



GLOBAL TAX SERVICES

The Governance of Tax

A Discussion Paper

TAX



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1 Purpose of this paper

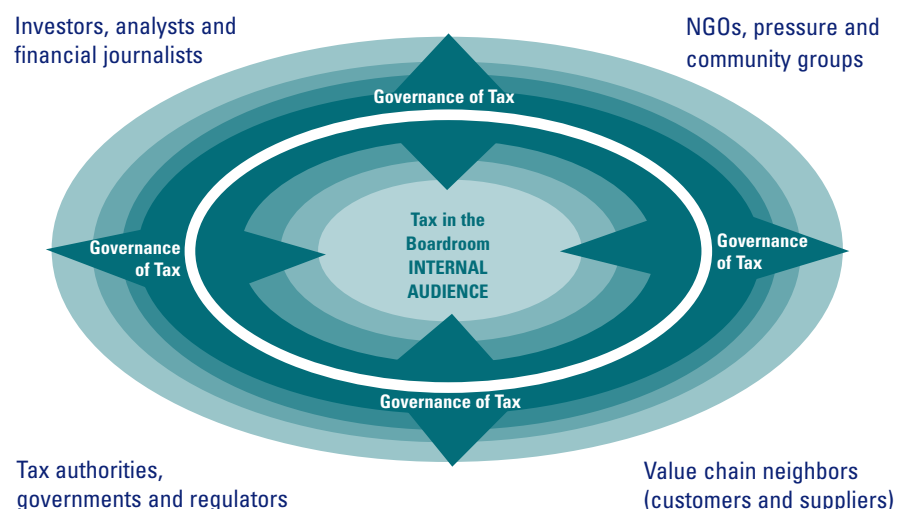
Two years ago KPMG International published a global discussion paper, *Tax in the Boardroom*, in which we put the case for elevating tax issues from their traditional obscurity in corporate tax departments, to the boardroom agenda.

The paper hit a nerve. It aroused interest and helped to provoke debate worldwide among academics, governments and regulatory bodies as well as business. Our argument has been generally accepted. Although tax is not yet established as a board issue throughout the world, it is well on the way to becoming so. We believe recent changes in the tax environment require the increased transparency of tax within companies to be extended to the relationships of companies with external 'stakeholders', such as regulators, tax authorities, investors and the media.

Tax in the Boardroom investigated the implications of treating the management of tax as a board level issue. This paper explores the implications of treating tax as a matter of concern to interested outsiders.

The Chief Financial Officers (CFOs) of major companies already spend significant amounts of time communicating with investors on financial issues.¹ Our purpose in this paper is to help them, their fellow directors, audit committee members and tax directors grasp the implications of, so that they can respond appropriately to, the growing demands of other external stakeholders for greater transparency on the management of tax.

Tax in the Boardroom initiated discussions about how to manage tax in a changing business environment. We hope this second paper will stimulate debate around the options open to companies in an environment in which the management of tax seems set to become one of the criteria by which corporate governance is judged by investors and important non-owning stakeholders.



Source: KPMG LLP (UK), 2007

¹ KPMG's Being the Best: Insights from Leading Finance Functions © Economist intelligence Unit September 2006

2 Recent developments

Heraclitus said ‘nothing endures but change’². Business leaders are all too well aware of this truth. Their competitive environment, the rules of the game and the key variables are in a constant state of flux. In 2005³ we asked our member firms’ clients what they expected their top challenges to be over the following three years. Their answers were emerging markets, new technology, increased competition and regulatory change. All of these demand internal and external adaptations from companies as they try to respond to the sustained demands of investors for ever more value in an ever more competitive, ever more regulated world. Two years down the line what have we seen?

2.1 Global competition

Until recently the term ‘globalization’ has meant the reshaping of supply chains on an international basis – the increasing use of outsourcing and off-shore call centers and the emergence of India, China and Eastern Europe as low cost centers for manufacture and service provision for international companies under pressure to reduce costs.

These days ‘globalization’ is acquiring another meaning as developing economies cease to be merely low-cost locations for the production of goods and the provision of services, and become, in addition, important and rapidly growing markets in their own right. Globalization is now a two-way street⁴. These so-called ‘emerging markets’ oblige multinationals to face up to the challenge of directing and controlling ever expanding businesses in an ever-widening world market, while taking into account a proliferating variety of local regulations, customs and stakeholder expectations.

Labor is more mobile, knowledge and intellectual property travel at the speed of light, and business practices and models are having to adapt constantly as a result.

All this is increasing the complexity of business, and this increased complexity means higher levels of risk of all kinds. Practical problems our member firms have come across include the risks created by local entrepreneurial activity, maintaining constant visibility of management’s performance, and problems associated with the interpretation of and the adherence to, local rules and regulations that were not designed for the age of global business.

But it is not just the number of environments to which companies must adapt that is increasing. The depth of the required adaptation is also becoming greater.

² Diogenes Laertius, Lives of Eminent Philosophers

³ KPMG International global survey 2005 with the Economist Intelligence Unit

⁴ 2005 saw a record level of investment with 25 emerging economies showing outward foreign direct investment flows of over US\$5bn, compared with only 6 in 1990. At the same time, there are big flows of investment into emerging markets from developed economies not to take advantage of low costs but to access new markets locally. An early example here was Kingfisher’s B&Q which has been trading in China since 1990 and now leads the local DIY market. Sources : World Investment report 2006⁶ United Nations Conference on Trade and Development Oct 2006 www.unctad.org and company websites www.bnq.com.cn and www.kingfisher.com



2.2 Corporate governance gains ground

As businesses scour the world for opportunities to create value they're becoming subject to increasingly rigorous regulation and growing pressure from a variety of stakeholders, local and global, to demonstrate that they're well run, responsible organizations. The fields of corporate governance and social responsibility, once regarded as 'soft' business issues of little more than academic interest, have begun to move to centre stage.

Standard & Poor's produce Corporate Governance Scores⁵ for companies and use them in credit rating calculations. A clear link between a company's market value and its standards of corporate governance has been established. A 2002 McKinsey & Company survey⁶ of institutional investors showed that three-quarters would pay a significant premium for good governance, while 60 percent might avoid investing in companies because of concerns about their governance. In the U.K., major fund managers actively try to improve the standards of governance at the companies they invest in, governance standards has been a recurring theme in recent shareholder challenges to boards, and shareholders are generally becoming more vocal about how they expect their directors to behave.

The so-called 'Henderson letter' sent to UK-based FTSE 350 CEOs by Henderson Global Investors in 2004 asking them how they managed tax was an early indicator that tax governance was being considered an important component of corporate governance as a whole.

The sensitivity of non-owning stakeholders to corporate governance standards has also been heightened in recent years by well publicized corporate failures, and has taken a very tangible form in the Sarbanes-Oxley Act in the U.S. and similar legislation and codes of practice elsewhere in the world. The practical costs in time and effort of meeting these new demands, particularly in tax governance and reporting, have become all too evident.

It can no longer be doubted, therefore, that the way a company is *and is seen to be* run affects its cost of capital and market value, and that reputational risks associated with corporate governance, including tax governance, have thus become key variables in the calculus of shareholder value.

The challenge for companies is how to comply with increasing regulation and more vocal stakeholder expectations, while remaining competitive and flexible. With this paper we aim to consider this problem from a tax perspective.

5 S&P Corporate Governance Scores and Evaluations: Criteria, Methodology and Definitions published August 2006
6 SEC, Commissioner Speech, 'Sarbanes-Oxley and the Idea of "Good" Governance', Cynthia A. Glassman, American Society of Corporate Secretaries, 2002.

2.3 The 'responsible' taxpayer

Corporate governance has also been an important if not the dominant theme in the streams of legislation, guidelines and consultation papers issuing from national governments and their regulatory bodies, as they try to regulate the response of business to the new competitive pressures created by globalization. Here too tax issues are prominent.

*"It is clear that governments are more and more convinced that encouraging responsible corporate tax behavior and more transparency, combined with providing a better service to taxpayers, is the only effective long term strategy to promote good compliance." **Good corporate governance: the tax dimension**, OECD Forum on Tax Administration, September 2006.*

Political developments, demographic trends and demands for high quality services in developing countries have led to growing pressure on public finances all over the world. This in turn has led to increased scrutiny of the business conduct of multinationals. There have also been concerted efforts to add a 'moral' dimension to tax management by questioning the 'fairness' of tax planning. An increasingly heated debate, fueled in part by pressure groups, about what is 'acceptable' tax behavior has put boards in a quandary. There is some evidence, despite the legal obligations of directors to endeavor to minimize costs and maximize shareholder value, of a creeping conservatism on tax at many large companies as a result of this uncertainty.⁷

There appears to be a belief among tax authorities that many businesses are in some way shirking their tax responsibilities. We don't think that is what corporates believe. In our member firms' experience many companies believe they are adequately complying with tax regulations worldwide and that they have low risk profiles with the tax authorities⁷. Despite this, it is likely, however, that companies will have to accept greater transparency if they are to close the trust gap between taxpayers and the tax authorities.

2.4 The 'responsible' tax authority

That the demands of tax authorities for what they see as improved tax governance within companies requires some kind of *quid pro quo* was recently acknowledged in a speech⁸ by the Commissioner of the Australian Tax Office (ATO):

"It has become clear to us in the Tax Office that the promotion of good governance and, by implication, responsible corporate tax behavior should be the cornerstone of our tax compliance strategy for large business. We are, of course, not forgetting our responsibility to provide better and more responsive service, and our efforts to ensure a level playing field."

Dave Hartnett the Director General of the U.K.'s HMRC recently spoke of the tax authority 'embracing' corporate responsibility. He cited responding to consumer demand for more accessible services, demonstrating responsible business practices, building and maintaining reputation as an ethical organisation and being ranked in a corporate responsibility index as key strands of HMRC's internal changes.⁹

⁷ 'The tax function, facing up to the changing world', KPMG LLP UK November 2006

⁸ 'Why we need to govern well' Speech by Michael D'Ascenzo, Commissioner of Taxation, to the International CFO Forum - Sydney Australia, 19 October 2006.

⁹ Source: 'Creating a competitive corporate tax environment for Europe' Joint CFE, CIOT, ICAEW Tax Faculty Conference, September 2006

The concept of the well-governed tax authority has recently focused attention on the administration and management of national tax systems. One major development has been the consolidation, in six OECD member countries so far, of the administration of direct and indirect taxes. This has had important implications for taxpayers in these countries, because information on compliance behavior previously held separately by tax and customs administrations¹⁰ can now be combined to give a more complete picture of the compliance policies of taxpayers during tax enquiries. This is one reason why we advocated in *Tax in the Boardroom* the inclusion of all taxes when determining a tax strategy.

Sharing information to build more comprehensive pictures of taxpayer compliance is progressing apace at the international level too. The Joint International Tax Shelter Information Centre (JITSIC) taskforce established in September 2004 has, according to the national tax authorities involved, already identified a number of 'abusive' transactions, which 'otherwise wouldn't be known'¹¹. In addition, the tax administrations of 10 countries - Australia, Canada, China, France, Germany, India, Japan, South Korea, the U.K. and the U.S. - formed the so-called "Leeds Castle" Group in early 2006 and agreed to meet regularly to discuss national and international tax administration issues and mutual assistance arrangements¹². This is the first time China, India and South Korea have been included in discussions of this kind. Authorities are also employing technology, so called 'spider' programmes, to mine the internet for evidence of taxpayer economic activity.¹³

Another crucial development is the recognition, by tax authorities, that a risk-based approach to compliance is one of the most effective (for which read efficient) and 'fairest' policing methods and that such risk assessments should be made available to taxpayers. Australia and the U.K. have already adopted this approach, tending to allocate investigative resources to those taxpayers deemed to be at a higher risk of non compliance when benchmarked against a number of different risk factors. Other OECD countries are expected to follow suit. Some taxpayers are beginning to respond to this development, by assessing their own tax risk profiles, often as part of an overall review of the tax function. What's 'fair' in this context is, of course, open to debate. There is anecdotal evidence that corporate taxpayers are challenging how some of the risk factors chosen by the tax authorities are being applied to them. We welcome these discussions as heralding a higher level engagement between authority and taxpayer.



¹⁰ Tax administration in OECD and selected non-OECD Countries: Comparative Information Series (2006) draft of 18 August 2006

¹¹ IRS press release 1 August 2006

¹² OECD Seoul declaration September 2006

¹³ Wired News "Taxtakers spend in spiders" 25 January 2007

3 Is tax on the board's agenda?

If the world's tax authorities are to be believed tax is being regularly debated at board level.¹⁴ We agree, up to a point.



The number of U.K. companies with board-approved tax strategies has certainly increased. In a recent KPMG survey in the U.K., 84 percent of respondents said that tax governance was rising up the board agenda.¹⁵ Vodafone has gone so far as to publish its code of conduct on tax on its website.¹⁶ The addition of tax reporting as a category in the 2006 annual Building Public Trust Awards also reflected this increased awareness.¹⁷

More businesses are questioning how tax is dealt with. Below we outline the main reasons, based on our member firms experience, why a company may choose to review how its tax affairs are managed. Any such review would tend to be for the board's attention.

Common triggers for review

Source: KPMG LLP (UK), 2007

Board direction

Audit committee requests

Peer pressure

Compliance issues

Organizational changes

Investor pressure to deliver value

Key staff changes

Inclusion of review in personal goals

Lack of resource

But the picture isn't that simple. Although a quarter of U.K. CEOs were directly involved in tax decisions in 2006, twice the percentage recorded in the previous year, the same proportion of respondents said tax was moving down their agendas, compared to 2005.¹⁸ Globally, only 40 percent of organizations have received board direction on tax risks.¹⁹ In the U.S., only 25 percent of internal audit directors thought the board status of tax was changing as a result of Sarbanes-Oxley 404.²⁰

¹⁴ "What is clear is that the recent spate of corporate scandals, the success of a number of tax administrations in challenging aggressive tax schemes and the general change in attitudes towards tax planning, will all combine to produce a greater awareness of the importance of tax issues." Good Corporate Governance : the Tax Dimension - OECD Forum on Tax Administration - September 2006

¹⁵ 'The tax function, facing up to the changing world', KPMG LLP UK November 2006

¹⁶ Source: Company website www.vodafone.com

¹⁷ Source: BPTA website www.bptawards.com . AstraZeneca won the tax reporting award in 2006 with Vodafone and BHP Billiton highly commended.

¹⁸ 'The tax function, facing up to the changing world', KPMG LLP UK November 2006

¹⁹ KPMG International's Global Survey of Tax Departments November 2006

²⁰ Perception versus reality? The relationship between internal audit and tax, KPMG LLP US 2006

This suggests that although directors know tax should be on their agendas, it is often still delegated to the CFO, to deal with 'off line'. There is thus still a risk that tax is not really understood at board level. We believe that there may be a number of reasons for this, including:

- The growing complexity of tax legislation, as national tax authorities try to increase their tax takes, makes tax harder to explain and understand.
- Increased compliance and reporting requirements (Sarbanes-Oxley 404, etc.) leave less time to debate strategic issues and consider the 'big picture'.
- The persistence of the belief that tax is a purely financial issue and its reputational or strategic implications do not merit board debate.

Despite the need for change, there are practical difficulties. These can hamper companies, discouraging them from undertaking reviews that would help boards understand the role of tax in the organization. KPMG firms have seen the following:

Constraints to factor in

Source: KPMG LLP (UK), 2007

Corporate culture

Existing workloads

Lack of direction from the Board

Global complexity

Legislative complexity

Staffing levels

Unclear accountabilities

An irony of the current situation is that, although real progress has been made towards recognizing tax as a key issue for boards, tax has become simultaneously more complex and demanding, and thus harder to grasp. This has led some companies to continue to regard tax as a specialist area, indigestible at board level. The consequences can include lost opportunities, poor communication of material tax issues and, therefore, ill-informed boards and exposed tax departments.

4 Impact on business

The way a particular company approaches tax management depends ultimately on its culture. This will be a function of many factors, including its attitude to risk in general, its industry, its location and the attitudes and general outlooks of its key staff. Over half the respondents to a recent U.K. survey said that their tax planning strategy was driven by the tax director, rather than the board.²¹

4.1 Tax management: a tale of two policies?

There are two generic responses to the changes discussed above. Companies either acknowledge and respond to the environmental changes, or continue as before.

Those who are responding appear to have chosen one of two broad policy options. Some choose a bold, strategic use of tax, link it directly to tangible demonstrations of added value, and focus on planning. Others have become more conservative, and focus on compliance.

The CFOs of many major companies understand the information demands of investors and have already installed strong financial reporting processes to satisfy them²². Tax should be no different to other finance processes and many companies responding actively to the environmental changes discussed above are working hard to improve the tax information they are supplying internally and to their external stakeholders, such as tax authorities and investors.

Progressive tax managers have long believed that tax is a strategic issue and should be managed accordingly. In a recent survey of U.K. tax managers, 40 percent said they wanted to spend more time contributing to strategic decisions²³. But a number of companies that actively acknowledge the strategic significance of tax remains relatively low. Tax only tends to acquire a high profile if it is either particularly visible, as in the case of duty in the beverages industry and stamp duty in the property industry, or has a direct bearing on investment decisions, as in the case of the oil and film industries. Recent evidence suggests that tax considerations are exerting a major influence on strategic decisions in the fund management industry, such as where to locate the headquarters²⁴.

It seems, therefore, that boards will tend to accept more readily the importance of tax in achieving corporate goals if tax is obvious in its commercial importance.

21 'The tax function, facing up to the changing world', KPMG LLP (UK) November 2006

22 Source: KPMG's Being the Best: Insights from Leading Finance Functions © Economist Intelligence Unit September 2006

23 'The tax function, facing up to the changing world', KPMG LLP (UK) November 2006

24 Taxation and the Competitiveness of UK funds: KPMG LLP (UK) September 2006

4.2 The importance of being sustainable

Henry Ford said: “You can’t build a reputation on what you are going to do.” The reputation of a company emerges from its results over time, and a key component of a good reputation for investors, analysts and regulators alike is a lack of surprises. Sustainability, the ability to sustain performance at a given level over a period of time, will, therefore, be a major target in any corporate strategy.

Logically, this ‘sustainability’ requirement must include tax. Companies should therefore be thinking about whether their tax reports to external stakeholders are contributing to the general impression that it projects of sustainability. So far, this requirement is usually interpreted as the company’s ability to maintain a steady rate of tax in the published accounts. Other disclosures on, for instance, losses available to offset against future profits and the status of tax authority investigations, are also relevant. The challenge is to know what stakeholders expect to hear, to recognise that these expectations are evolving and to manage communications accordingly.

“On-going schemes that achieve sustainable tax rate reductions will achieve the value increases companies and investors want.”

Unlocking tax value – Citigroup September 2006.

In February, 2006 Google surprised the market, by announcing lower than expected earnings, because of a higher than expected tax charge. Investors responded by temporarily wiping US\$20 billion off its market value. They were concerned, not so much about the tax rate itself, as about what Google was planning for the future²⁵ and how it was communicating with investors.

Rightly or wrongly analysts are more likely to infer better governance from a stable rate than from a fluctuating one. The surprise of an unexpected change in the rate says more to them about the quality of governance than the rate itself. So for companies that take long-term views of tax management and communication, sustainability is clearly a prize well worth winning.

This desire for ‘no surprises’ is why there has been such emphasis recently on improving tax reporting and why new accounting rules, such as the U.S. FIN48, are being introduced to encourage more consistent tax disclosure although arguably FIN48 may lead to less consistent tax rates in practice. Clear and open reporting improves transparency, but it does not by itself deliver sustainability. One must delve deeper and analyze how tax is managed as well as reported.

²⁵ “Such an assumption says something about Google’s ability to project how its expenses should be allocated. The matter is indicative of the company’s ability to effectively plan and evaluate,” Scott Kessler, analyst Standard & Poor’s, as reported WebPro News 2 February 2006

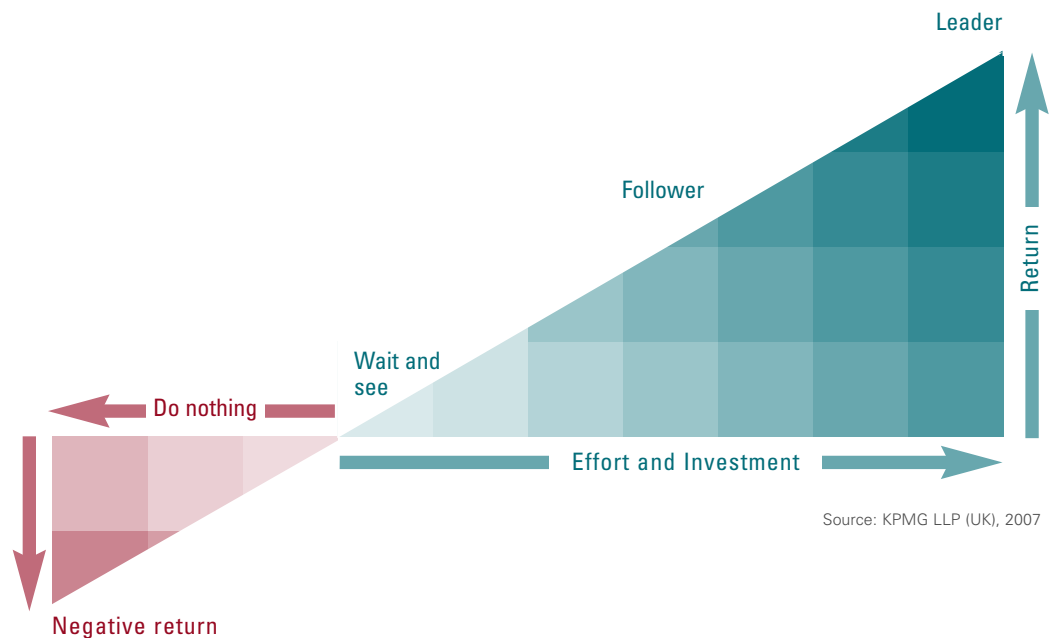
5 How can business react?

Businesses the world over are being affected by and are responding to the issues discussed here.

We estimate that the average tax department is carrying out 20 percent more reporting, provisioning and compliance tasks than last year, at the expense of activities known to add value to an organization, such as risk management and developing relationships within the business²⁶.

Resources aren't infinite. There are always trade-offs. A good way to strike a balance between conflicting demands on tax department time that satisfies external stakeholders is to try to ensure that all interested parties understand what's happening and what's possible within the organization's particular constraints. Communication is a vital tool for boards in their efforts to manage expectations while they work to meet their governance responsibilities relating to tax.

In adopting either of the generic responses referred to above companies will fall into one of three broad categories. Each has costs, risks and opportunities.



Source: KPMG LLP (UK), 2007

²⁶ KPMG International's Global Survey of Tax Departments 2006

5.1 Leaders

Leaders range from aggressive to conservative, but they formulate their tax strategies on the basis of both the current, and the prospective tax environments. They see tax as a source of competitive advantage whether in the form of business driven tax planning, a well executed disposal, or stealing a march on their competitors by anticipating compliance developments or communicating more clearly with investors. In other words tax is considered in a strategic, as well as an operational way. Leaders typically:

- have a clear, defensible position on how tax and tax risk are managed
- have a well-documented, board-approved tax strategy
- have a 'tax sensitized' ERP system
- present tax information in a clear, meaningful way to both internal and external stakeholders
- seek influence in the tax debate between taxpayers and the tax authority.

Leaders invest in their tax function with cash and management involvement in the belief that this will enable them to mount a strong defense against unwarranted tax claims, particularly in less developed countries; explain the impact of tax changes around the world without volatile stakeholder reactions and make better use of tax in government and investor relations. They see tax as an enabler and value generator in strategic areas such as acquisitions, disposals, supply chain restructurings, pricing and marketing, and try to make more efficient use of resources by striking the appropriate balance between compliance, regulatory and planning activities.

5.2 Wait and see

At the other end of the spectrum are taxpayers who choose to keep their powder dry, await developments and the emergence of standards and carry on much as before. They're in the minority. Many large corporates have either changed already or are planning to change how their tax departments are run²⁷.

Wait and see companies have a "if it ain't broke, don't fix it" philosophy. They tend to focus on direct corporate taxes leaving other taxes on the business with a default strategy. They do not have a clear policy on how they manage tax as a whole, apart from acknowledging that it is a separate technical subject that has little, if any, impact on the day-to-day running of the business. They have not reviewed their policies on planning and compliance recently or given any serious thought to their tax risk profiles.

On the other hand they have invested little if anything extra in the tax department and there has been no disruption of day-to-day activities. Everything is business as usual.

In effect, this is a 'pay as you go' or 'self insured' policy. The basic premise is that it is cheaper to settle problems as they arise than try to mitigate risk through premature investment. It is not a sustainable long-term strategy, however, because, as claims get larger, and costs and damage spread beyond disputes with local tax authorities, risks increase and there will come a time when something must be done. We suggest that the 'wait and see' policy should, in any event, be disclosed to the board, which has overall risk management responsibility.

²⁷ 'The tax function, facing up to the changing world', KPMG LLP (UK) November 2006

The issue for directors is at what point do growing 'pay as you go' risks and costs outweigh the cost of a methodical review of tax management designed to reveal problem areas. The problem here is that, because there has been no serious internal debate of these issues, the board may not understand the consequences of the 'wait and see' policy on the financial and management time costs as well as the company's relationships with tax authorities and for its wider reputation.

5.3 Followers

Many companies fall into the 'followers' category. The typical follower is aware of the current changes in the tax environment and may have started to define its risk position, or draft a tax strategy. It will not, however, commit much time or money to these activities or reviewing let alone modernizing its tax function, until it sees what others are doing.

Followers may not yet have changed how they manage and communicate tax, but they know that change is inevitable. Their approach is to prepare to act, pending the arrival of more information. Typically followers will have moved tax down or off the boardroom agenda in the meantime. There is no common vision between the tax department and the board on the likelihood of pressure from external stakeholders for increased transparency about tax management and no consensus about the significance of tax as a source of competitive advantage.

The policy is 'safe', in the sense that waiting to move until the trail has been blazed by others reduces the risks and costs of false starts and wrong turnings, but it precludes the reputational and competitive advantages earned by a leader and locks the follower into 'catch up' mode. Whether or not such a policy proves acceptable or sustainable will depend on the company's industry and its investor base. There is also the risk that their lack of preparation will cause followers to be caught out by sudden developments they might otherwise have anticipated, and force them into 'fire fighting' mode, obliging them to rely on quick fixes that treat symptoms, rather root causes.

In a typical follower company tax is not an integral part of transformational projects, such as ERP system changes, company-wide risk assessment, financial reporting reviews and government and investor relations initiatives. It will tend to be 'bolted on' almost as an afterthought. At the least this can reduce the ease and efficiency and sometimes the accuracy with which the tax department is able to respond to requests for information from external stakeholders. Last but not least, followers may be missing the opportunity their competitors may have taken to re-shape their relationships with regulators.

Many businesses will find themselves in the follower category by default, rather than design. The populations of the 'follower' and 'wait and see' categories will, of course, change as some followers drop back into 'wait and see' mode and others decide to act and join the leaders.

5.4 Three crucial questions

When considering the appropriateness or otherwise of their existing responses to the changes in the tax environment companies should ask themselves the following questions:

- **Have we consciously decided that this is the right response for us?**
- **What kind of developments might persuade us to change our response?**
- **How will we monitor emergence of those developments?**

6 A practical approach

Good governance creates value when it allows managers to manage more effectively and has been shown to add value in the eyes of external stakeholders. That is as true of tax governance, as of corporate governance as a whole.

There's no unique answer to the question of how tax should be managed. Preferred practice for each company depends on its own 'house style', and its own drivers and constraints. A number of issues common to all companies and circumstances need to be addressed, however, when evaluating and, when appropriate, changing your tax management and strategy.

6.1 Getting your house in order

Tax in the Boardroom focused on what companies could do to adapt their internal tax management to environmental changes. Since then, tax directors have not been idle. Many are planning improvements in how they run their departments. Some are focusing on technology, others on processes, and others on increased training²⁸. It is clear, therefore, that 'internal' governance is on the agenda.

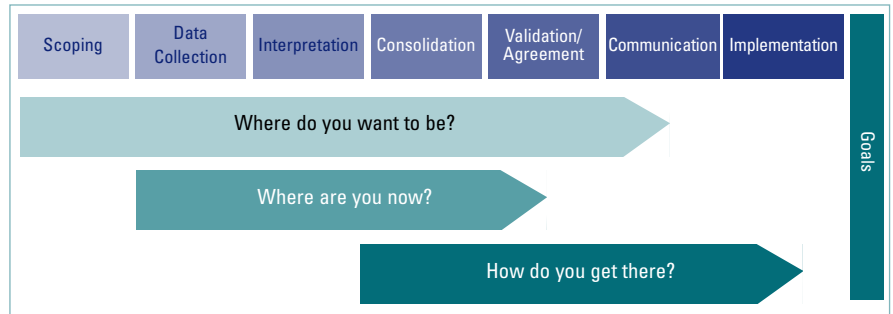
'External' governance enables companies to interpret the needs of stakeholders, decide what the company will and will not do, communicate, set out procedures to ensure this happens and measure and report the results. The major challenge is to be able to provide evidence that what is stated publicly happens at an operational level. *Tax in the Boardroom* discussed how all this could be achieved internally and what 'best in class' could look like. A checklist of behavioral indicators is given below.

- A 'tone from the top' articulating the tax philosophy
- Clear policies on deviations from prescribed procedures
- Active oversight of tax strategy, including risk strategy
- The ability to ask perceptive questions of tax management
- Informative and timely reporting to the board on material tax issues
- Appropriate reporting lines and access for the tax function
- Clear definition of responsibilities/delegation of authority
- Appropriate staffing of the tax function
- Appropriate controls within the tax function
- Independent reviews of the tax function

For further information on preferred practice indicators see in Appendix I.

²⁸ KPMG International's Global Survey of Tax Departments 2006

On the basis of this checklist, the straightforward approach outlined below can help companies address internal tax governance. This framework can be used to help ensure each aspect of tax management is addressed.



Source: KPMG LLP (UK), 2007

6.2 Preparing for external scrutiny – an ‘outside in’ approach

So how do you address the external requirements, without disrupting existing plans? It is essential to ensure external communication is aligned with internal messages, while avoiding reporting overload. We suggest the following:

- Review your existing tax strategy and, if necessary, develop a new one.
- Consider all your stakeholders’ needs when planning improvements going forward.
- Modify existing plans to accommodate communication with external stakeholders.
- Consider whether your processes enable you to tell external stakeholders about your tax management. Is it what you want to tell them? Is it what they want to hear?

When assessing readiness for external scrutiny, it is worth looking at the issue from the outside, in. This allows a ‘gap analysis’ on the state of readiness, by comparing your tax function’s resources, capabilities and profile with external requirements. At each stage the actions we suggest can be used to challenge your existing processes and priorities.

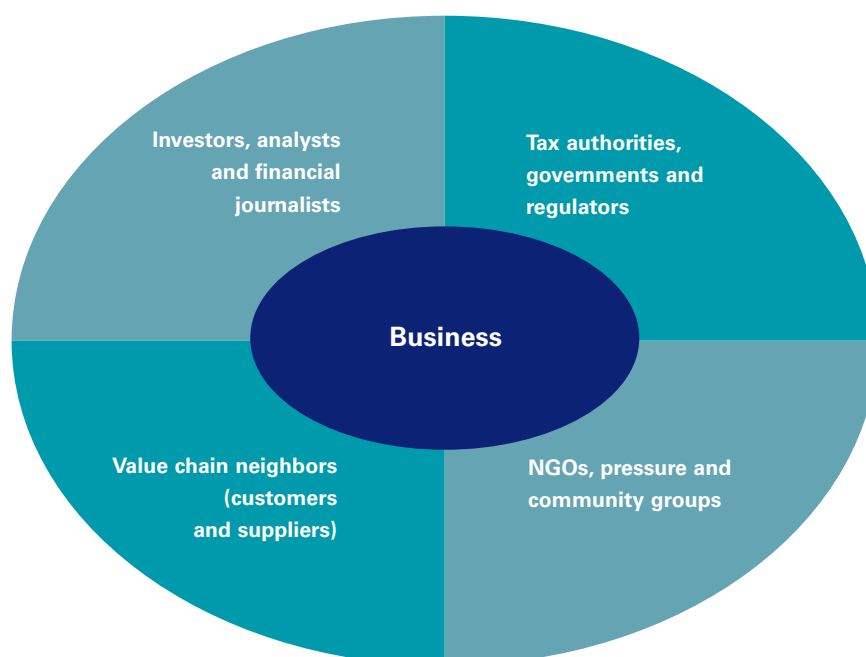


Source: KPMG LLP (UK), 2007

6.2.1 External communication

The starting point for any communications plan is to know your inquisitor. Which stakeholders are likely to ask questions? What are they likely to ask questions about? What do you want to tell them? How do you want to tell them? What can you say with confidence?

Your external inquisitors fall into four broad categories – investors, including investment analysts and the financial press; tax authorities, governments, local authorities, regulators; value chain neighbors (suppliers and customers); ‘non-governmental organizations’ (NGOs), pressure and community groups concerned with a wide range of public interest issues, such as third-world poverty, social and educational deprivation, housing, ‘fair trade’, the environment and business ethics.



Source: KPMG LLP (UK), 2007

Investors, analysts and financial journalists

These are the ‘owning’ stakeholders plus their agents and representatives. Their needs are well-known. They want to be sure you are committed to value creation; they want clear and detailed financial information and, increasingly these days, they want to know how much tax you expect to pay in future; why actual taxes are different from expected taxes; what your tax strategy is; and whether or not the company is subject to any tax authority enquiries and, if so, the current status of those enquiries.

They are also becoming much more interested in tax risks, and the sustainability of effective tax rates, irrespective of their current levels. As Kenneth Lee, of Citigroup, said in September, 2005:

“Despite being one of the most commonplace and material costs any business incurs, taxation is often viewed by the market as beyond meaningful analysis. However, recent changes in both the attitude of governments to, and regulation of, tax planning suggest that significant changes are afoot. Therefore we view tax as a key risk facing companies that is worthy of significant analysis.”

Tax authorities, governments and regulators

National and local governments, and fiscal authorities, want predictable revenue streams to finance public services; balance their budgets; close their so-called 'tax gaps'; ensure compliance with tax laws, rules and regulations at a reasonable cost; use their statutory powers and resources effectively; and preserve their tax bases by maintaining a competitive business environment. Regulators want assurance that taxpayers are meeting their regulatory requirements.

They are likely to be interested in whether the company has a board-approved tax strategy; attitudes to tax planning; the chosen risk profile and risk management arrangements; reporting arrangements from the tax department, to the board; the tax-sensitivity of resource planning and accounting systems; compliance controls and processes; and adherence to accounting standards.

Value chain neighbors (customers and suppliers)

Customers and suppliers want reliable and accurate tax treatment in purchase and sales transactions; reliably compatible systems; clear reporting lines and audit trails; fair and consistent treatment; managed transactions tax risks; and the financial health of their trading partners.

They're likely to be most interested in indirect transaction taxes. They may ask questions about readiness and arrangements for new tax laws and regulations; the tax-sensitivity of systems; recoverability of taxes suffered; and the status of any tax enquiries.

NGOs, pressure and community groups

Groups with no direct involvement with the company, but driven by convictions of various kinds about human suffering, for example, environmental degradation, the role of companies and their responsibilities to societies and communities where they operate, employment practices, fairness and 'business ethics', are becoming more vocal and more interested in tax. It is clear that these groups can influence public opinion and can thus affect corporate reputations. They can also, through ethical investment funds and practices they promote, exert some influence on the cost of capital.

Although arguably it is early days, these groups can be expected to ask about tax policies; whether the company uses tax havens and other tax planning stratagems; and how it can demonstrate that it is complying with the spirit, as well as the letter of the law. There could also be questions about the tax paid in each country compared to net income attributable to each country and the tax treatment of community, educational and welfare projects supported in countries, communities and neighborhoods in which the business operates.

Once you have a picture of your prospective inquisitors, you need to decide what 'transparency' means for you. Its meaning can vary depending on the stakeholder involved, the board's attitudes to disclosure and communications in general, and relevant regulatory requirements. Transparency itself is unlikely to add value. Information should be useful, it should 'earn its place'. You need to consider what information is relevant to the particular stakeholders to avoid 'over-reporting'. Putting yourself in the shoes of your inquisitors and asking the questions they might ask will help you decide what is appropriate for each stakeholder and what your priorities are (or should be).

One way to communicate with multiple stakeholders on tax, is to state the policy in the Annual Report. For example:

“Our tax strategy is to manage all taxes to provide a sustainable and competitive outcome. Tax policy is aligned with our overall business strategy and operational capabilities. We seek open dialogue and good working relationships with tax authorities and government in all our business locations. We ensure that appropriate resources, processes and controls are in place for compliance with our corporate principles and legal requirements.

“Within these boundaries, we will seek tax efficiencies in our corporate structure, our supply chain and in our acquisitions and disposals²⁹.”

Although an historical statement the annual report is a vital information source for external stakeholders seeking information on the company. It often includes a Corporate Social Responsibility statement, in which taxes paid to national and local governments can be specified. More current media for statements and other announcements on tax include the company website, the company intranet and press releases. Statements such as these can be effective ways to convey good governance.

The example statement above tells the interested stakeholder that the business is run to produce sustainable, as well as competitive results, that tax considerations do not drive decision-making, that external stakeholders are acknowledged and respected, that controls are in place, and that tax is regarded as a legitimate business lever and tax planning will, therefore, be defended.

To have value a statement needs substance. Although relatively short the example is intended to be both informative and useful. The company must, of course, be sure that it is delivering the right messages to investors, regulators and tax authorities, and it is also imperative that any statement can be fully supported and can stand up to scrutiny. Unsupported blanket statements can come back to bite you later.

In reviewing their tax policies and processes with our firms' clients we have found this external perspective helps to affirm the purpose and benefit of their investments in tax. The expectations of external stakeholders should be checked against corporate culture. This helps companies to see, when assessing the clarity of messages they wish to send, the extent of any gap between external expectations and their internal assumptions.

²⁹ KPMG LLP (UK) – this is an example wording

6.2.2 Board level information

Once you have decided what you want to say to external stakeholders, you need to consider what the board needs to know to transmit the right messages, and you need to review the board's information requirements regularly to ensure they are up-to-date. Board briefing material will vary from company, to company, but will normally include information on strategy, risk profile, principles,³⁰ current tax risks in each market and business, controls and updates of financial information in appropriate detail.

If reporting is to be efficient, the materials should be the natural output from someone's explicit responsibilities, rather than a cobbled together 're-work' of materials designed for other purposes. The briefing material might look a little like this:

1. Strategy , principles and risk profile								
2. Market risk profile								
Key countries	Market risks	Key assets	Turnover	Profit	Taxes paid	Tax contribution ratios		
	Volatility Relationships with authorities	IP brand Customer base Government licence Procurement				Turnover Profit Net Assets		
3. Key planning and dispute management								
<ul style="list-style-type: none"> • Amount under dispute • Resolution milestones 								
4.								
A) Disposals					B) Acquisitions			
Proceeds	Accounting profit	Tax charge	%[+ vs corporate rate]	Purchase price	Tax assets	Tax disputes	Impact on rate	Impact on Cash flow
5. Systems and controls								
Systems reviewed			Outcome			Remediation		
Upcoming programme								

Source: KPMG LLP (UK), 2007

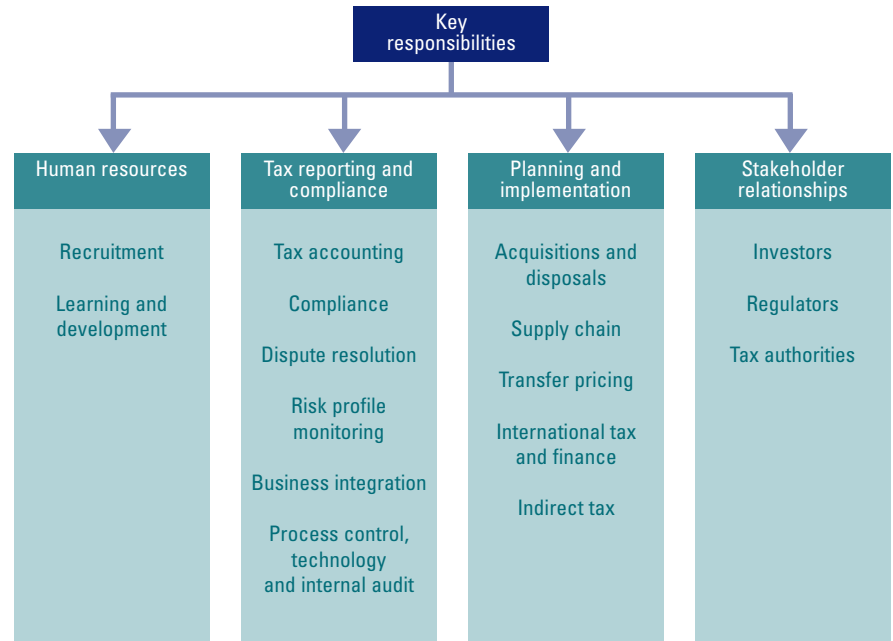
The main point is that the board requires information in sufficient detail, in a digestible form to be confident that the messages they are giving externally are both intelligible and valid.

When reviewing the quality of the data received and produced by your tax department, as our firms' know many companies are planning to do this year, generating a board briefing pack such as this can help to pay dividends with minimal disruption.

³⁰ For more information around these issues please see 'Tax in the Boardroom' KPMG LLP UK 2005

6.2.3 Tax department design

Clearly, a tax department needs to be able to implement the strategy agreed with the board. It has to be able to provide the board with the information they need to monitor progress, make decisions and set targets. Responsibility should align to reporting. An example of how this might look in practice is given below.



Source: KPMG LLP (UK), 2007

A good test here is whether the assignment of responsibilities appears likely to result in the efficient communication of external messages.

Our firms' clients often start at this stage, because they realize that the way they're managing tax at the moment isn't appropriate for today's environment and want to review how their departments run.

6.2.4 Communication of risk

A prerequisite for clear responsibilities and internal tax messages aligned with external statements is an internal understanding of risk management. Risky areas need to be managed directly, and reported on clearly. A common terminology makes communications between and comparisons with different tax and geographical areas easier and more efficient. An approach to tax risk consistent with the company's overall risk management policies reduces duplications and the chances of missing something important.

There are many different tax risks, but each could be said to fall into one of three interlinked categories; financial and reputational, processes and controls and market risk. The box below lists some examples of the issues that need to be considered, to understand and manage each risk category.

Financial and reputational	Process/control	Market
<ul style="list-style-type: none"> • Estimated impact on ETR and cash tax • Additional financing requirements or potential to repay funds • Impact on other planning implemented or planned • Costs of defence, unwind or restructure • Impact of implementation on investor undertakings or statements • Context of relevant media coverage, country, industry or company specific 	<ul style="list-style-type: none"> • Technical capabilities required to be in place to maintain new structures or entities (e.g. treasury) • IT systems changes to be implemented to evidence and maintain transaction flows • Monitoring procedures to be in place to sustain entity or system changes (e.g. board meetings) 	<ul style="list-style-type: none"> • Assessment of volatility of changes to legislation • Impact of implementation on regulator constraints, undertakings or licenses • Impact on major assets located in country • Impact of implementation on tax authority agreements, consents, disputes or open years

Source: KPMG LLP (UK), 2007

Risk analysis is an integral part of a tax department review and the development of any tax strategy. Many companies carry out separate risk reviews to identify areas requiring attention and to populate their tax strategy with specific goals once the overall principles and stance have been agreed.

Classifying tax risks clearly and consistently, all the way from data collection to the statement in the Annual Report means there are fewer margins for misunderstandings and error. Tax becomes easier to understand, and thus more relevant to the board when they consider wider strategic issues for the business.

6.3 An appropriate pace of change

Tax directors face increasing demands on their time and resources. Many companies KPMG firms talk to plan to make improvements in the next 12 months, but few have either the wherewithal or the appetite for wholesale change. For the time being, at any rate, they favor taking one step at a time.

There’s nothing wrong with that. Tax is complicated and multi-faceted. It’s easy to over-complicate the problem, try to do too much at once, and end up achieving very little. Although tax management involves numerous issues, it is possible to plot a sensible course between wholesale and gradual change within a coherent, high-level strategy. If you focus, as we suggest, on what the market and other external stakeholders are expecting, you can achieve a great deal with a series of incremental steps, with limited disruption. The important thing for the tax director is to keep the board fully-informed throughout of the risks and opportunities of the various options, so that they can reach a properly informed judgment about what’s appropriate for the organization.

7 Conclusion

Over the past two years, since we published *Tax in the Boardroom*, companies have come to terms with the undeniable fact that the world of tax has changed, and is still changing.

They know it has become more global, in the sense that countries previously seen as low-cost locations for goods and services production, are now large and buoyant economies in their own rights. They realize it has become more complicated, more talked about and scrutinized by a wider variety of stakeholders, more controversial, and more moralized about. But they also know it has become a more important source of competitive advantage.

Tax in the Boardroom was designed to help companies to prepare for this brave new tax world internally. Some have made considerable progress towards a 'preferred practice' model we outlined, and are developing and implementing modern, fit for purpose tax strategies that are well understood in their businesses. (Appendix I describes *Tax in the Boardroom's* best practice model in more detail.)

Although each company will approach the modernization of its tax function in its own way, the overriding requirement, when making decisions about how tax will be managed, is that the board are kept fully informed throughout of both the risks and opportunities attached to the options selected and rejected. Too often, this information is not presented to them either because it's delegated away or is deemed too technical or irrelevant. There is a risk that an ill-informed and inappropriate position may be chosen, which could seriously damage the company's finances and reputation. With more external stakeholders, including trades unions, pressure groups, regulators, investors and national and local governments, emerging and becoming ever more vocal in their demands for greater transparency and a more ethical approach to tax governance, your company's reputation has never been more under scrutiny.

In this paper we have looked at this external dimension of tax management - what the wider market expects of companies and how good tax governance can add value to an organization. Clear credible communication is at the heart of the approach outlined here. Whether you are a leader, a follower or a member of the wait and see brigade, time spent on thinking about how information about tax is presented externally will be time well spent.

This report aims to show a practical way to develop a tax governance system for a world in which companies are scrutinized by their external stakeholders more intently than ever before. The proposed system is based on what KPMG member firms' have learned working with our clients. By seeking to ensure that relevant and useful tax information is presented to external stakeholders clearly and consistently, company boards can free themselves from the fear of sudden attacks from unexpected quarters and can focus on positioning their businesses for success in a competitive world.

8 Appendix I – KPMG’s Preferred Practice Indicators³¹

ASPECTS OF MANAGEMENT	TAX PREFERRED PRACTICE INDICATORS
Strategy	<ul style="list-style-type: none"> • Tax strategy derived from and aligned with the business strategy. • Tax strategy understood, agreed, and supported by the board. • Documented, communicated and understood policies around key strategies and risks. • Strategies in place to address stakeholder expectations with suitable controls around them.
Relationships and communication (internal and external)	<ul style="list-style-type: none"> • Tax department seen as a business partner with relationships and clear points of contact across the business. • Tax department reporting to the board and located close to CFO, as the first point of contact for tax related issues. • Tax department goals and strategic drivers are understood by the business as a whole. • Tax department stakeholders identified (eg, fiscal authorities) and relationships managed.
Staff	<ul style="list-style-type: none"> • Tax team to understand role in achieving business strategy and frame service delivery with this in mind. • Clear roles and responsibilities around management of tax, including adequate support of internal clients. • Use of appropriately qualified staff with defined areas of responsibility. • Training programs for suppliers of tax information and tax team.
Process and technology	<ul style="list-style-type: none"> • Tax processes coordinated with management of taxation to help improve efficiency and accuracy. • Tax technology systems coordinated with accounting systems. • Tax relevant information built into coding processes and accounting systems.
Risk management and control	<ul style="list-style-type: none"> • Tax risk policy aligned with business risk policy. • Control environment established by the board. • Risk identification and control processes in place and subject to checks.
Accounting	<ul style="list-style-type: none"> • Forecast and report activities coordinated with finance function. • Controls to confirm accuracy of provisions in place, e.g., adequate audit trails. • Accounting consequences of any tax planning fully considered.
Coverage	<ul style="list-style-type: none"> • Taxation on the boardroom agenda. • Adequate coverage of <u>all</u> taxes. • Formal process to raise awareness of tax within the business.
Planning	<ul style="list-style-type: none"> • Tax department proactively involved at strategic level. • Tax department to have easy access to management information and decision makers. • Tax department procedures aligned with risk policies.

³¹ Source: Tax in the Boardroom , KPMG LLP (UK) March 2005

- 1 KPMG's Being the Best: Insights from Leading Finance Functions © Economist intelligence Unit September 2006
- 2 Diogenes Laertius, Lives of Eminent Philosophers
- 3 KPMG International global survey 2005 with the Economist Intelligence Unit
- 4 2005 saw a record level of investment with 25 emerging economies showing outward foreign direct investment flows of over US\$5bn, compared with only 6 in 1990. At the same time, there are big flows of investment into emerging markets from developed economies not to take advantage of low costs but to access new markets locally. An early example here was Kingfisher's B&Q which has been trading in China since 1990 and now leads the local DIY market. Sources : World Investment report 2006' United Nations Conference on Trade and Development Oct 2006 www.unctad.org and company websites www.bnq.com.cn and www.kingfisher.com
- 5 S&P Corporate Governance Scores and Evaluations: Criteria, Methodology and Definitions published August 2006
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- 8 'Why we need to govern well' Speech by Michael D'Ascenzo, Commissioner of Taxation, to the International CFO Forum - Sydney Australia, 19 October 2006.
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- 11 IRS press release 1 August 2006
- 12 OECD Seoul declaration September 2006
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- 27 'The tax function, facing up to the changing world', KPMG LLP (UK) November 2006
- 28 KPMG International's Global Survey of Tax Departments 2006
- 29 Source: KPMG LLP (UK) – this is an example wording
- 30 For more information around these issues please see 'Tax in the Boardroom' KPMG LLP (UK) 2005
- 31 Source: Tax in the Boardroom, KPMG LLP (UK) March 2005

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