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The changing tax risk-management landscape: Initial insights from the United States of America, the United Kingdom and South Africa

Segal, Talya

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University of the Witwatersrand

The changing tax risk-management landscape: Initial insights from the United States of America, the United Kingdom and South Africa

Talya Segal

Supervisor: Warren Maroun
Date: 29 May 2013

A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

ABSTRACT

Tax risk-management is a topical issue which delves into the governance, control structures and risk-management plans, and policies of companies. The aim of this research is to explore the tax risk-management concept, specifically focusing on and analysing how perceptions of tax risk-management have changed. The research will centre on regulatory and control and risk-management corporate governance developments over the past decade, locally and internationally. An analysis will be performed on how these developments have resulted in changes in tax risk-management. The research will also examine, through analysis of the literature, what the main tax risks facing companies are and, in this context, whether or not there has been a change in tax risk- management. It is stated, however, that the research is exploratory in nature and does not purport to be a complete account of tax risk-management.

Keywords:

Tax risk-management; risk-management plans; regulatory developments; governance developments; tax risks

DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

_____

Talya Gail Segal

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II: List of abbreviations and acronyms

AIR	Accelerated Issue Resolution
ATAF	African Tax Administration Forum
CODE	Code of Practice on Taxation for Banks
CAP	Compliance Assurance Process
ERM	Enterprise risk-management
FTS	Fast Track Settlement Programme
FASB	Financial Accounting Standards Board
HMRC	Her Majesty's Revenue and Customs
IOD	Institute of Directors
ITC	Income Tax Act
IRC	Internal Revenue Code
IRS	Internal Revenue Service
IAS 12	International accounting standard 12: current and deferred tax
ISA 330	International standards of auditing 330: The Auditor's Responses to Assessed Risks
IOTA	Intra-European organisation of tax administrations
LBC	Large Business Centre
LIFE	Limited Issue Focused Examination
LSS	Litigation and settlement strategy
NDPP	National Department of Public Prosecutions
NPV	Net present value computation
OECD	Organisation for Economic Co-operation & Development
PAYE	Pay As You Earn
SAO	Senior accounting officer

S.A	South Africa
SARS	South African Revenue Services
SEC	Securities Exchange Commission
SDL	Skills development levy
SOX	Sarbanes Oxley Legislation
TCRM	Tax compliance risk-management process
TCF	Tax control-framework
TRF	Tax risk-framework
TRM	Tax risk-management
UIF	Unemployment Insurance Fund
U.S.A	United States of America
U.K	United Kingdom
WACC	Weighted average cost of capital

1: Introduction

1.1: Context of the study

Enron led to a paradigm shift in American corporate governance (Sy and Tinker, 2008; Canada *et al*, 2008; Gavious, 2007). Gone was the belief in the all-mighty free market system. With the promulgation of the Sarbanes Oxley Act of 2002, Pub. L. 107–204, 116 Stat. 745 (SOX, 2002), the world's largest economy submitted to more government-backed regulation and control. Almost 10 years later, the international community is again dealing with a financial crisis, questioning the adequacy of risk identification, management and curtailment policies (Gerding, 2009). Few researchers have, however, considered the relevance of taxation as part of the change in risk-management ethos. Tax remains a 'resultant', determined 'simply' by applying the 'applicable tax rate' to the taxable incomes determined in accordance with the respective jurisdiction's tax rules (International Accounting Standards Board [IASB], 2012). In the context of unstable financial markets (Witherell, 2012), rapid changes in domestic and international tax laws (Weinberger *et al*, 2012) and an increased propensity for tax authorities to engage in aggressive tax administration and collection

policies (Weinberger *et al*, 2012) this perspective may no longer be appropriate (Elgood, 2004). Tax has ceased to be something that interests only a select few (Elgood, 2004; Leitch, 2003), especially given the growing complexity of tax laws (Weinberger, *et al*, 2012) which translates into potentially material impacts on a company's profits and its ability to demonstrate compliance with a jurisdiction's regulations (Weinberger *et al*, 2012).

At the same time, stakeholders are specifically showing increasing interest in obtaining comprehensive information on how tax risk-management (TRM) and corporate conduct are implemented and supervised (Erle 2006). What is increasingly apparent is the need for a comprehensive system of risk identification and management that proactively addresses tax-related risks (consider Institute Of Directors [IOD], 2009); (IRC. Framework for Integrated Reporting and the Integrated Report [IRC], 2011; Loots, 2012). In the spirit of integrated reporting (IRC, 2011) and existing codes of corporate governance, this needs to take cognisance of the company's overall commercial strategy, the potential impact on stakeholders and the need for enhanced transparency and accountability (OECD, 2006)

For the purpose of this research TRM refers to the underlying risks of applying the tax laws, regulations and decisions to business operations (Elgood, 2004). It is seen as part of the organisation's overall enterprise risk-management (ERM) function for which the board of directors is, ultimately, responsible (Leitch, 2003; IOD, 2009). This research will consider how TRM practices, including the perceived importance of TRM, has changed over the last 10 to 15 years in response to material regulatory and governance developments taking place within the same time frame. The United States of America (U.S.A), United Kingdom (U.K) and South Africa (S.A) are the focus. This will necessitate an examination of nature and purpose of significant governance, regulatory and tax developments, including emerging tax risks, and how these issues are internalised by corporates from the perspective of TRM.

1.2: Purpose statement

1.2.1: The Research question

As a result of international corporate governance risk-management reform, how has the perceived need for sound tax risk-management changed, in general, and in the U.S.A, U.K and S.A specifically.

1.2.2: Sub-questions

Sub-questions include:

- What recent material regulatory and governance developments have been taking place in the U.S.A, U.K and S.A as part of the drive for international corporate governance risk-management reform? (Chapter 2)

- What is 'tax-risk', what is its relevance for the international corporate and what are the material classes of tax risks facing companies in general? (Chapter 3)

- What are the recent changes to tax risk management practices and administration in the U.S.A, U.K and S.A? How has the perceived importance of tax risk-management been affected by these changes? (Chapter 4)

1.3: Significance of the study

Firstly, TRM is rapidly becoming a major focus for many international corporates (see Weinberger *et al*, 2012). Globally, tax authorities are combining their efforts at enforcement of tax laws and monitoring of companies' tax liabilities which is, in turn, increasing the large number of tax audits for companies (Weinberger *et al*, 2012). According to the Ernst & Young survey (2012), for example, the complexity and large volumes of tax policies, legislation and administration are placing additional burdens on the tax planning of companies. Many corporates are concerned that the rapidly growing and changing landscape is making it virtually impossible to maintain adequate TRM planning (consider Weinberger *et al*, 2012). By exploring emerging tax-based risks, including how companies are responding to these risks, this research is able to highlight

the dynamic nature of risk-management, extending this into the little-studied area of tax-specific risk-management.

In addition, the growing need to comply with improved corporate governance requirements has re-emphasized the need for companies to focus on their risk-management policies and procedures and, particularly, TRM. This is an attempt to improve the efficiency and effectiveness of companies' operations (OECD, 2006). The past decade has seen an increase and change in corporate governance reforms (Solomon and Solomon, 2004). Sound corporate governance mechanisms are considered the foundation for maintaining controls and structures which ensure the maintenance of companies' reputation and economic and operating stability (Demidenko *et al*, 2010). A crucial component of corporate governance is an entity's enterprises risk-management profile (ERM) (Demidenko *et al*, 2010). This research makes an important contribution by extending our understanding of ERM, highlighting how this incorporates TRM as part of an overall commitment to sound corporate governance (Demidenko *et al*, 2010). In order for companies to achieve this desired corporate governance maintenance within their entities, these companies need to be proactive to tax risks as opposed to being reactive. Proactive management will result in proper management of their tax risks and will thus reduce exposure to penalties and audits (Erasmus, 2008).

Prior literature points to the fact that an economic crisis frequently giving rise to corporate governance reform and promulgation of additional external regulatory measures (Sy and Tinker, 2008; Canada *et al*, 2008; Gavious, 2007). Few studies have, however, examined this from a tax perspective and there is very little formal academic research on the relationship between TRM, corporate governance and financial crisis from a South African perspective. This is despite the country being the continent's largest and most sophisticated economy. Accordingly, this research contributes to the existing tax and corporate governance literature by drawing links between these two focal points, shedding light on tax reform and risk-management in the U.S.A, U.K and S.A in the process.

1.4: Delimitations of the study

The research is exploratory in nature. Based on an interpretive approach, the paper identifies risk-management 'themes' emerging from the prior literature to provide an initial assessment of changing perceptions of TRM. No effort is made to quantify changes in a risk-management measure over time. Further, the nature of interpretive research is that the researcher is inextricably involved in the data collection and analysis processes (Maroun, 2012). The result: a measure of subjectivity is inevitable and the research cannot purport to be a complete account of TRM. Finally, this report provides an initial exploratory account of TRM in general. No effort is made to study the risk-management controls of specific organisations or tax jurisdictions in detail. Related to this, the study does not provide a complete account of every tax regulatory development (including anti-avoidance legislation and case law). A more detailed examination of these issues is deferred for future research (Section 5.2).

1.5: Research methodology

This research will be performed using a qualitative approach in the form of an extensive literature review. The results of this review will provide a basis for exploring TRM changes, including changing attitudes towards TRM over the past ten years. The review will incorporate both local and international literature with a particular focus on the U.S.A, U.K and S.A. The aim is not to provide a detailed account of every change in these jurisdictions but rather to focus on the material developments that highlight the broader changes to the TRM landscape in each country under review.

1.6: Report outline

This report is organised as follows: Chapter 2 explores recent changes in the corporate governance landscape in the U.S.A, U.K and S.A. In this context, the chapter makes the case for a growing awareness of the need for effective risk-management and, hence, TRM. Chapter 3 focuses on a general discussion and definition of tax risk and what tax risk means for the international corporate; thereafter the chapter delves into the general different tax risks which impact organisations. Chapter 4 focuses specifically on the tax control frameworks (TCF) and tax risk framework (TRF) of the U.S.A, U.K and S.A

and discusses how tax authorities in these countries have been reacting to the changes in tax risk over the past 10 to 15 years and, therefore, concluding on the increased awareness of tax risk and TRM. Chapter 5 summarises the findings. It presents concluding remarks and identifies areas for additional research, as well as research limitations.

2: Corporate governance and the need for tax risk-management

2.1: Introduction

This chapter explores changes in corporate governance over the past 15 years. The chapter begins with a brief historical overview of corporate governance reform, focusing specifically on the U.S.A, U.K and S.A. The chapter shows the link between the changes in corporate governance and the development of sound ERM policies, followed by TRM policies. This ultimately illustrates the changing TRM landscape discussed in more detail in Chapter 4.

2.2: Corporate governance: A theoretical perspective

The emergence of the company as a legal person, operated by agents on behalf of 'distant' shareholders gives rise to the classic principal-agent problem. With this, comes the need for a system of checks and balances and, hence, the impetus for an effective system of corporate governance (Morck *et al*, 2005; Solomon, 2004; Smith, 2009). Modern corporate governance structures are, however, far from perfect and have been subject to dramatic change over the past three decades, specifically with regard to conceptualisation of the relationship between investors, managers and other stakeholders (Solomon and Solomon, 2004). A key result is that corporate governance is no longer concerned only with the management of agents to ensure the maximization of wealth for shareholders. Instead, it concentrates on the management of organisational risk; financial reporting; the provision of non-financial information and the safeguarding of sustainable and ethical business practice in both the short-and long-term (Cheffins, 2012; IRC, 2011; IOD, 2009; Morck *et al*, 2005; Solomon and Solomon, 2004).

2.2.1: Development of corporate governance from 1990's

During the 1980's there was a global increase in takeovers and mergers. The structure of these corporates resulted in an improved legal framework aimed at protecting shareholders (Cioffi 2006). This takeover environment (which was largely hostile) resulted in an increased focus on and awareness of corporate governance and sound managerial and financial control (Cioffi, 2006) which continued into the 1990's and ushered in managerial remuneration linked to organisational performance, including returns on stock markets and a drive to remove ineffective incumbent managers (Cheffins, 2012). A series of corporate scandals during the early part of the 21st century led to additional, far-reaching reforms. Most notable are the direct consequences from the demise of Enron and WorldCom (Solomon and Solomon, 2004).

The collapse of Enron in 2001, followed shortly by WorldCom, caused a wide-spread loss of confidence in existing corporate governance structures and policies and a global awareness of how corporate governance weaknesses could lead to material financial loss and social strife (see Solomon and Solomon, 2004; Reinsten *et al*; 2004;Scharff, 2005). These failures prompted significant reform of the American corporate governance landscape, most notable of which was the Sarbanes Oxley Act in 2002 (SOX) (Canada *et al*, 2008; Riotto, 2008).

Sarbanes Oxley is fundamentally about risk-management and disclosure (Taylor, 2012). It was enacted to enhance corporate governance by improving control testing within companies, enhancing credibility and improving transparency. For example, SOX requires directors to use an established industry-recognised framework for assessing their internal controls (SOX, 2002). Section 302 and section 404 of SOX have particular importance regarding disclosure and financial controls (see Bakker *et al*, 2010 for examples). A requirement from SOX is that management's internal report contain detail statements identifying the framework used by management in evaluating the effectiveness of controls (SOX, 2002). What SOX ultimately highlights is how a corporate scandal leads to an awareness of the limitations of existing corporate governance policies (particularly the need for effective risk-management) inducing

additional reform to restore confidence in the American Free-Market system. In the U.K, a similar theme emerges.

The world's first formal code on corporate governance, the Cadbury Code (Solomon and Solomon, 2004) was considered to be a reaction to corporate governance failures such as the Maxwell affair (Iskander & Chamlou, 2000). The Cadbury Code was based on the 'apply or explain' principle (Solomon and Solomon, 2004), where companies are required to comply with the code or explain, with reasoning, deviations from the code (Cadbury Code, 1992). The code was designed so that companies followed best practice standards and as such the internal control structure and risk-management of companies should be formalised and directors should be taking responsibility for these functions (Cadbury code, 1992). The report specifically states that the acceptance of its principles will result in a significant change in the financial reporting and governance paradigm (The Cadbury Report, 1992). The Cadbury report re-enforces the importance of companies maintaining profits and expanding but still exercising this growth and development within a regulated and controlled framework (The Cadbury Report, 1992). This message was reiterated by the Greenbury Report (1995), Hempel Report (1998) and Combined Code (1998) which stress the importance of a flexible system of corporate governance able to respond to emerging risks and ensure corporate transparency and accountability (Solomon and Solomon, 2004).

In particular, the Combined Code, coupled with the recommendations of the Turnbull Committee, means that companies are required to review the system of internal control and risk-management and are thereafter encouraged to express an opinion on the effectiveness of the internal control and risk-management system[1]. The ultimate aim was to assist companies in establishing the formal system of risk-based approach to corporate governance. A key feature of the Turnbull report is that it emphasises the importance of on-going and systematic risk assessment of the business, as well as the

[1] For example, the report allowed internal auditors to be given enhanced responsibility for risk-management and assessment processes. The risk identification and assessment process included the production of risk registers and internal audit was increasingly retained to comment on and improve risk-management and internal controls within organizations (Solomon and Solomon, 2004; Page and Spira, 2012). A major development from the Turnbull report is that risk-management has become a central focus of corporate governance (Page and Spira, 2012).

importance of embedding risk-management and internal control within an organisation (Turnbull report, 1999; Page and Spira, 2012).

Following the demise of Enron, the focus on risk identification and control was heightened. For example, The Higgs Report (2003), Smith Report (2002) and Walker Report (2009) proposed certain amendments to the corporate governance systems of corporates and the combined code was revised. In each case, the aim was to clarify the need for effective corporate governance, including sound risk-management (Walker Report, 2009). Enron, WorldCom and the global financial crisis also had implications for South Africa.

South Africa is somewhat unique. The transition from Apartheid to democracy coupled with an associated increase in international trade, foreign investment and economic growth resulted in significant corporate governance reforms (Malherbe *et al*, 2001). Most significant was the publication of the King Report on Corporate Governance (King-I) (IOD, 1994) in response to prevailing socio-economic pressures post-Apartheid (Walker *et al*, 2010). King-I provided the country's first framework for effective corporate governance, with recommended standards for boards and directors of listed companies, banks, and certain state-owned entities (IOD, 1994)[2]. In response to changing global trends in the governance arena, including a host of corporate scandals and persistent social and economic constraints, the King Report for Corporate Governance in South Africa (King-II) was released in 2002. Following from King-I, a greater emphasis was placed, not just at the level of the board of directors, but on a more holistic approach to corporate reporting that recognised the relevance of a wider group of stakeholders and the importance of non-financial disclosures, including effective risk-management policies (IOD, 2002). A new section was incorporated in King-II dealing specifically with risk-management (Berwick *et al*, 2007; IOD, 2002) including, *inter alia*, the need for the board of directors to be responsible for the process of designing, implementing and monitoring the process of risk-management. All policies should be clearly communicated to stakeholders and the risk strategy should be

[2] The key principles covered by the code included the make-up and mandate of the board of directors, the role of non-executive directors, and appointments to the board of directors, board meetings, annual reporting, effective auditing, affirmative action programs and a company's code of ethics (IOD, 1994).

incorporated into organisation's operating ethos (IOD, 2002). The board is also responsible for maintaining and implementing sound systems of risk-management, as well as for ensuring the effective utilisation of risk-management frameworks in order to maintain a sound system of internal controls (IOD, 2002). This should culminate in formal risk documentation and management, including a risk-management policy. The board ought to be responsible for determining the risk appetite of the company and for managing threats to the sustainability of the organisation. Consequently, the company's exposure to risks from non-compliance with laws and regulations, including tax laws, should be examined, assessed and managed at the highest level (IOD, 2002).

In the wake of a global financial crisis, a third report on corporate governance was released in 2009 (King-III) (IOD, 2009) together with the world's first discussion paper on integrated reporting during 2011 (IRC, 2011). A new development in King-III is that companies are required to adopt an internal audit function that provides assurance and manages the company's governance, risk-management and internal controls (IOD, 2009; Smith, 2009). This requirement differs from Sarbanes-Oxley in that the internal auditors (as contrasted to the external auditors) are required to attest and report on the internal control and risk-management processes of a company [3] (Smith, 2009). Additional guidance is also provided in King-III on risk-management (IOD, 2009) (Smith, 2009). The implications of this is that the board will have to spend more time on risk-management and that risk-management will be required to be integrated fully into the operations of the business (Smith, 2009). This approach is referred to as the ERM plan of the company (Erle, 2006). The board is required to comment in the integrated report on the effectiveness of the risk- management process and system, as well as review annually the risk-management plan and continuously monitor and assess the levels of risk tolerance within a corporation (IOD, 2009). Part of the company's risk-management plan may include the creation of specific risk committees to assist the board with its risk-management functions including the execution of a formal risk

[3] According to the South African Companies Act No. 71 of 2008 s94(7)(f,h,i) it is the audit committee's responsibility to perform such functions including the development and implementation of a policy and plan for a systematic, disciplined approach to evaluate and improve the effectiveness of risk-management, control, and governance processes within the company. This is in line with King-III as internal audit will report to the audit committee on the risk-management of the company and a risk-based internal audit plan should be agreed upon with the audit committee for its approval (IOD, 2009).

assessment at least annually and the maintenance of a risk register (Smith, 2009; IOD, 2009). In addition, full disclosure in the integrated report is required of management's view of its risks, as well as any unusual risks which the enterprise may be facing (Smith, 2009).

These recommendations follow from lessons learned during the global financial crisis which highlighted weaknesses in corporate governance systems, particularly in the area of risk-management (Kirkpatrick, 2009). Although risk-management had been gaining momentum, this concentrated mainly on financial reporting aspects, to the detriment of fundamental operational and compliance issues (Kirkpatrick, 2009). The inability of risk-management staff to impose effective controls was also noted at several failed companies such as Credit Suisse and Bear Sterns (FSA, 2008b; SEC 2008b). For example, a 2008 review of major American and European banks found that all of the 11 surveyed companies failed to assess adequately the risk-management appetite of their corporations, confirming concerns that adequate and sufficiently broad risk-management practices were not in place (Kirkpatrick, 2009). This has led the OECD (2009) to conclude that:

> "Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk-management in what were widely regarded as institutions whose speciality it was to be masters of the issue." (p.31)

Consistent with the sentiment of the IRC (2011) and IIRC (2011), risks were either not being identified due to existing risk-management policies lacking in scope or were not appropriately linked to the organisation-wide strategy (Kirkpatrick, 2009; Mirvis *et al*, 2010). A disconnect between risk-management, key performance indicators and managerial compensation has aggravated this (Kirkpatrick, 2009). When it comes to the issue of tax-compliance, similar shortcomings may hold. Tax is very often seen as simply a resultant transaction (Erasmus, 2008), with the effect being that a detailed analysis of the ever-evolving tax environment, including the promulgation of changes to tax laws and changing attitudes of tax collectors, are not being specifically considered by large corporations. This is despite the emphasis on the need for an integrated outlook on corporate governance, including risk identification, management and control (IRC,

2011). Before examining this in more detail, Section 2.2.2 explores the link between ERM and TRM

2.2.2: The case for tax risk-management

Tax is often a material line item in a company's financial statements, implying that it is a relevant consideration for users wishing to assess the financial performance of the organisation. Tax is also qualitatively material. In a climate of increasing awareness of the need for ethical, sustainable business (IOD, 2009), stakeholders are interested in the extent to which companies structure their affairs in compliance with both the letter and spirit of the relevant jurisdiction's tax codes (see King, 2012). Tax compliance would also form part of the assessment of the overall culture of corporate commitment to the principles of transparency, fairness and accountability enshrined in most codes of corporate governance (Bakker *et al*, 2010).

The tax control framework in the U.S.A is centred on risk-management as opposed to direct compliance management (Bakker *et al*, 2010). Traditionally, many tax functions were primarily concentrated on calculating, reporting, and paying taxes for companies, as well as reactively responding to tax audits (Bakker *et al*, 2010). In a climate of increased awareness of the need for effective risk-management per Section 2.2.1, many U.S.A corporates now require an increased responsibility from their board of directors in actively becoming more involved and accountable in assessing TRM (Elgood *et al*, 2004).

In the U.K a company is subject to self-assessment for its tax returns. This means that it is required to notify Her Majesty's Revenue & Customs (HMRC)[4] of its chargeability to tax, then to calculate its own liability, and file a corporation tax return along with sufficient additional information to explain the entries (Bakker *et al*, 2010). In 2006, HMRC published *Tax in the Boardroom*. This study was the basis for the HMRC's risk-assessment methodology which defined a new approach to risk-management in the U.K (Bakker *et al*, 2010). A key result of the study is that U.K boards are becoming increasingly more aware that taxes affect shareholder value (Butler, 2006). Another

[4] HMRC–Her Majesty's Revenue and Customs: the UK tax authority

important change which resulted from change in legislation was implemented in the U.K April 2009 budget. In this, it was legislated that Senior Accounting Officers (SAO's) were required to sign annual declarations that "appropriate accounting arrangements" had been used to calculate the company's tax liability (Bakker *et al*, 2010). This new measure is an attempt to increase the profile of tax compliance in the Corporate Governance policies and procedures of an entity (Bakker *et al*, 2010).

In S.A, in implementing the principles of King-III, a tax steering committee should be in place and regular internal tax reviews should take place in order to assess in detail all relevant facts of corporations in order to anticipate probable tax audits to expose potential hidden tax risks (Bakker *et al*, 2010). Tax strategies, which incorporate mapping known tax issues between the South African Revenue Services (SARS) and taxpayers, as well as those uncovered through the tax review process, should be formed with a tax steering committee (Bakker *et al*, 2010).

It is evident from the above that TRM, as a sub-component of ERM, is a crucial factor in operating and managing corporate entities and in ultimately ensuring the smooth and effective organisation of companies. This highlights the growing need for changes in, and attitudes towards, practices of TRM, something explored in more detail in Chapter 4.

2.2.3: Summary

Chapter 2 began with a general discussion of the history of corporate governance, and particularly, risk-management. The chapter then provided an analysis of the developments of corporate governance with a particular focus on risk-management in three countries – the U.S.A, U.K and S.A. The impact of failure to adhere to adequate risk-management policies was also briefly discussed and the chapter drew the connection between corporate governance legislative changes, risk-management and TRM, illustrating the need for changes in attitudes of the international corporates towards sound TRM. Chapter 3 will discuss what tax risk is and its relevance for companies and, thereafter, an analysis will be made, discussing the general and specific tax risks facing companies.

3: Tax risks facing the international corporate

3.1: Introduction

Having explored how recent regulatory and governance developments have impacted on risk-management in general, this section highlights emerging tax risks (consider Weinberger *et al*, 2012). A detailed content analysis of the prior academic and professional literature is carried out. The aim is to identify those aspects of tax administration and practice that, over the last 10 to 15 years, has led companies to increase their awareness and understanding of tax risk and how this translates into an effective TRM ethos for the international corporate.

Chapter 3 is structured as follows: a definition of tax risk and what tax risk means for corporate entities will be discussed. This discussion will focus on the relevance of TRM for companies, as well as on what an effective TRM philosophy entails. Thereafter the chapter will deal with the different tax risks which impact on organisations, focusing on both the specific and generic risks and drawing the link between the broad TRM philosophy supplemented by a transaction-specific methodology.

3.2: What is tax risk-management and what does it mean for companies?

3.2.1: What is tax risk-management?

'Tax risk' is a highly context-specific subject (Elgood *et al*, 2004). Every entity makes numerous decisions about business operations, activities and control structures, including decisions about tax administration and functions. These tax decisions may relate to the link between system operations and the achievement of desired tax results or around compliance with the tax requirements of an entity (Elgood *et al*, 2004). Ultimately these operating decisions and considerations may lead to uncertainties which are, in turn, formulised as risks, with the tax elements of this uncertainty resulting in tax risk (Erle, 2006).

TRM is concerned with making sound judgements' and decisions to ensure the effective management thereof (Elgood *et al*, 2004). TRM is a multi-dimensional activity. The

primary source of tax risks is the legal environment created by tax laws, international agreements and the interpretation of this environment and these agreements (Erle, 2006). An important element of tax risk is the realisation that it is not only about trying to minimise taxes but primarily about identification of the tax risks facing an entity and the appropriate management and reduction thereof (Elgood *et al*, 2004). In order to make profits and to increase shareholder-value, businesses will be required to take risks, and certain of these risks may impact tax compliance and administration of an entity (Elgood *et al*, 2004). Tax compliance, based on the accounting numbers which may be incorrect, could result in increased risk (Erasmus, 2008).

Any corporation should, therefore, consider its policies and values when actively considering and monitoring its tax risks and TRM plans (Elgood *et al*, 2004). Corporates are no longer enthusiastic about increasing tax-avoidance strategies because reputational damage is becoming an important feature for organisations. These considerations have resulted in entities reassessing and re-aligning their tax risks on a continual basis (Erle, 2006). Corporate conduct and reputational risk are being more actively considered within organisations and this is having a direct impact on the TRM of companies (Erle, 2006).

TRM describes the analysis of scenarios and possible outcomes and likelihood of these scenarios (Bakker *et al*, 2010). This can be viewed through a 'tax-pyramid' type of analysis whereby the overall financial goal of the organisation is considered first and, thereafter, this is broken down into several value drivers. Some of these drivers are directly in the domain of tax and tax management and others have an indirect link to taxes (Bakker *et al*, 2010; Mc Grail, 2011).

The culture of tax awareness is a foundational element of an effective TRM process (Mc Grail, 2011). This culture must be forced by management through an emphasis of rigorous tax analysis which will ensure that the TRM process implemented by companies will achieve the desired and optimal results (Mc Grail, 2011). This idea will be dealt with in the next sub-chapter.

3.2.2: The relevance of tax risk-management for organisations.

TRM has been considered as something automatically taken into account in an organisation's policies and business operations (Bakker *et al*, 2010). As a result of tax risk often being a secondary agenda in corporations, there has been little consistency in how to manage this tax risk (Erasmus, 2008). Discussions and seminars relating to the management of tax risk have historically remained high-level with minimal formalisation and structuring (Bakker *et al*, 2010; Erasmus, 2008). In order to understand why TRM is relevant for an organisation, consideration needs to be given to the fact that tax authorities globally have begun to work jointly in sharing tax data, as well as joining forces in developing and maintaining key tax enforcement requirements (Weinberger *et al*, 2012). An example of this is the African Tax Administration Forum (ATAF) which is exerting influence on African Revenue Jurisdictions (Weinberger *et al*, 2012). Likewise, the Organisation for Economic Co-operation & Development (OECD) and the Intra-European Organisation of Tax Administrations (IOTA) have expanded membership and are sharing practices. The OECD, in particular has grown considerably in the wake of the recent financial crisis (Weinberger *et al*, 2012). This has resulted (and is expected to continue to result) in an increase in required compliance and tax audits in entities which, in turn, means an increase in tax risk facing companies (Weinberger *et al*, 2012).

Globalisation and added competition driving the need for higher post-tax profitability adds to this. As companies seek to maximise returns for shareholders, innovative tax management strategies are conceived, providing an added impetus for collaboration among tax collectors and regulators (Owens, 2006). Socio-political forces complement this. Firstly, in the context of the global financial crisis, governments are under increased pressure to widen the tax base in order to finance increasing deficits (Ventura *et al*, 2013). Going hand-in-hand with this is political pressure to demonstrate that tax avoidance schemes are being actively dealt with; that governments are calling those who may not be paying their fair share to account (Vivian, 2006).

The result is a climate of anti-abuse and added regulation leading to an increase in the volume and complexity of tax legislation reaffirming the need for effective tax risk-

awareness and management (Owens, 2006). Compliance from a global perspective means the effective integration with accounting and reporting, automation of processes and the ability to organise and structure tax processes around it (consider Bakker *et al*, 2010). As emphasized by the OECD (2006) the innovations of businesses, development of financial products and the commoditisation of tax schemes has resulted in an increased emphasis on tax compliance. This has, in turn, necessitated an improved TRM plan and policy from corporates (OECD, 2006).

Consequently, companies should not make the mistake of reducing the tax risk-management of their entity to a 'reactive' process (Erasmus, 2008). A proactive TRM approach can result in a positive relationship between revenue authorities and a company, as well as eliminate additional, unnecessary tax risk exposure (Erasmus, 2008). By implementing and maintaining a documented tax philosophy within an organisation, particularly around acquisitions, operations, accounting policies and financial reporting (Mc Grail, 2011), the entity transforms the 'reactive' process into a 'proactive' one (Erasmus, 2008). This means that Financial Directors and Chief Financial Officers must consider TRM in the management of their ERM, specifically the tax implications of unfavourable tax balances, non-compliance with tax laws and improper recording of tax assets and liabilities in the Annual Financial Statements (McGrail, 2011). Further, the tax department must be informed and updated about important changes to the business (Hassing, 2012; consider Erle, 2006). It is important for other departments outside the tax department to be aware of elements which will ultimately impact the tax risks facing the entity (see Erasmus, 2008).

More broadly, the drive for improved corporate governance discussed in Chapter 2 also makes a case for effective ERM, including TRM. In the U.S.A, the U.K and S.A, there is a generally recognised need for an effective and holistic risk identification and management paradigm (Solomon, 2010; IOD, 2009; IRC, 2011). This must form an inextricable part of the strategy and operations of the organisation and, ultimately, with the need to generate sustainable returns in the short-, medium- and long-term (see, for example, IOD, 2009; Solomon, 2010). From a tax perspective, this means that the TRM needs to form an active part of the overall risk-management ethos of organisations,

rather than play an isolated and often secondary part of the firm's governance systems (McGrail, 2011).

If the tax function is operating as an integral part of the business, as opposed to a stand-alone separate entity (Erle, 2006; McGrail, 2011), a proper TCF can then be implemented within the organisation and appropriately maintained (Bakker *et al*, 2010). An effective control framework will see the tax department managing and integrating the tax function into the daily business processes (see Hassing, 2012). The transparency of the tax function is also a critical element in an effective TCF (Bakker *et al*, 2010). Company personnel should have a role to play in tax function and each decision within the tax department should be transparent about the effect that particular decisions will have on the tax strategy of the business (Erasmus, 2008). The tax function must be organised to ensure that the desired goals are achieved as efficiently as possible and that all necessary and available resources have been considered in achieving these goals (consider Hassing, 2012; Elgood, 2004).

In considering the above, once the start-up phase of the company is complete, tax planning should be integrated into the growth, stabilisation and control phases of the entity (Hassing, 2012). In compliance with International Standards of Auditing 330: The auditor's responses to Assessed Risks (ISA 330) controls must be built into the business processes of entities and a sound TCF within the growth phase will ensure a sound, all-inclusive risk control framework as called for by codes of corporate governance (Section 2.2.1) (Bakker *et al,*2010).

Finally, the relevance of TRM is also seen when considering how entities appraise investment opportunities (Mc Grail, 2011). A common investment decision-making tool is a net present value computation (NPV) (Negash, 2004). This technique discounts the cash flows of a proposed project at a suitable discount rate, often the organisations weighted average cost of capital (WACC) (Negash, 2004). Normally, the WACC is a post-tax discount rate that assumes a consistent tax rate over the life of the project, consistent with the views of, *inter alia,* the IASB, that tax is simply a residual item (Erle, 2006). As explained by McGrail (2011), this may not be a conceptually rigorous approach. Unlike most operating, investing and financing risks which are factored into

either the cash flows or discount rates when determining the project's NPV (Negash, 2004), tax risks are assumed to be constant and negligible. Seldom are organisations' effective tax rates used; the possibility of changing tax rates taken into account; and the impact of changing tax laws, anti-avoidance schemes and associated tax-penalties taken into consideration (Mc Grail, 2011; Erle, 2006). Likewise, where a project has a negative NPV, particularly in the start-up years, the relevance of associated tax losses should not be overlooked. The availability of tax deductions or tax loss carry-forwards could reduce the total risk-exposure of the project as government, in effect, provides a partial subsidy (Negash, 2004). The converse is also relevant. The company would need to consider whether or not the provisions of the relevant tax laws allow for the deduction of losses; if those losses are ring-fenced; and whether or not the tax losses may expire (Mc Grail, 2011). As explained by Owens (2007), the implications of this approach can be material, leading to poorly informed investment-decisions due to a failure to integrate actively tax strategies and risks with the operationally-based cash flows of the respective project.

3.2.3: A philosophy for tax risk-management

Due to the importance of actively managing tax risks, companies should develop an effective TRM philosophy or entity-level tax control framework (see Section 3.2.2) Appropriate tax risk processes will seek to manage effectively the uncertainties associated with tax laws and how these are applied in each specific context at organisational level (Mc Grail, 2011). In establishing this tax philosophy the board is responsible for setting the general standards. Similar to recommendations of codes of governance in the U.S.A, U.K and S.A (Chapter 2), the board should define a global TRM framework. This should unambiguously establish the entity's appetite for tax risk and define the resulting governance systems to identify these risks and reduce them to acceptable levels (Erle, 2006). The result is, in essence, a type of tax 'code of conduct' that states the overall position of the company towards tax and the management thereof (Erle, 2006). This 'code of conduct' should be centred on the entity's TCF in ensuring that the tax function within an organisation is effective, efficient and transparent (Bakker *et al*, 2010). In doing this, the entity will need to ensure that the strategic planning of the company is aligned with the tax function and that the tax risks that have

been assumed (consider Hassing, 2012). The accounting and reporting process should be organised so that tax compliance flows seamlessly (consider Hassing, 2012).

Responsibility frameworks, specifically implementation of responsibility assurance levels within a company, as well as a discussion of tax risk in the Annual Report, are effective tools in ensuring that TCF is appropriately applied and implemented within an organisation (Bakker *et al*, 2010). An organisation must ensure that they are in control of their tax filing processes, that they have an efficient and organised tax accounting process, and that compliance with tax authorities has been maintained (Hassing, 2012). This can be achieved through continual improvement in their tax systems and controls (see Bakker *et al*, 2010; consider Hassing, 2012).

For entities the effective management of tax risk poses a number of crucial questions: firstly, are the board members aware of their responsibilities for tax risk-management? Secondly, are members of the board aware of the impact that tax risks will have on the policies, processes, structures and transactions of their companies? Thirdly, is the board sufficiently informed of the potential complexity of tax-associated risks (Erle, 2006)?

To ensure that each of these concerns is addressed, the board needs to consider whether it collectively has adequate qualifications to understand and manage tax risks. Companies will only implement an inclusive TRM system when they are fully aware and appreciate the relevance of tax for their corporations (Erle, 2006). This requires boards to have a broad range of skills (IOD, 2009) and the time needed to discharge their duties effectively (Erasmus, 2008). Going hand-in-hand with this is the need for a thorough understanding of the systems, procedures and structures that underpin a sound TRM system (Erle, 2006). As per the recommendations of the IOD (2009) and Solomon (2010), the board should ultimately accept responsibility for TRM, effectively ensuring a measure of corporate accountability. This is particularly important when tax is assessed as a quantatively and/or qualitatively material component of an entity's overall risk environment (Erle, 2006)

Further, the board should require active communication on and detailed documentation of TRM, ensuring that the TRM system has sufficient resources to identify and manage tax risks effectively (Erasmus, 2008). This ensures an 'awareness' of the importance of

TRM throughout the organisation. It is also important for safeguarding against inconsistent decision-making by management when it comes to assessing and responding to perceived tax risks (Erle, 2006). Consequently, all key committees of the board should be actively engaged in TRM strategies such as audit, risk and compliance and ethics committees, including executive and non-executive members of the unitary board (Erasmus, 2008).

At the operational level, tax managers ought to have sufficient authority to ensure thorough application of professional judgement when dealing with complex or contentious tax issues (Erasmus, 2008). Consistent with codes of best corporate governance practice, tax risk managers should have clear reporting lines and access to either the board or suitable committee of the board. Tax managers should be required to provide detailed reports dealing with *all* material taxes borne by the company; associated controls to ensure compliance with those laws and regulations; and the result of control assessments[5] (Erle, 2006). Naturally, this requires the scope of the tax department's authority to be sufficiently extensive. At a minimum, tax managers should monitor actively all direct and indirect taxes including, *inter alia*, normal tax, Pay As You Earn (PAYE), Unemployment Insurance Fund (UIF) and Skills Development Levy (SDL), as well as changes in the regulatory environment. These taxes will have to be considered on an individual corporate basis as well as on the impact they will have on the reputational tax risk of the company (Bakker *et al*, 2010). Interconnected with this is the need for continuous assessment of how the nature, purpose and extent of an organisation's activities may alter its tax-liability exposure (See Erle, 2006).

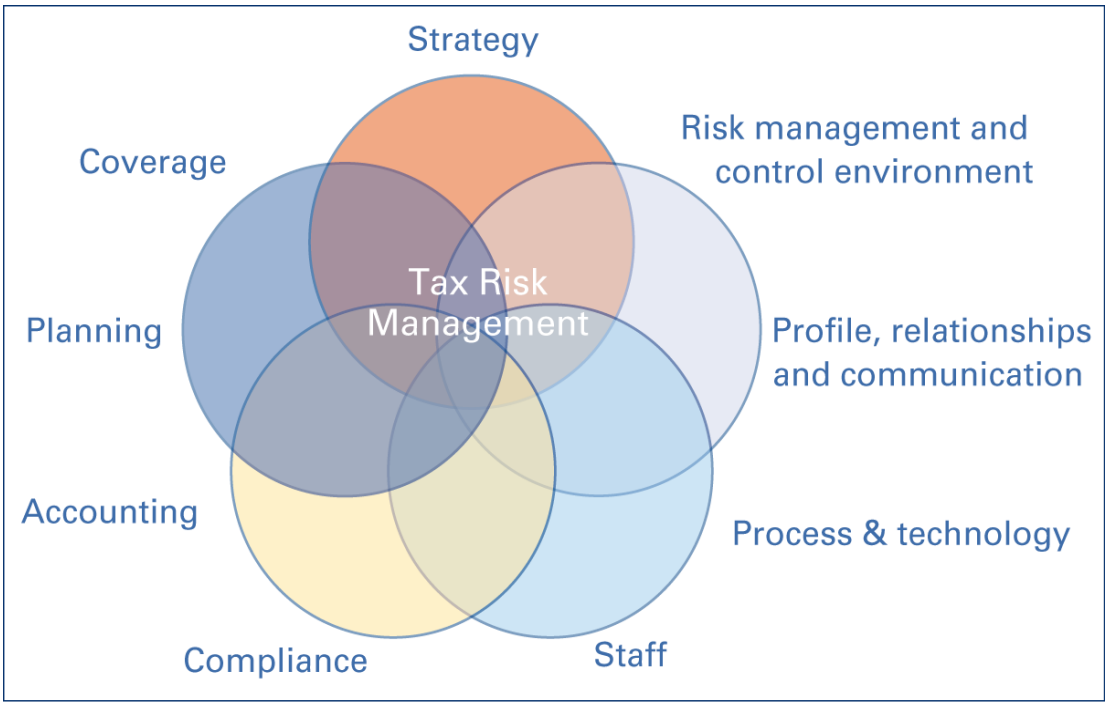
Finally, and consistent with the corporate governance literature (IOD, 2009; Solomon, 2010), the board needs to have a progressive, forward looking approach towards TRM, seeking to pre-empt issues, rather than adopting a reactionary *modus operandi* (Erle, 2006; McGrail, 2011). Interconnected with this is the need for continuous monitoring and evaluation of the TRM system. The board should be dynamic, relying on internal and external audit functions to identify deficiencies in the TRM control environment. Simultaneously, it should consider how the firm's long-term objective, macro-economic outlook and changing socio-political climate may impact tax-related risks. The aim is

[5] Practically, this would be carried out in consultation with the internal audit function (see, for example, IOD, 2009).

thus to ensure that the TRM system remains relevant, pre-empting emerging tax risks, rather than simply reacting to them (Erle, 2006). Communication and involvement by all staff members are crucial components of an effective TCF and TRM environment, communicating business issues, during commercial decision-making processes, with the tax function will improve the decision-making process as a whole (Bakker *et al*, 2010).

Figure 3.1 provides an illustrative summary of the 'elements' of an effective TRM system. Table 3.1 provides examples of the functions of different elements of the board in connection with TRM:

Figure 3.1: Venn-Diagram: Tax Philosophy



Stamm (2004)

Table 3.1: Responsibilities of the board of directors		
PERSON RESPONSIBLE	**RESPONSIBLE FOR**	**REVIEW CYCLE**
The board	The overall control activities of the entire organisation	Annually
The audit committee	Review of the tax risk management policy and confirmation that the internal control framework is being operated and monitored.	Bi-annually
CFO	All control activities relating to the finance function, including all control activities over taxes and tax risks	Quarterly
Head of tax	Control activities over tax and tax risk-management	Monthly
CFO/tax managers	Control activities over the finance function, including all taxes and including management of subsidiaries and divisions which the tax manager has responsibility for.	Monthly
Individual staff members of the tax department	Responsibility for control activities over taxes and taxes specific to their area of responsibility e:g VAT considerations likely to be assigned to the Sales department	Continual
Internal audit	Review of applications of controls and procedures	Quarterly

It should be stressed that Figure 3.1 does not imply that TRM is solely about reducing tax liability. Rather the tax philosophy is concerned with ethical minimisation of exposure to tax-based risks (Mc Grail, 2011). This requires a formally established policy supported by an appropriate system of internal controls (Mc Grail, 2011) and a clear focus on active TRM in both the short-and long-term. At the same time, this section has focused on a culture of effective TRM. While a broad TRM philosophy is important, this needs to be complemented by a methodology for focusing on **specific** tax risks at **a transactional level.** To this end, Section 3.3 discusses different classes of tax risks. These are used to make a more detailed assessment of the firm's risk exposure and design specific TRM controls.

3.3: Tax risks impacting organisations

Tax risks can be divided into generic and specific risk areas (Elgood, 2004). Specific risk areas are divided into transactional, operational, compliance and financial accounting risk; while generic risk areas include portfolio, management and reputational risk (Elgood, 2004; Bakker *et al*, 2010).

3.3.1: Tax-specific risks

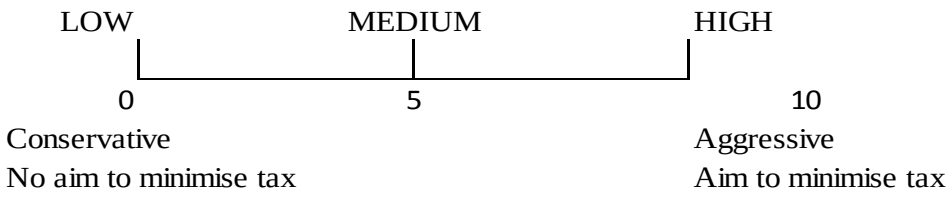
The first tax-specific risk is transactional tax. Transactional risk also refers to accounting transactional risk (consider Weinberger *et al*, 2012). As in any transaction, a certain level of uncertainty may exist regarding how the tax law applies to that transaction (Stiglingh *et al*, 2013): specifically the more complex and unusual and less routine transactions will result in an increased transactional tax risk (Elgood, 2004). Significant corporate restructuring and acquisition and disposal transactions will result in a higher element of uncertainty and, thus, increased transactional risk, as opposed to the daily economic activity of purchase and sale of products (see Elgood, 2004). In addition, an increasing concern for tax authorities may be that certain transactions are carried out to achieve expected tax results (i.e: specifically aimed at maintaining tax losses) (see Bakker *et al*, 2010 and Elgood, 2004). These types of transactions will, thus, result in increased exposure to and challenge by the revenue authorities, increasing the tax risk of an organisation (Elgood, 2004). Anti-avoidance legislation implemented by revenue authorities also increases the transactional risks of an entity (Bakker *et al*, 2010).

As illustrated in Section 3.2.3 boards of directors are being required to take responsibility for the tax management and strategies of a company (McGrail, 2011). Failure to adhere to these new policies further increases the transactional tax risk faced by entities, specifically in that tax departments are not integrally involved in a transaction but are, rather, consulted after the fact when it is often too late for further amendments to the respective contracts (see Erasmus, 2008). Failure to account for and document these transactions appropriately, results in an inadequate tax strategy framework, increasing the transactional risk (McGrail, 2011; Elgood, 2004).

In some instances companies have adequate policies and frameworks in place but it is the failure to implement and document these policies appropriately that results in the significant increased transactional risk (Stamm, 2004). Often the need to complete the transaction expeditiously results in an unfavourable tax transaction risk (see Stamm, 2004; Elgood, 2004) and frequently, also results in the challenging of the tax treatment of the transaction by the revenue authorities (Elgood, 2004).

In examining the literature directly linked with transactional risk, a commonly considered question is whether or not the company has established a profile specifically linked to transaction risk (Stamm, 2004; Consider Weinberger *et al*, 2012).
The scale below illustrates a typical rating for an organisation:

Figure 3.2: Company's profiled transaction risk



(Stamm, 2004)

Tax risks unique to the nature of the transactions concluded by a company can be managed if appropriately identified in advance and dealt with according to the entity's document risk strategy and appetite for aggressive tax management (Section 3.2.3). The frequency and type of transactions will, however, also be affected by the operational profile of the taxpayer, this giving rise to a related 'operational tax risk' (Elgood, 2004).

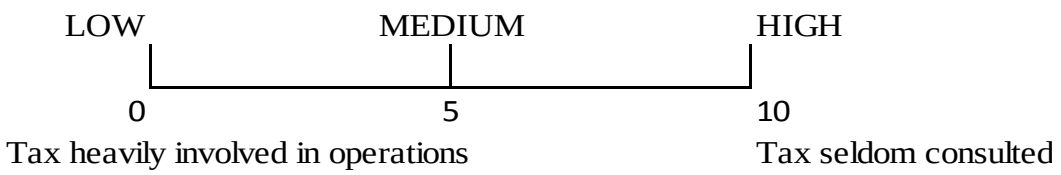
Operational risk is defined by the Basel Committee on Banking Supervision as "the risk of loss resulting from inadequate or failed internal processes, people, systems or external events" (Basel II, 2006). The above definition includes legal risk but not

reputational risk (Bakker *et al*, 2010). Operational risk concerns the primary risks of applying tax laws, regulations and decisions to the routine daily operations of a business (Stamm, 2004). Operational tax risk is often referred to as the tax risk run by a tax department because of failure of processes either within the remit of a tax department or outside of it (Bakker *et al*, 2010). An example of this could be where a company loses a tax appeal because its tax department missed a critical submission date (see Bakker *et al*, 2010).

Disparate operations will result in varying associated levels of tax risks (consider Elgood, 2004). For example ordinary third-party product sales will have vastly different risks associated with them than intra-group cross-border products sales. The latter will have increased tax risks (primarily linked to transfer pricing issues) (Stamm, 2004). As discussed above, the closer the tax function is to the operations of the business, the lower this operational risk (see Erasmus, 2008; McGrail, 2011).

Another example is tax costs companies have faced as a result of the accounts payable department not saving relevant data for sales tax computation or when well designed transfer pricing mechanisms were incorrectly implemented (Bakker *et al*, 2010). These obvious errors can be avoided when the tax department is sufficiently and appropriately integrated into the organisation (see Erle, 2006). Related to this, the internal processes and controls must be well documented to ensure that operations can be structured to mitigate tax costs and reflect accurate pre-and post-tax amounts in the tax returns and financial statements. In the context of the requirements for formal control systems, as discussed in Section 2, this should not impose an undue burden on the taxpayer (see Bakker *et al*, 2010). The scale below is an outline of how a company could rate itself in the operational risk schematic:

Figure 3.3: Company's profiled operational risk



(Elgood, 2004)

As illustrated in Figure 3.3, the more involved the tax department is in the operating function, the lower the operational risk will be (Erasmus, 2008). Operational tax risk-management requires a tax manager to keep track of market developments, including areas in which other companies are audited and where other companies may encounter operational problems (Bakker *et al*, 2010). Past experiences, and weaknesses identified in the company's control structure, should be considered (see Stamm, 2004; Bakker *et al*, 2010).

External as well as internal audits may also play a significant role in effectively managing an entity's operational risk. Often weaknesses in fiscal management and operations will highlight operational tax weaknesses (consider Bakker *et al*, 2010; ISA 330). Operational tax risk can be effectively managed via a method that identifies the risks, attempts to amend the risk, and subsequently, reviews of whether risk mitigation strategies have been executed (preferably prior to revenue authority audits) (consider McGrail, 2011, Bakker *et al*, 2010; Erle, 2006). Active management of transaction and operational-associated tax risks alone is, however, inadequate. Changes in tax laws, including how the requirements of tax authorities are expected to be implemented, give rise to compliance risk.

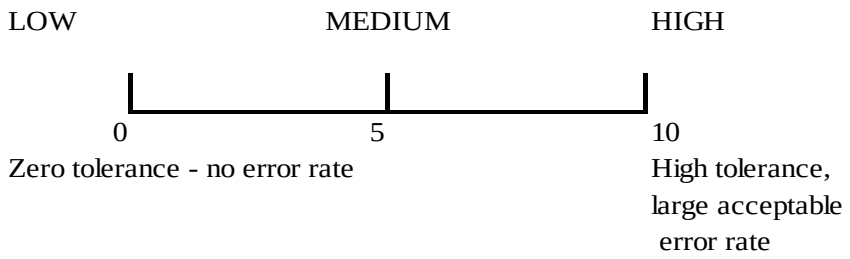
Compliance risk refers to the risks associated with not meeting an entity's tax compliance obligations (Stamm, 2004). The recent global economic recession and constantly changing regulations and updated tax amendments world-wide have resulted in an increasing risk, specifically associated with tax compliance (Weinberger *et al*,

2012). In considering this tax compliance risk, we must consider that risk of 'discovery' by tax authorities is not a factor. Full disclosure and review by tax authorities is an implicit assumption in this consideration (Elgood, 2004). From a basic tax perspective, compliance refers to the preparation, completion and review of an organisation's tax returns (irrespective of type) and the risks within the processes involved in the preparation, completion and review processes discussed above (Consider Elgood, 2004; Stamm, 2004).

Compliance risk also takes into account the updated and new tax legislation emerging globally (see Weinberger *et al*, 2012). Of growing significance are the following: firstly, the integrity of the underlying accounting systems and information. Secondly, the process of extracting tax-sensitive information from the accounting systems. Thirdly, ensuring that tax compliance analysis processes are based on up-to-date knowledge of the most recent tax laws and practices and, fourthly, the effective and efficient use of technology in monitoring and managing the processes (Elgood, 2004).

In achieving the desired compliance risk balance as discussed above, a company will need to consider the trade-off between costs and benefit (Stamm, 2004). To achieve zero errors on a tax return would be cost prohibitive (Elgood, 2004). Another consideration is whether companies are over-analysing the process and could possibly reduce the cost with improved planning and thus minimum impact on the associated risk (consider Elgood, 2004). The more a company is prepared to accept errors in their returns, the higher the compliance risk (Stamm, 2004) as illustrated by Figure 3.4

Figure 3.4: Company's profiled compliance risk



(Elgood, 2004)

A company, in attempting to effectively managing its compliance risk, needs to consider its error tolerance levels (Stamm, 2004). Tax compliance risk also considers the risks arising from the agreement of tax returns and from enquiries on, or the audit of, submitted tax returns by the fiscal authorities (Elgood, 2004). To this end, considering the many instances of disagreements in tax returns between revenue authorities and taxpayers, in order to reduce the compliance risk, companies need to be cognisant of the balance between increasing fiscal stimulus (predominantly done in an attempt to counter the global economic recession) while still maintaining appropriate compliance policies in their businesses (Stamm, 2004; Weinberger *et al*, 2012).

Considering the tax strategy points raised above, another compliance consideration could be the fact that there may be a significant number of returns that the tax department is not formally involved in such as payroll, indirect tax, customs and duty returns (consider Erle, 2006; Stamm, 2004). In considering Figure 3.4, it is necessary to consider how the revenue authorities would rate a company on the scale: aggressive policies (and possibly increased tax audits and monitoring by authorities) versus being considered a conservative taxpayer, as this will aid the company in assessing and managing its compliance risk (Elgood, 2004).

The final specific risk to be examined is the financial accounting risk. Since the implementation of SOX, 2002 there has been a significant global increase in and awareness of the risks regarding financial accounting (Elgood, 2004). Specifically, there has been a greater demand for companies to document and test their internal controls and this has been expanded to include the controls in the companies' tax department specifically linked to financial reporting (see Bakker *et al*, 2010). Of particular importance in understanding this risk is the fact that many of the tax amounts included in the financial statements are estimated (Stamm, 2004). Deferred tax, in particular, is considered to be a tax that will be paid or recovered in the future, based on assets and liabilities which are recorded in the accounts in the current period (consider Bakker *et al*, 2010). *International Accounting Standard 12: Current and Deferred Tax* (IAS 12) states that current taxes related to prior and current periods that are based on taxable profits and expected to be paid to or received from tax authorities should be accounted for (Bakker *et al*, 2010; IASB, 2010). The result is that a company's management is required to consider, not only the immediate tax implication of a transaction, but how differences between accounting and taxation treatments may impact the financial position and performance of the organisation in the eyes of key stakeholders (Elgood, 2004). In other words, there is an added 'dimension' to effective TRM with the final tax expense in the statement of comprehensive income a product of tax charges levied in terms of relevant tax acts, as well as a product of accounting-based adjustments that may have a material effect on post-tax performance (Bakker *et al*, 2010; IASB, 2010).

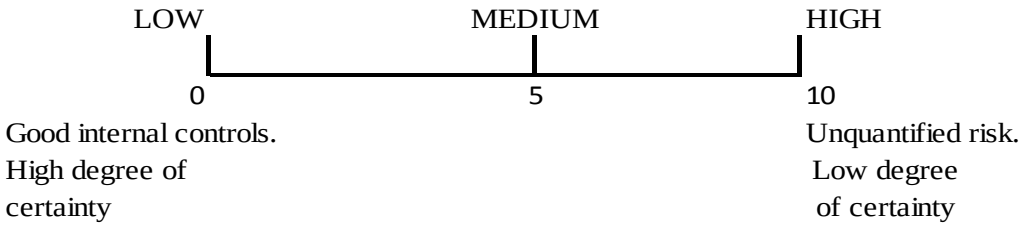
Therefore, tax departments should be fully aware of and understand the timing differences between cash-based taxes and the impact of the underlying transaction on the financial statements. Similarly, the effect, *inter alia*, of differences in tax rates, denied deductions, exempt incomes and accounting rules on the amounts recognised and disclosed in the financial statements must be considered (Bakker *et al*, 2010). Going hand-in-hand with this, the processes and internal controls involved in arriving at the accounting figures must be subject to continuous managerial review (Stamm, 2004). Consideration must also be given as to the amount of uncertainty that will be allowed and accepted in interpreting and applying the tax laws to compute the tax amounts

(Elgood, 2004). Whether or not the quality of data received from or used in the transactional, operational or compliance areas are appropriate (Stamm, 2004); legal questions on the application of tax laws; and the need for provisions to deal with uncertain tax positions are additional TRM factors (Elgood, 2004; Stamm, 2004). Other than the statutory financial accounts which result in this financial accounting risk, consideration must also be given to tax amounts which appear in cash- flow planning analysis, Net present analysis, future forecast and investor expectation analysis can all be affected by the current and future tax treatment of transactions (Elgood, 2004).

What the above discussion highlights is the highly sophisticated tax risk environment that requires sound prudential judgement to manage (consider IRC, 2011; IOD, 2009). Consequently, simply following a legalistic approach to TRM where all that matters is 'ticking the boxes' is short-sighted and likely to result in tax departments focusing too heavily on the processes involved in arriving at the tax amounts, to the detriment of appropriately monitoring and managing pervasive tax risks (consider Elgood, 2004; Bakker *et al*, 2010).

The consideration of a company's status in assessing the above risk can be effectively determined using the scale below:

Figure 3.5: Company's profiled financial accounting risk



(Elgood, 2004)

Before a company can be placed on the scale above a variety of factors is to be addressed and considered. Firstly, the competence of the company's personnel, their technical training and knowledge in both financial accounting as well as local and international tax law must be addressed (Stamm, 2004; Hassing, 2012) . Secondly, the data available to the company should be assessed. More specifically, this would include evaluating the integrity of the data by examining the systems (manual and/or computerised) that are producing the data (Elgood, 2004; Bakker *et al*, 2010). As part of this assessment, the company would need to be mindful of whether or not data are subjective and, if so, the extent to which related estimates and judgements are appropriate (Stamm, 2004). Thirdly, care needs to be taken to ensure that tax departments have sufficient time to finalise tax calculations and assessments, especially in instances where last-minute accounting changes or complex business transactions could result in a material alteration to the tax liability (Bakker *et al, 2010)*. A final consideration is whether or not information is adequately communicated across departments and jurisdictions, specifically with regard to large multinational group structures (Bakker *et al*, 2010).

The above factors and considerations are sufficiently significant to indicate that, if any area does not operate as it should, the result would be the incorrect and improper reporting of income taxes in the financial statements. If severely inaccurate, this could cause future losses for and mistrust by the investors, creditors and other stakeholders who rely on the accuracy of the financial statements (Bakker *et al*, 2010).

3.3.2: Tax generic risks

After considering the above specific tax risks facing companies, we will now examine the generic risk areas. The first generic risk area to be examined is the portfolio risk. Portfolio risk concerns the aggregate level of risk when examining transactional, operational and compliance risks discussed above (Elgood, 2004; Stamm, 2004). The interaction of the three disparate risk areas is considered in assessing the portfolio risk (consider Bakker *et al*, 2010).

Some companies are simpler and have fewer transactions and, thus, their portfolio risk will be lower than the larger, more complex, corporates (consider Erasmus, 2008). In

assessing portfolio risk, an aggregate assessment of the different risks must be taken into account before arriving at a final assessment (Stamm, 2004). Once a risk is part of a portfolio, it should be continuously reviewed (Bakker *et al*, 2010).

Even though each particular risk in isolation may not be considered high-risk, when combined and considered in aggregate (and when considered together with the positions taken with the revenue authorities), the aggregate cumulative risk profile may be considered too high and, therefore, not acceptable (Elgood, 2004). The implications of this will be detrimental to the company, leading to severe losses, going concern problems and a diminution of stakeholder confidence (see Bakker *et al*, 2010; consider Elgood, 2004).

In assessing this risk, companies should allocate each tax risk a percentage probability of 'going-wrong' and should aggregate the result (Stamm, 2004). This assessment would be worst-case scenario and the implications on the financial statements would also need to be considered (see Elgood, 2004).

The second generic risk is management risk. This risk refers to the company not managing the various risks raised in Section 3.3.1 (Stamm, 2004). This risk is not individually determined but rather a detailed consideration and analysis of all the disparate tax risks faced by an entity and whether or not the entity has effectively considered and managed those risks (Weinberger *et al*, 2012). This risk is, in effect, the overall consideration of the individual risks discussed in Section 3.3.1, specifically considering whether companies have sound and effective strategies, appropriately qualified staff, as well as appropriate levels of integration of taxes in their control environment (Consider Erle, 2006; Weinberger *et al*, 2012). This is discussed in more detail in Chapter 4.

The final generic risk which will be examined is reputational risk. Reputational risk concerns the wider impact on the organisation that might arise from an organisation's actions if these actions became public knowledge (Elgood, 2004). This risk is one of the most well-known in the tax environment (Bakker *et al*, 2010). Reputational risk will, by its nature, have a significantly wide impact on the company's business interests

and activities. If information about tax practices, perceived by stakeholders as being unsound or contrary to the tenets of good governance becomes public, this can adversely impact the legitimacy or credibility of the organisation (consider Stamm, 2004). For example, the public image of KPMG was tarnished, leading to loss in client confidence and brand goodwill, after damning testimony in the US Senate on questionable involvement by the firm in the creation of tax shelters (see Bakker *et al*, 2010). Similar reputational damage occurred for a group of banks that offered undisclosed offshore saving possibilities for US private clients (Bakker *et al*, 2010).

In this context, reputational tax risk is defined as the risk that clients or authorities are less (or more) willing to enter into agreements with a company due to its known tax positions. Simplistically this can create a situation where a company makes more or less profit, based on its positive or negative tax reputation (Bakker *et al*, 2010). Although this risk appears relatively straightforward, the firm's tax-based reputation needs to be managed very carefully (consider Weinberger *et al*, 2012). When planning a tax position and entering into a transaction a company needs to consider whether or not its tax standing, based on prior interactions with the tax authorities, could weaken or improve the tax position on current transactions (Bakker *et al*, 2010).

Operational tax risk – as discussed above- can also impact the reputational risk of a company (see Weinberger *et al*, 2012). A co-operative taxpayer that provides timely and reliable information to the tax authorities (versus an administratively poor taxpayer) will have a lower reputational risk which will serve to enhance future negotiations with authorities and lead to improved tax positions (see Bakker *et al*, 2010).

Reputational tax risk also refers to public perception. Many companies are under public scrutiny in terms of their corporate citizenship. Compliance with tax laws is part of ensuring holistic corporate awareness and companies can enhance their reputations by improving compliance and avoiding aggressive tax policies (Bakker *et al*, 2010). In this way, reputational risk is not an isolated risk but rather a crucial inter-woven risk. It is an important element in TRM as it examines how tax risk may influence and shape the reputation and standing of a company in all facets of the business and operations (Erle,

2006; Bakker *et al*, 2010). Likewise, and as noted in Section 3.3, generic and specific tax risks should not be seen in isolation. They are integrated into the tax function of the business. Table 3.2 illustrates this concept of examining the tax risks in an integrated manner, yielding a holistic tax risk-matrix of a business that can be employed for understanding, assessing and managing tax-risks:

Table 3.2: Risk Matrix of specific and generic tax risks

	Tax specific Risks			
	Transactional risk	**Operational Risk**	**Compliance Risk**	**Financial Accounting Risk**
Tax Generic Risks				
Portfolio Risk (aggregate of transactional, operational and compliance risks)	**x**	**x**	**x**	
Management Risk (adequate management of all the tax specific risks)	**x**	**x**	**x**	**x**
Reputational Risk (stand-alone generic risk linked to operational specific risk)		**x**		

3.3.3: Summary

Chapter 3 began with a general discussion of 'tax risk'. The chapter then delved into the relevance of TRM for organisations with a further focus on a TRM philosophy within an organisation. Finally, the chapter considers the specific and generic tax risks faced by an organisation which illustrates how the broad TRM philosophy is complemented by the transaction-specific TRM philosophy. In Chapter 4, this report will focus on the tax control and risk frameworks of the U.S.A, U.K and S.A illustrating how revenue fiscal changes have resulted in increased tax risk exposure and, therefore, necessitated changes in TRM practices on a corporate level.

4: Tax control framework s and tax risk frameworks of the U.S.A, U.K and S.A.

4.1: Introduction

After considering the broad TRM framework, TRM philosophy and generic and specific tax risks faced by entities, this chapter focuses on the tax control and risk frameworks of the U.S.A, U.K and S.A. The aim of this chapter is to identify those aspects of tax administration and practice that, over the last 10 years, have led to an increased financial or legal risk-exposure for international firms within the U.S.A, U.K and S.A and would have thus resulted in changing TRM practices.

4.2: Tax control and risk frameworks in the U.S.A, U.K and S.A

4.2.1: Tax control and risk framework in the U.S.A

The TRM framework in the U.S.A is ever-evolving (Bakker *et al*, 2010). The multiple regulatory agencies in the U.S.A, including the Internal Revenue Service (IRS), the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB) and the state and local authorities each have very specific requirements related to tax (Bakker *et al*, 2010). Each of these forms part of a very complex tax control and risk management framework.

According to title X of SOX, it is stated that the corporate tax return should be signed by the chief executive officer (SOX, 2002). According to an analysis performed by Deloitte (2009) it was identified that 54% of Forms 10-K and 10-Q[6] filed with the SEC from January 2008 to December 2008 reported material tax weakness. The majority of the failures are attributable to lack of appropriately qualified personnel, as well as the fact that the companies surveyed did not maintain effective controls over the determination and reporting of the provision for income taxes and related income tax balances similar to those described in Chapter 3 (Bakker *et al*, 2010).

The most prevalent tax risks encountered in the U.S.A relate to federal income tax although other important areas include state income tax, franchise and gross receipts taxes, indirect taxes, property tax and payroll tax (Bakker *et al*, 2010). In the U.S.A, the scope of income tax is extensive in that the computation of taxable income applies with a concept of gross income being "all income from whatever source derived" (Bakker *et al*, 2010). This wide definition results in foreign corporations effectively being taxed on all income that is connected with the U.S.A (Weinberger *et al*, 2012). Complexity in terms of application of tax laws and added tax risk arises in the following arrears: firstly, rules regarding sourcing of income which may become arbitrary, for example when interest or dividends may be deemed to be from a US source (Weinberger *et al, 2012)*. Secondly, foreign tax credit rules and complex tax treaties may be cumbersome and difficult to apply (Bakker *et al, 2010)*. Thirdly, withholding and government information reporting requirements with respect to certain outbound payments or transfer of assets may be incorrectly applied (Weinberger *et al, 2012)*. Fourthly, transfer pricing rules in the U.S.A which require 'arms-length' intercompany pricing evidenced by simultaneous documentation and analysis may be complex and not appropriately applied (Bakker, *et al*, 2010).

The IRS is a bureau of the U.S.A Department of Treasury. In the U.S.A Congress passes tax laws: the taxpayer's role is to understand and meet her tax obligations. The IRS's role is to assist taxpayers with the administration of amounts due to the State and

[6] A Form 10-K is an annual report required by the U.S. Securities and Exchange Commission (SEC), that gives a comprehensive summary of a company's performance (SEC 2012). Form 10-Q is a quarterly report mandated by the SEC, to be filed by publicly traded corporations, It contains similar information to the annual form 10-K, however, the information is generally less detailed, and the financial statements are generally unaudited (SEC 2012).

to ensure that citizens 'pay their fair share' (IRS, 2012). Despite this, there seems to be little increase in effort on the part of corporate executives to resolve and minimise tax errors; highlight key tax risks; and manage these effectively (Weinberger *et al*, 2012). In response, the IRS has implemented various programmes and processes (Cohn, 2012).

Firstly, significant transactions concluded during a tax year will benefit from an assessment of tax risk, including tax exposure, to reduce transaction risk. Operational risks are also lowered by detailed and transparent disclosure of the company's tax position (Cohn, 2012). This process links to s 6662 of the Internal Revenue Code (IRC) (Imposition of accuracy – related penalty on underpayments), indicating that a position which is adequately disclosed on the tax return should generally not be taken into account in calculating penalties due to inaccurate tax estimates, while certain other tax penalties imposed by the IRS may be waived if taxpayers can demonstrate that they have exercised due care and skill in computing their tax liability (Bakker *et al*, 2010). The IRS also publishes from time to time a list of 'reportable transactions'. These generally include transactions which the IRS views as potentially abusive tax shelter transactions (Palmer, 2012). The intention is to highlight unacceptable tax practices with an aim to minimising their use. Unfortunately, it has proven technically challenging and administratively onerous to implement this anti-abuse system (Palmer 2012, Bakker *et al*, 2010).

Nevertheless, non-compliance would result in penalties of up to USD 200 000 per transaction, as well as non-compliance disclosure penalties levied by the SEC (Palmer, 2012). Consequently, the IRS suggests that taxpayers plan effectively for reportable transactions by identifying and deciding upfront whether a transaction needs to be disclosed (Bakker *et al*, 2010). Accordingly, this programme plays a part in reducing an entity's exposure to transactional risk and compliance risk (Elgood, 2004) discussed in Section 3.3.1. Specifically, an entity would need to be aware of the transactional risks and would need to account for and document these transactions appropriately (McGrail, 2011; Elgood, 2004).

Further reducing an organisation's tax risk exposure are the limitations imposed by Congress on the period during which the IRS may assess taxes and taxpayers may claim a refund or any tax credit due (Cohn, 2012). By providing a clear cut-off point after which the tax position must be finalised, the tax liability of the organisation may be determined with greater certainty, thereby lowering transactional, operational and compliance tax risks (Cohn, 2012; Bakker *et al*, 2010). Added to this, the IRS has introduced a streamlined examination process aimed at mitigating organisation's tax risk (Bakker *et al*, 2010).

The first part of this process is the Pre-Filing Agreement (IRS, 2012). This programme encourages taxpayers to request an examination of an issue before the tax return is filed and, thus, resolve potential issues as early as possible (Cohn, 2012). The aim is to provide a greater level of certainty regarding a particular transaction, as well as to ensure better use of both taxpayer and IRS resources (Bakker *et al*, 2010). Allowing the taxpayer and IRS to determine the tax consequences of a transaction before a return is filed also promotes reduced reputation risk pre-empting formal disputes. Corporates that have a sound TCF and strong tax management risk process (see Table 3.2; Hassing, 2012) will be able to comply efficiently with this programme.

In addition to the pre-filing arrangements, taxpayers can make use of the Accelerated Issue Resolution (AIR) process (IRS, 2012). Taxpayers are able to enter into an AIR agreement when involved in an IRS audit. This will result in extending the resolution of issues arising under audit for a particular period to all subsequently filed returns for tax periods ending before the date of the AIR agreement (Cohn, 2012, Bakker *et al*, 2010).

Thirdly, we have the Compliance Assurance Process (CAP) (IRS, 2012). This allows a taxpayer to work through potential issues with the IRS before filing a return (Cohn, 2012). The objective of this programme is to reduce taxpayer uncertainty and burden while assuring the IRS of accuracy of tax returns prior to filing. This programme can significantly reduce the burdens associated with post-filing examinations and increase certainty for financial reporting purposes (Cohn, 2012; Bakker *et al*, 2010). In addition it eliminates problems associated with loss of data, documentation and in-house

knowledge in the case of examinations conducted years after the transactions at issue and the filing of the return (IRS 2012; Cohn 2012). The CAP programme will be effective in reducing an entity's tax specific compliance risk as companies will be less accepting of a higher compliance risk (consider Weinberger *et al*, 2012). Companies will be able to focus on generating profits while not being burdened with heavy compliance requirements (Weinberger *et al*, 2012) which will also serve to reduce reputational risk (Section 3.3.2).

The fourth IRS initiative is the Fast Track Settlement programme (FTS) which provides an opportunity for taxpayers to resolve tax disputes earlier in the examination process (IRS 2012, Cohn, 2012). FTS generally reduces the time during which an examination issue remains unresolved and it allows the taxpayer to seek a formal appeals process if FTS fails to yield an agreement (Bakker *et al*, 2012).

Fifthly, the IRS has introduced the Limited Issue Focused Examination (LIFE). This process uses a risk-based approach in limiting the scope of the examination to the areas of the greatest risk of non-compliance (IRS, 2012). The LIFE process is intended to create an atmosphere in which the examination is less difficult, less time consuming, less expensive and less contentious (Bakker *et al*, 2012). LIFE is not appropriate for fraudulent, unwilling and unco-operative taxpayers (Cohn, 2012; Bakker *et al*, 2012). For the majority of taxpayers, however, it encourages an entity to manage its disparate tax risks more effectively (Stamm, 2004) and thus encourages companies to lower their generic tax management risk as well as their portfolio risk (Elgood, 2004).

The final initiative examined by this report is the process followed by the IRS when dealing with cases characterised by a high risk of non-compliance with relevant tax laws, specifically the issue tiering system and the IRS audit guidelines. The former, introduced by the IRS in 2006, was aimed at ensuring that high risk compliance issues were properly addressed, consistently treated and segregated into three tiers (Bakker *et al*, 2010). Tier 1 includes issues that are of high strategic importance to the IRS and could include areas involving large numbers of taxpayers, high financial risk and substantial compliance risk (Zerbe, 2012). Tier II incorporates areas of potential high

non-compliance as well as emerging issues which, although well-established legally, require further development, clarification, direction and guidance (Bakker *et al*, 2010). Lastly, Tier III represents issues relating to the highest compliance risk for a particular industry and requiring unique treatment for an industry (Zerbe, 2012). It must be noted, however, that in the later part of 2012, the IRS has indicated that this tier approach will be phased out in the future and instead a new approach known as the 'manage knowledge network' approach will be adopted (Zerbe, 2012). This approach reflects a movement away from focusing on tax shelters, to a higher concentration of offshore activities (Zerbe, 2012).

Another crucial source of information for U.S.A tax executives seeking to manage risks from IRS examinations is the IRS Audit Techniques guide (Bakker *et al*, 2010; Cohn, 2012). These guides help to identify, co-ordinate and resolve complex and significant industry-wide issues by providing guidance and uniformity (Bakker *et al*, 2010). This also assists corporates in reducing their generic tax management risk as strategies can now be implemented in a company that incorporates effective complex industry management techniques.

Based on the above legislative changes adopted by the U.S.A, it is evident that corporations will be required to focus their tax management and planning in incorporating sound TRM policies within their organisations. These regulatory developments also suggest that the U.S.A Legislature and corporations have taken cognisance of the need for a comprehensive system of TRM and control and TRM practices (Section 3.2.3). The same applies in the U.K.

4.2.2: Tax control and risk framework in the U.K

Since 2008 there has been a significant increase in the focus of U.K governments, regulators and the public on tax compliance and anti-avoidance and as a result the revenue authorities in the U.K are facing increasing internal and external demands to ensure that governance, processes, controls and systems are effective and demonstrated to be effective (Bakker *et al*, 2010). In order to understand fully the approach taken by

the U.K tax authorities in assisting companies with managing their tax risks, it is necessary to gain an understanding of the U.K tax authority and its operations.

In the U.K, companies follow a self-assessment process for their tax returns. This means that a company must notify the HMRC of its tax charge then calculate its own tax liability and finally file a tax return with supporting documentation. Once this has been completed, the HMRC may file queries on the return within 12 months of submission of the return (Bakker *et al*, 2010).

In line with the corporate governance and development changes in the U.K discussed in Chapter 2 the HMRC, in 2007, launched its tax compliance risk-management process (TCRM) which defined a new approach to risk-management in the U.K. The main goals of this were to promote faster resolution of issues through action plans and advance agreements, as well as to match HMRC's resources with areas of high risk to ensure these risk issues are dealt with expediently and as collaboratively as possible (Bakker *et al*, 2010). This will ensure that companies with an embedded tax philosophy and TCF (Section 3.2.3) and control over their generic tax management and portfolio risks (Section 3.3.2) will be able more effectively to comply with TCRM. In order to operate this risk assessment process the HMRC has developed a standard template covering six factors: complexity, boundary, change, delivery, governance and tax strategy (HMRC, 2012).

The first three factors refer to 'inherent risk' which essentially assesses the risk of tax compliance issues as a result of the size and scope of the business and are risks which tax directors are unlikely to have much control over (Bakker *et al*, 2010; HMRC, 2012). The implementation of effective tax processes and strategy; specifically board accountability, board oversight as well as planning implementations in line with HMRC directives relate to the second three factors 'delivery, governance and tax strategy'. Directors would have more control over these factors and would be able to manage these risks (Bakker *et al*, 2010). The latter risk will directly link to transaction, compliance and financial accounting risk as companies policies, procedures and control

functions would be able to directly impact the management of these risks (Elgood, 2004).

Based on the above factors companies are then rated by their tax officers as being low- or high-risk (HMRC, 2012). These risk-assessment ratings will naturally be influenced by the corporate governance control structure and environment at the respective companies (Section 3.2.2). Good systems of checks and balances will lead to lower risk assessments and, in turn, lower compliance costs. The converse is also true. The intention is that, eventually, companies will start moving towards the lower risk profile (Bakker *et al*, 2010). This will influence companies to manage their reputational risks in an effective manner as they will be inclined to move towards a more positive tax position with HMRC and thereby HMRC would be more willing to enter into agreements with them implying a reduction in reputational risk (see Weinberger *et al*, 2012). Aligned to the risk-based approach, a new penalty regime was also introduced for companies with year-ends after 31 March 2008 (Groom, 2010). This is aimed at behavioural risk-management of companies and heavily penalises systematic understatement of liabilities, tax evasion and deliberate concealment of offences. Honest mistakes that arise despite good control-governance-structures attract lower penalties (Bakker *et al*, 2010)[7].

Disclosure of facts by the corporate may also serve to mitigate penalties. If the disclosures indicate a level of self-review and transparency, the penalty will be lower than if the disclosure is called for by the HMRC (Groom, 2010). This links to the concept of suspension of penalties for careless errors, which is a novel idea in tax and is aimed at encouraging behavioural change and supporting the risk-based tax approach (Bakker *et al*, 2010). The idea behind this approach is that companies will be inclined to improve their processes, controls and systems and ensure that their goals have been achieved, rather than just paying the penalty (Groom, 2010). This will, in turn reinforce the idea that companies manage their portfolio risks as well as their reputational risks

[7] In the guidance received from HMRC, large companies which fail to maintain and configure underlying systems to track tax sensitive entertainment expenditure (as an example) are be regarded as having committed a deliberate error and this would result in significant increase in penalty exposure (HMRC, 2012; Groom, 2010).

(Elgood,2004), as well as ensuring that the TRM philosophy of a company will be entrenched in their organisation (see also Section 3.2.3).

In 2007 the HMRC also launched a litigation and settlement strategy (LSS). Similar to the initiatives of the IRS discussed in Section 4.2.1, the predominant aim is to provide greater clarity and certainty in the resolution of disputes between the HMRC and the taxpayer (Bakker *et al*, 2010). This strategy aims to resolve each dispute on its own merit and no compromise agreement or settlement will be considered in case disputes (Bakker *et al*, 2010). The effect of this is that the HMRC will only pursue meritorious cases (Bakker *et al*, 2010). The effect of this on organisations has proven to create difficulty for large companies as they now need to devote even greater time and resources to effective tax risk-planning, given that the HMRC is able to concentrate its efforts on tax avoidance and evasion schemes (Bakker *et al*, 2010).

A significant legislative change which has had a dramatic impact on TRM of corporations came into effect in the U.K in the April 2009 budget when it was announced that SAO's of qualifying companies[8] would be expected to sign an annual declaration that 'appropriate accounting arrangements' had been used to calculate the company's tax liabilities (Williams, 2009). If the arrangements fall below this standard, the SOA will be held responsible and subject to a financial penalty of GBP 5000 per instance, as well as facing a possibility of further penalties for additional related-compliance failures (Callahan *et al*, 2012). The HMRC have stressed that this implementation does not set a higher standard of care than would ordinarily be imposed but rather aims to address a perceived gap in the accountability of senior management for the financial process and systems which are the foundation of tax compliance (Bakker *et al*, 2010).

An argument which has been raised is that this SAO legislation links appropriately with SOX legislation (as discussed in Chapter 2) in that corporations that are already SOX-compliant would have improved governance by involving board members on tax

[8] Qualifying companies include those companies which on their own or when aggregated with other UK companies in the same worldwide group have a turnover of over GBP 200 million or a balance sheet total of more than GBP 2 billion.

matters and strong controls which would impact the tax function, such as staff training and management supervision (Williams, 2009; Callahan *et al*, 2012).

The implementation of this legislation reinforces the TRM application of companies in that all delegation of work by SAO's must be within an appropriate control framework that comprises the appropriate personnel, processes, controls and data access at the appropriate times (Williams, 2009). A level of assurance to be provided within this framework would also assist in the process (consider Callahan *et al*, 2010). Should any issues arise the SAO must be available to assist the tax team in highlighting these to the board and in discussing a resolution (Bakker *et al*, 2010). It also achieves the goal that companies have a good understanding of the tax risks faced by their entities and have adequately designed and implemented controls to manage these tax risks , as well as having implemented control and governance measures for communicating and allocating responsibilities to manage and mitigate these risks (Callahan *et al*, 2012; Bakker et *al*, 2010). The majority of companies, in response to this legislation, should have been documenting their critical tax compliance processes and associating risks and, thereafter, prioritising gaps between their current state and best practice (Williams, 2009). The long-term aim of this is that businesses will apply additional effort in mitigating their compliance risk as discussed in Section 3.3.1 and managing their tax risks more effectively (Bakker *et al*, 2010), reducing the generic tax management-risk discussed above and reinforcing the arguments raised that TRM must form part of the company's culture and should not be relegated to the status of an inferior component of the company's operations and management (Section 3.2.2).

A further legislative development in the U.K is aimed at the financial services industry in which the Code of Practice on Taxation for Banks (the "Code") has been legislated (Bakker *et al*, 2010). Banks which do not comply face the risk of significant reputational damage and these banks will also be classified as 'high-risk', as discussed above (Bakker *et al*, 2010). The code is established in 3 broad sections: namely, governance, tax planning and relationship with HMRC (Blakemore *et al*, 2009). The assessment of governance is closely linked with the HMRC's TCRM process in that it requires banks to have a documented tax policy and governance process for tax matters

that are included within a formal compliance policy (Bakker *et al*, 2010). Appropriate tax planning includes precluding transactions that are unacceptable to the code, such as transactions with little or no pre-tax profit which rely on anticipated tax reduction for significant post-tax profit as well as transactions that have little or no economic substance (Blakemore *et al*, 2009)[9].

Based on the above legislative changes adopted by the U.K tax authorities, an argument is made for the revision by companies to an approach which is holistically inclusive of a sound TRM position, it is evident that the legislative changes are closely linked to corporations having sound TRM policies and to incorporating the specific and generic tax risks into their board-room agendas (Section 3.2.2).

4.2.3: Tax control and risk framework in S.A

Early in Pravin Gordhan's first term as Commissioner of SARS, the SARS Act was promulgated, granting SARS a certain amount of autonomy in the ways in which it conducted itself (Bakker *et al*, 2010). Gordhan was able to structure the organisation as if it was an independent corporation, with a mandate from the Minister of Finance to collect (among others) the following taxes on behalf of the state: Marketable Securities Tax Act, 1948 (Act 32 of 1948); Estate Duty Act, 1955 (Act 45 of 1955); Income Tax Act, 1962 (Act 58 of 1962) (Bakker *et al*, 2010). The powers of SARS are limited by the Constitution which requires the tax collector to ensure that its policies and procedures are fair and reasonable and not unconstitutional (Keulder, 2011). In addition, SARS is expected to act with the highest degree of professional ethics in an unbiased and transparent fashion (Keulder, 2011).

The SA tax control framework is divided into two main sections – substantive law tax-control pertaining to accurate compliance with provisions of tax legislation (Du Toit, 2006) and procedural tax-control (SARS, 2012). Substantive law tax-control entails accurate compliance with provisions of the tax legislation and can only take place after careful assessment of all relevant facts has taken place (Du Toit, 2006). Procedural tax-control entails knowing what procedural tax rules are applicable to SARS and how

[9] The negative effect of this Code is that foreign banks may become more attractive to corporations due to the fewer restrictions and, as a result, this may cause UK banks to lose business and incur losses (Bakker *et al*, 2010).

to ensure SARS complies fully with these procedural rules (Bakker *et al*, 2010). This has resulted in its becoming customary for SARS to issue a comprehensive letter of findings, setting out the facts and law upon which their conclusion and outcomes are based (SARS, 2012).

Since 1999, the increase in tax collection in SA has risen from ZAR 23 billion to ZAR 1 414 billion. This has resulted from SARS forming close relationships with (among other) the following institutions: The Registrar of Companies; the Master of the High Court and the Banks. SARS was also able to increase its collections by gathering information about all tax practitioners in SA through a registration process and through the formation of the Large Business Centre (LBC) to facilitate the collection of taxes from, and audit of, large businesses in SA. Complementing this are means of direct contact between the Commissioner and selected CEO's of large corporations in the event of a perceived dispute; direct control by SARS of the tax court roll and the strong influence by SARS over the National Department of Public Prosecutions[10] (NDPP) (Bakker *et al*, 2010).

An important regulatory development which has impacted significantly on the TCF and TRM of companies is the implementation of the King Codes of corporate governance discussed in Chapter 2 (IOD, 2009). The noticeable effect that this has had on TRM is seen through increased interaction between SARS and large corporations through the LBC (Smith, 2009); the implementation of tax steering committees (IOD, 2009; Smith, 2009); regular internal tax reviews where errors are identified and corrected (Bakker *et al*, 2010). In addition, the move towards a more integrated system of governance and reporting (IOD, 2009; IRC, 2011) has led to more effective tax-strategy-mapping. This entails mapping any known issues between SARS and the corporate taxpayer and determining, through a formal review process how issues should be reported to SARS and appropriately treated (Smith, 2009; Bakker *et al*, 2010).

Added commercial complexity (IOD, 2009), the impacts of globalisation (OECD) and the reduction in revenues due to the global financial crisis have, however, resulted in a

[10] The relevance of power dynamics in the collection of tax revenues is beyond the scope of this report.

higher tax risk environment. This is especially true, given the added incentive to structure transactions to avoid or evade taxation when corporate profitability is under pressure. Consequently, there is a general concern on the part of SARS that the culture of tax compliance could be adversely affected and also the possibility of more aggressive tax audits and reform to tax legislation to collect monies due to the state (Bakker *et al*, 2010). As part of this, SARS has formed the LBC to attend to the administration and collection of taxes from large corporations worldwide. The LBC of SARS operates under a separate unit within SARS (Bakker *et al*, 2010).

Taxpayers who are part of LBC can expect to be audited a minimum of once every 2 years. Typically this would involve an integrated audit, where SARS audits income tax, VAT and PAYE (SARS, LBC, 2012). The LBC is currently responsible for about 57% of all additional assessments raised against taxpayers and is indicative of the increased tax risk facing the large S.A corporates (Bakker *et al*, 2010). Comparisons of published financial results are being made by the LBC to provisional tax payments and discrepancies are being investigated, resulting in increased penalties and tax risk-exposure (Bakker *et al*, 2010).

The e-filing process recently implemented by SARS has also resulted in increased risk-exposure as more adequate tracking and comparisons can to be implemented by LBC and non-compliance is thus identified (Bakker *et al*, 2010). The reportable transaction provisions in the Income Tax Act (ITC) have further resulted in increased field audits and thus increased tax risk exposure to corporates in that compliance failure can result in fines of up to ZAR 1m (SARS, LBC, 2012). This has forced the South African corporates to monitor actively and consider their compliance specific risks (Section 3.3.1) whilst ensuring that penalties are reduced through a holistic and integrated TCF and tax philosophy framework into their organisations (Section 3.2.2; Section 3.2.3) .

Based on the above legislative changes adopted by SARS, it would appear that the South African corporates would need to change their TRM practices to one of sound integration (Section 3.2.2). It is evident that the legislative changes are closely linked to corporations having sound TRM policies and to incorporating the specific and generic

tax risks into their board-room agendas (Section 3.2.2) thus resulting in a changing TRM practice and increased awareness of the importance of sound TRM.

In order to alleviate the additional tax-risks, many SA corporates have begun implementing a multi-faceted approach to TRM. Companies have formed tax-complaint departments that encompass formal tax professional teams. These teams proactively manage, on a daily basis, their companies' tax risks (Erasmus, 2008). The compliance departments are allocated higher levels of responsibility and held accountable for detailed fact checking (Erle, 2006). In addition, companies have developed a proactive corporate TRM policy (Erle, 2006; Section 3.2.3). There is also evidence of increased involvement by CEO's and FD's in the companies' tax planning and strategising activities with these executive directors instilling a corporate tax ethos within the corporations in which tax transparency and disclosure become part of the culture of the company (Erle, 2006; Erasmus, 2008; IOD, 2009). Aligned with this are the improved communication processes between managers and personnel and, specifically, an implementation of a corporate 'people-to-people' communication policy in many organisations (Erle, 2006; Erasmus, 2008). Companies have also begun to include internal tax audits with mandates including non-compliance with SARS, as part of their internal audits directives (IOD, 2009; Bakker *et al*, 2010).

These moves are designed to assist South African corporates in managing their tax-specific risks (transaction, operational and compliance risk) (consider Elgood, 2004), as well as their general portfolio risks (see Stamm, 2004). It also ensures that corporates are integrating their TRM with their tax approaches by ensuring that TRM is treated as a priority within their governance policies and procedures (Section 2.2.2).

Going hand-in-hand with this, the antiquated approach of hiring outside accounting tax practitioners to assist and manage the tax affairs of the corporate is being dispensed with. Many corporates are now hiring tax staff to deal with tax risks internally, although this is being combined with the participation of outside tax advisors (Bakker *et al*, 2010) (Section 3.2.3).

4.2.4: Summary

Chapter 4 began with a discussion of the TCF in the U.S.A. The chapter discussed the major legislative changes introduced by the IRS for U.S.A corporates and analysed the reactions by the corporates in order to minimise their risk exposure. In doing this, a link was drawn between the TRM process in Chapter 3 and the need for and implementation of an enhanced system of TRM. The chapter then discussed the TCF in the U.K and introduced legislative changes implemented by the HMRC. Specifically, it was shown how the U.K authorities have implemented regulatory changes that are very closely aligned with compelling companies to engage actively in an integrated TRM philosophy, the result of which has highlighted the changing TRM landscape. Finally, the chapter discussed the TCF in S.A, illustrating its uniqueness by virtue of the fact that it is a relatively newly established democracy, ultimately governed by the Constitution. Regulatory changes introduced by SARS were discussed and the link was drawn between the need for and changes introduced to existing TRM practices by the SA corporate. Chapter 5 will provide concluding remarks and recommend additional areas of research.

5: Conclusion and additional research recommendation

5.1: Concluding remarks

The world over the past 10 to 15 years has seen significant expansion and change (Weinberger *et al*, 2012). This has to led to rapid transformation in the ERM and, more specifically, TRM culture of the international corporate (Solomon and Solomon, 2004; Erle, 2006). It is in light of this consideration that the work in this research report was conducted.

Chapter 2 provided a brief overview of the change in the corporate governance landscape in the U.S.A, the U.K and S.A, focusing on certain of the most recent corporate governance developments in the last 15 years. In particular, this chapter highlighted the need for a comprehensive system of corporate governance, characterised by effective risk identification and management policies. Tax-related risks are no exception. The spirit of sound integrated reporting and focus on long-term suitability of

organisations requires managers to take cognisance of the dynamic and highly complex tax risk environment. Rather than see tax as simply a resultant, there is a clear need for an effective system of tax risk-management as part of the broader corporate governance paradigm.

Following from Chapter 2, emerging tax risks were discussed. Chapter 3 carried out a detailed content analysis of the prior academic and professional tax literature. It dealt with the meaning of tax risk-management and expanded on the initial arguments raised in Section 2 by highlighting the impact of tax risks on organisations and the relevance of an effective TRM system. The chapter then discussed the tax control framework within a company and how this framework ultimately creates the need for a sound tax philosophy that is inextricably linked to the company's formally established internal-control systems and frameworks. In light of this, Chapter 3 analysed the requirement that the broad system of internal-control must be complemented by a focus on the tax specific and generic risks of a company. The disparate generic and specific tax risks were then elaborated on, illustrating how the overall TCF is complemented by the transaction-specific TRM philosophy.

Chapter 4 contextualised the theory presented in Chapter 3. It discussed tax control frameworks and tax risk frameworks in the U.S.A, U.K and S.A. An examination of certain key legislative changes within each of these countries was conducted. At the same time, the chapter pointed to changing TRM practices and an increased awareness of the importance of sound TRM, reaffirming the discussion in Chapter 2 and Chapter 3. More specifically, how certain regulatory changes in the U.S.A, the U.K and S.A have led to a change in attitude towards TRM, and evolving management practices, in an attempt by the international corporate to reduce their individual financial and legal risk-exposure were dealt with. Legislative changes examined include, among others, the implementation of 'reportable transactions' by the U.S.A, the risk-based approach and penalty regime in the U.K and the implementation of the LBC and e-filing monitoring by SARS.

5.2: Further Research

Firstly, it must be noted that the research is exploratory in nature, based on an interpretive approach analysing the American, British and South African content-specific literature. Further research may, therefore, include examination of additional countries to expand on the role and relevance of TRM.

In addition, no effort was made to quantify the findings. Future researchers may find it useful to perform a quantitative analysis of, for example, risk-based disclosure in annual and integrated reports to complement the detailed content analysis provided by this report. More specifically, a sample of integrated and annual reports over the last ten years could be interpretively analysed or interrogated, using a scientific text analysis approach to discern the nature and extent of changes in risk associated disclosures with an emphasis on tax issues. How actual TRM practices, including changes in attitudes towards TRM, have evolved in response to recent regulatory and governance developments could also be better understood by using detailed interviews with a sample of tax professionals to understand exactly how organisations identify, rank and manage tax risks. Related to this, this report has only explored tax regulatory developments in three countries. Future researchers can expand on our understanding of TRM by examining TRM practices in other countries. Including a specific focus on the relevance of anti-avoidance provisions for attitudes towards and changes to existing TRM policies. Ultimately, with only a limited number of studies concerning themselves with TRM as part of the broader corporate governance machinery, this particular area of corporate governance is little researched, offering numerous opportunities for future academic efforts.

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