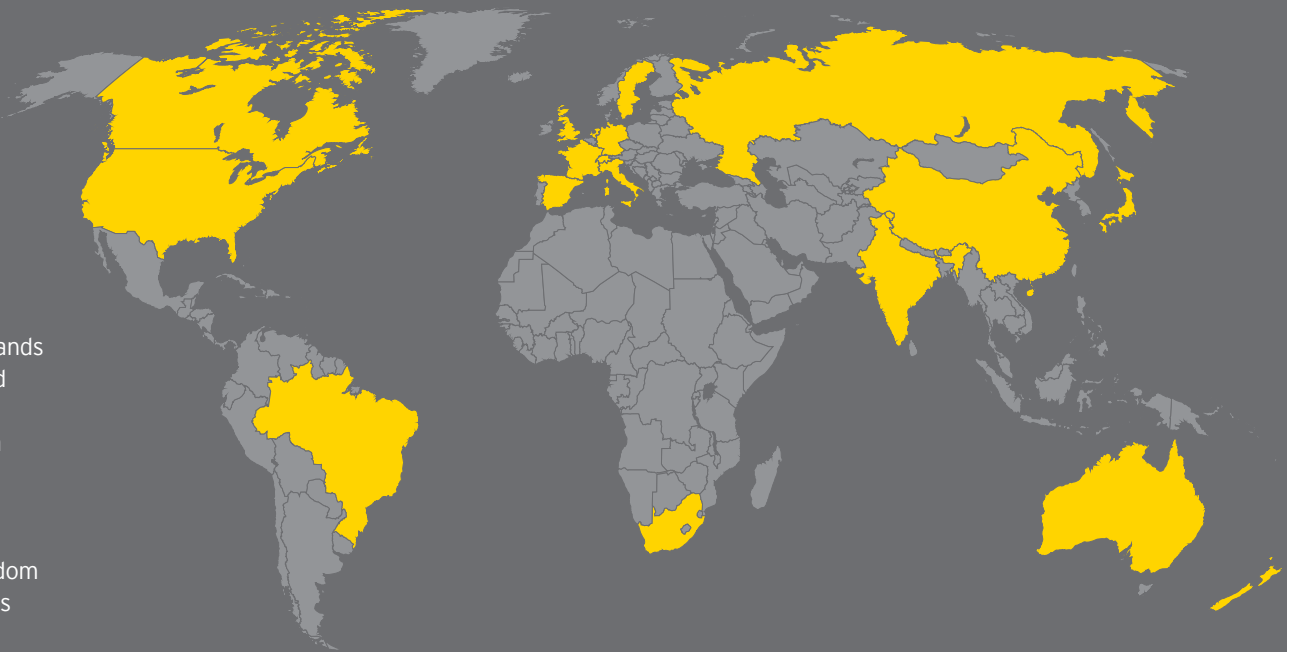
The sample universe for the main survey and audit committee survey was companies with revenues of US\$8 million or more in each country. For the main senior tax executive and CFO survey, up to 25 interviews were conducted in each country except the United States (100), Canada (50), Sweden (21) and Japan (11). One hundred audit committee members covering the same markets participated in the survey.

Figures contained in the report may not add to 100% due to the rounding, non-reporting of "don't know" and/or no responses or where multiple responses were accepted.



Countries that took part in the tax director, CFO and audit committee member surveys:

Australia
 Brazil
 Canada
 China
 France
 Germany
 India
 Italy
 Japan
 The Netherlands
 New Zealand
 Russia
 South Africa
 Spain
 Sweden
 Switzerland
 United Kingdom
 United States



Global and area leaders



United Kingdom
Chris Sanger
 Global and EMEIA Tax Policy Director
 Tel. +44 20 7951 0150
 Email: csanger@uk.ey.com



United States
Rob Hanson
 Global Tax Controversy Director
 Tel. +1 202 327 5696
 Email: rob.hanson@ey.com



United States
Tom Neubig
 Americas Tax Policy Leader and
 National Director of QUEST Group
 Tel. +1 202 327 8817
 Email: tom.neubig@ey.com



United States
Debbie Nolan
 Americas Tax Controversy Leader
 Tel. +1 202 327 5932
 Email: debbie.nolan@ey.com



Asia Pacific
Alf Capito
 Asia Pacific Tax Policy Leader
 Tel. +61 2 8295 6473
 Email: alf.capito@au.ey.com



Asia Pacific
Howard Adams
 Asia Pacific and Australia Tax Controversy Leader
 Tel. +61 2 9248 5601
 Email: howard.adams@au.ey.com



United Kingdom
Chris Sanger
 Global and EMEIA Tax Policy Director
 Tel. +44 20 7951 0150
 Email: csanger@uk.ey.com



EMEIA (Europe, Middle East, India and Africa)
Monique van Herksen
 Tax Controversy Leader, EMEIA
 Tel. +31 88 4071284
 Email: monique.van.herksen@nl.ey.com



Japan
Taichi Haraguchi
 Tax Policy Leader
 Tel. +81 3 3503 1100
 Email: taichi.haraguchi@jp.ey.com



Japan
Taichi Haraguchi
 Tax Policy Leader
 Tel. +81 3 3503 1100
 Email: taichi.haraguchi@jp.ey.com

Ernst & Young's Tax Policy and Controversy services

The economic downturn and its effect on profits is increasing the pressure on tax directors. Rapid globalization has brought increasing interconnectivity between businesses and permanent shifts in the flow of capital. Tax departments are bearing the responsibility of more corporate risk than ever. Tax now has a higher profile, not only with company management but also with shareholders, regulators, the media and other industry observers.

Developing a tax policy that resolves impediments to business needs a team that can work with government to explain issues, clarify objectives and achieve a successful outcome for everyone.

Ernst & Young's global tax policy network has extensive experience helping develop and implement policy initiatives, both as external advisers to governments and companies and as advisers inside government.

Our dedicated teams of tax policy professionals and business modelers help address your specific business environment and improve the chance of a successful outcome.

In addition, our global tax controversy network works with you to address your global tax controversy, enforcement and disclosure needs. We focus on pre-filing controversy management to help you properly and consistently file your returns and prepare the relevant backup documentation. Our controversy professionals leverage the network's collective knowledge of how tax authorities operate, and increasingly work together, to help resolve difficult or sensitive tax disputes. It's how Ernst & Young makes a difference.

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Effective compliance and open, transparent reporting are the foundations of a successful tax function. Tax strategies that align with the needs of your business and recognize the potential of change are crucial to sustainable growth. So we create highly networked teams who can advise on planning, compliance and reporting and maintain effective tax authority relationships – wherever you operate. You can access our technical networks across the globe to work with you to reduce inefficiencies, mitigate risk and improve opportunity. Our 25,000 Tax people, in over 135 countries, are committed to giving you the quality, consistency and customization you need to support your tax function. It's how Ernst & Young makes a difference.

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