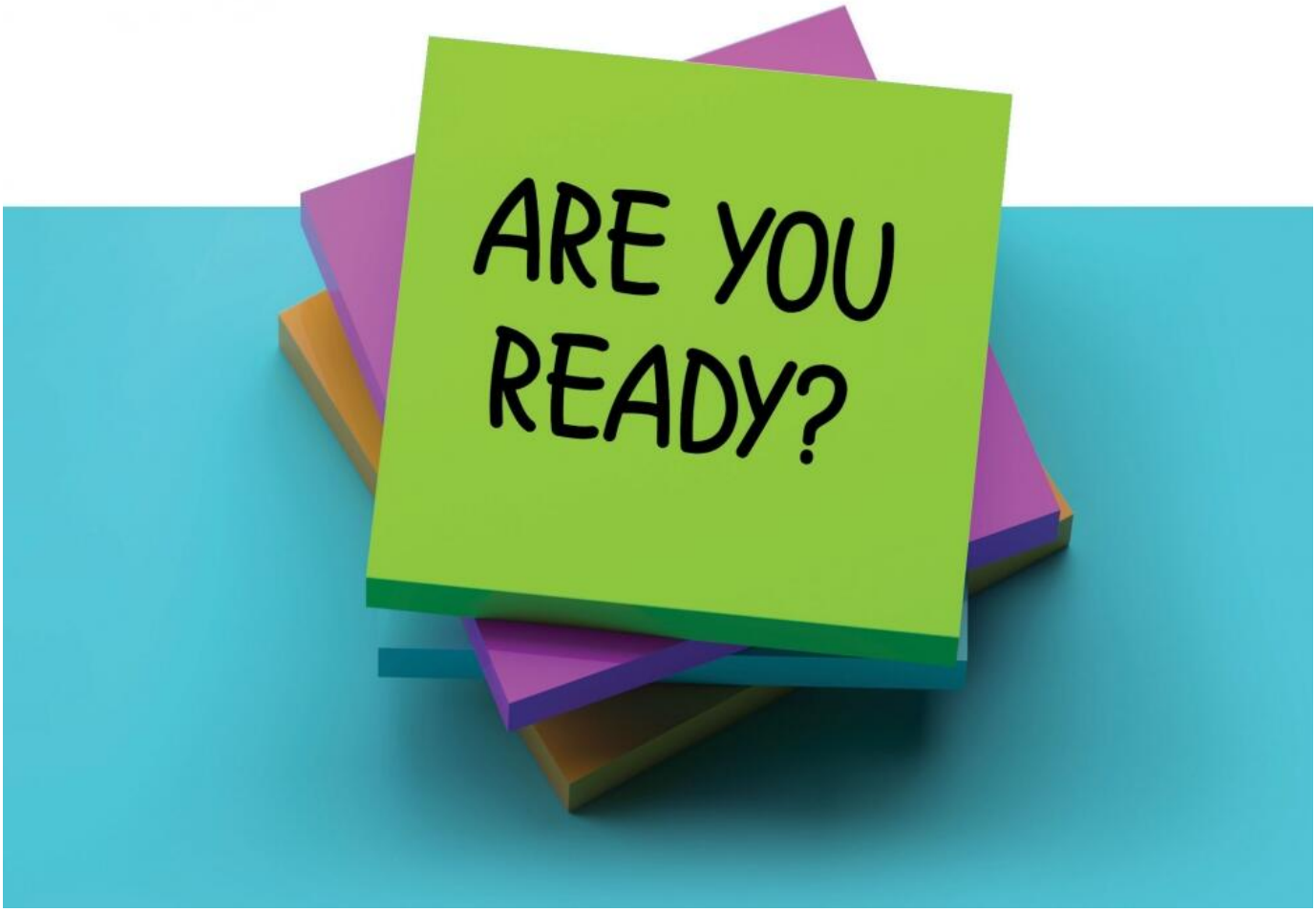
Tax controversy: are you ready?

Professional standards



30 September 2021

Binka Layton and Tim Millson ask how preparing thoroughly for tax audits can help to avoid controversy

Key Points

What is the issue?

Businesses must simultaneously look at meeting the demands of tax authorities, whilst ensuring they have means to mitigate the financial and reputational costs of a tax audit.

What does it mean for me?

There are practical ways for a global business to prepare and meet these challenges, including tax audit preparedness, a tax and business controls framework, consistency of data and a forward looking controversy strategy.

What can I take away?

Businesses must simultaneously look at meeting the demands of tax authorities, whilst ensuring that they have ways and means to mitigate the financial and reputational costs of a tax audit.

Tax risks and audit enforcement are increasingly topical following the global pandemic. Businesses are facing an ever-changing tax landscape with countries introducing increased corporation tax rates, new digital capabilities to interrogate taxpayer data, and tough enforcement practices and penalties. Some global megatrends are emerging as a result.

Digital capability has seen proliferation amongst tax authorities, with over 60 countries looking to increasing this capability over the next five years. The objective is to issue tax audit assessments based on data provided ahead of the actual tax return filings. E-filing of tax return data is the start, which is then matched to accounting and other source data such as bank statements and invoices. Latin America is the most advanced in these digital capabilities but developing countries such as South Africa and India are also moving to real time systems.

Another trend is the enforcement regimes, whereby new and evolving tax laws seek to apply criminal and civil penalties for issues such as the omission of data and the failure to disclose a permanent establishment in another country (including the UK, Germany and Mexico, amongst others). Corporate officers are increasingly accountable for tax filings that can be interrogated by a foreign tax authority.

This article looks at tax audit preparedness in this changing landscape and the practical ways in which a global business can prepare ahead to meet these challenges.

Tax audit preparedness

Tax audit preparedness should be a core part of the tax return compliance process. Businesses typically view tax audits as one-off events, committing resources and time to address questions when they are raised by a tax authority. A more proactive management of tax data and controversy could better address these stress factors and time commitments, including:

- a tax and business controls framework linking process, people and technology; and
- a forward looking tax controversy strategy that looks at advanced agreements with tax authorities and compliance assurance programmes to get more certainty on tax filings.

A comprehensive tax and business controls framework, linking processes, people and technology, is the foundation for identifying and monitoring tax risks, and reporting them as they arise. For example, is transactional data in a VAT return being contemporaneously documented? What are the protocols being followed to ensure that they are real-time and cross-functional?

If businesses maintain a comprehensive tax risk register and ensure the triangulation of identified risks to wider commercial data, that should help to mitigate controversy risk. In practice, however, this is not easy to execute. Businesses need to be vigilant about the different methods that tax authorities can use to access public information, including Companies House, the Chamber of Commerce, LinkedIn and even Ebay, enabling them to monitor company activities, such as senior management activity and location, and to identify controversy areas.

The interconnectivity of tax items in a return should also not be overlooked. Tax authorities will routinely review transfer pricing documentation in relation to transfer pricing form information, and values disclosed in a corporate income tax return. Similarly, they will review the country by country reporting and company accounting information to review the implementation of transfer pricing policy. This is likely to have significant impact in regions such as Africa, where tax authorities will seek group information to take tax assessment positions. Businesses need to be vigilant to check that the different data sources are aligned and that these checks and balances are routinely identified through the tax risk framework and as part of the return completion process.

Consistency of data

The role of people in the tax function will be critical, as they will operationalise the workings of the tax and business controls framework. During the compliance process, the tax department should routinely seek to understand the material tax positions being disclosed to a tax authority so that consistent positions are taken. They should also review the underlying documentation and data to consider whether they are sufficient to support a tax filing position or whether additional processes are needed.

In practice, this can be as simple as new control checks on sales receipts as they are being presented in a VAT return, and monthly checks on input VAT amounts and corporation tax expense deductions. It may also involve more complicated documentation in the form of legal opinions on tax restructuring matters. Tax departments should also prepare defence files for material transactions so as to be tax audit ready when questions are raised. Once returns are filed, a systemic process of cold reviews should be undertaken to pre-empt voluntary disclosures.

As tax data is sourced from the finance department, a data-centric approach to tax return filing should be adopted. Ensuring the quality of data feeding into the tax returns is the most basic way in which tax audit preparedness can be bolstered.

This is easier said than done, as data flows and quality will be traced to enterprise resource planning (ERP) systems and proactive recommendations on improvements could be considered. For example, if there are routine amendments to VAT returns due to manual adjustments in general ledger coding, a deeper dive into tax classification matters would be in point.

Technology tools will further enhance the reporting of tax risks and ensure that visibility is high on the tax agenda of any business. Applications can be wide ranging, including from the tracking and monitoring of ongoing tax audits; using data analytics to monitor trends and themes; and pre-packaging tax data in formats which tax authorities are known to use.

A forward looking strategy

If a business avails itself of the various pre-agreed assurance programmes run by tax authorities, this should mitigate controversy risk as part of a forward looking tax

controversy strategy. The objective would be to get a business standard policy in place: what risks are best resolved ahead with a tax authority as opposed to entering into a dispute and litigation.

Businesses should consider compliance assurance programmes that exist to provide assurance ratings on compliance. Businesses will need to invest time and resources, as these programmes are not always easy to participate in. However, the benefits are considerable and can help companies be proactive in their engagment with the tax authorities. Some programmes that are worth considering are set out below.

Advanced pricing arrangements

Advance pricing arrangements (APA) procedures should provide certainty on future pricing arrangements with tax authorities. As part of entering into these discussions, businesses will need to consider the robustness of their current transfer pricing policy and documentation.

Depending on the complexity of the transactions, businesses should consider whether an APA is possible and what the most appropriate type would be – whether a unilateral, bilateral or multilateral arrangement. There has been a reduction in the number of APAs agreed in the UK in recent years, primarily because HMRC has moved away from entering into unilateral APAs. Instead, HMRC is now focusing its resources on bilateral or multilateral APAs in complex cases where the relative benefit of reaching an upfront agreement on pricing is considered to represent the best use of the available resource.

International compliance assurance

The international compliance assurance programme (ICAP) is a voluntary programme for large multinational enterprise groups to manage international tax risks relating to transfer pricing and permanent establishments. It is forward looking and will provide assurance to roll forward periods, usually two subsequent filing periods, provided the facts and circumstances in the original application are not materially superseded. In starting these discussions, a business will need to have a group tax strategy documented at board level, and internal structures to set and manage tax policies, as well as an effective tax control framework to monitor risks at a global level.

Country specific business rating Depending on the material locations, a business should actively consider business risk ratings as there are clear links to the assurance a tax authority obtains from these applications to the incidence of controversy. For example, the UK has a business risk rating review process which has ‘justified trust’ principles, allowing the tax authority to draw conclusions on a business’s tax control framework and effectiveness. The Netherlands has a horizontal monitoring framework that allows the taxpayer to engage in a transparent discussion with the tax authority on management of tax risks.

In certain European countries, joint tax audits are predicted to increase. Whilst the decision to undertake a joint audit is for the tax authorities to make, in certain situations businesses may want to consider proactively pursuing a joint audit. Germany has led the way for most joint tax audits, with a specific centre in Bavaria to deal with the logistics of joint audits, such as the translation of documents originally in another language. This is the case as Germany does not have a country compliance assurance programme.