FT.com
FINANCIAL TIMES

Managers under pressure to give tax its due

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Published: August 18 2005 19:31 | Last updated: August 18 2005 19:31

Until recently, few top business people would feel compelled to know much about tax. Why should they take an interest in such a complex, technical subject with apparently little strategic importance?

But tax is raising its profile. This reflects both the corporate tax scandals of the late 1990s and a realisation of the potential costs of tax disputes. Earlier this year, for example, the US Internal Revenue Service raised to $7.8bn (£4.3bn) its demand for back taxes against GlaxoSmith-Kline, the pharmaceutical company, in a long-running dispute.

As a result, directors are increasingly being asked to take responsibility for their company’s tax affairs by legislators, tax authorities and investors. In Australia, for example, the Commissioner of Taxation took the unusual step in January 2004 of writing to the chairmen of the largest listed companies suggesting that they focus on tax risks as part of their approach to corporate governance.

Meanwhile, in the US, the Senate Finance Committee has repeatedly pressed for the adoption of a measure that would force chief executives to be legally responsible for the accuracy of their company’s tax returns.

The idea, which the US Chamber of Commerce described as “both onerous and unnecessary”, is seen as a step too far by many business people. However, there is a growing acknowledgement that tax presents too big a risk to be ignored by directors. Companies are beginning to question whether tax departments should be allowed to operate separately from the board and business units.

KPMG, the professional services group, says that perceptions of tax have changed dramatically in recent years. “Tax cannot remain in the splendid isolation to which its technical nature and its perceived independence from the business mainstream have historically placed it,” it said in “Tax in the Boardroom”, a discussion paper.

In part, this is because high-level tax planning can create opportunities. As tax competition between countries intensifies, companies can benefit from incentives designed to attract and retain corporate investment.

But the main issue is that corporate scandals – and the resulting crackdown by tax authorities – have increased the financial and reputational risks faced by companies seeking to minimise their tax bills.

Finance ministries are taking a more aggressive approach in the battle for revenues. The opaque, artificial structures used by some companies to avoid tax are viewed with increasing intolerance by governments.

Becoming embroiled in arguments with tax authorities can damage a business. In the US, companies that have entered into certain tax plans – reincorporating overseas – are ineligible for government supply contracts.

A company's reputation as a good corporate citizen could also be damaged by publicity about a dispute with a tax authority. The risks posed by tax disputes to shareholder interests were raised in a recent study by Henderson Global Investors, the investment group. It concluded that "many boards are not giving tax sufficient strategic attention. Fewer than half the boards of companies responding to the survey have reviewed tax strategically in the last year or adopted a formal tax policy".

There are signs that companies are starting to respond to these pressures. The Tax Justice Network, a group that campaigns against tax avoidance, says it "has observed a momentous shift in attitudes on taxation and corporate responsibility over the last year".

Tax has also been affected by improvements in internal controls introduced in the US, as a result of the 2002 Sarbanes-Oxley Act on corporate governance, and elsewhere. Ernst & Young, the professional services group, says that tax is starting to be seen as an intrinsic component of risk management. "The tax function is evolving from its traditional emphasis on effective tax rate and cash flow management into being part of how a company approaches its overall risk management."

A recent Ernst & Young survey found that two-thirds of tax directors received more direction on tax risk matters than they did two years before. Nevertheless, it found that the tax function was often not represented on the risk management committee – an oversight that could mean tax risk was inadequately addressed.

Boards have difficult decisions to make in deciding how aggressive their tax strategy should be. In the past, many companies have argued that they have a duty to their shareholders to use all legal means to minimise their tax bills. But tax authorities are increasingly taking the view that some practices, although legal, are abusive and irresponsible.

KPMG says: "In the past there was a clear distinction between legal tax avoidance and illegal tax evasion. The distinction remains clear in law, but has become blurred in the minds of governments, regulators and the public."

This blurring of the boundary between acceptable and unacceptable tax planning, which has happened in many industrialised countries, has annoyed some companies. They point out that it is unsurprising that directors undertake tax-driven activities, given that governments frequently try to alter companies' behaviour using tax incentives.

Some companies may be so unsettled about the avoidance clampdown that they would consider moving parts of their business to lower tax countries.

Some businesses are also fighting back against the assumption that tax planning is socially irresponsible. They argue that the emphasis on corporation tax ignores the much larger contribution they make to the public coffers through other taxes. This contribution has been illustrated by PwC, the professional services group, which has designed a "total tax contribution framework" for companies, encompassing social security, property taxes, road fuel duties, irrecoverable value added tax, vehicle excise duty and air passenger taxes.

The plethora of taxes paid by businesses at the operating level raises the question of how far tax considerations should be taken into account by operating units. Managers below board level are usually evaluated on pre-tax numbers, so they are not motivated to consider tax in their daily decision making.

Individual business units should become more involved with the management of taxes, according to KPMG. This could increase the chances of tax saving opportunities being identified where they would be most effective.

There are, however, risks in motivating managers to take an active interest in tax. It could, for instance, encourage competitive tax planning between different parts of the business, benefiting the individual unit at the expense of the company.

Managers have long been warned against taking decisions on the basis of tax consequences, rather than what makes good business sense.

Even though tax is set to become a more mainstream issue, its influence on corporate decision-making may remain limited. Nonetheless, its significance for top managers is inescapable: tax, as well as being one of a company's biggest costs, is also one of its biggest risks.

TAXING QUESTIONS

Tax authorities do not expect directors to become experts in tax legislation. But they should take an active interest in the risks posed by their tax policies. Questions for managers and tax advisers could include:

■ Is there anything to suggest that tax payments are lower than would be suggested by economic conditions and other companies in the sector?

■ Conversely, is the company being too prudent and paying more than its peers?

■ Is the pattern of tax payments in line with previous business results?

■ Are there complex structures and intra-group transactions associated with reducing tax bills that are not rooted in economic substance?

■ If parts of the group are reporting losses, are they genuine economic losses that can be properly explained?

■ Is there a likelihood that a change in legislation would affect the company's tax arrangements before they reach maturity, break-even point or the required return?

■ Is there a risk that the approach being taken will prejudice the relationship with the tax authorities – or relationships with shareholders, counterparties, policyholders and customers?

■ Is the tax strategy properly monitored, documented and communicated?

■ How reliable are the records and control systems that are used to comply with tax and financial reporting obligations?