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‘What’s tax got to do with it?’

(check against delivery)

Speech by Michael D’Ascenzo, Commissioner of Taxation, to the Australian Institute of Company Directors, Sydney, 16 February, 2010

Recent events in the global economy have shown how critical good corporate governance is to our financial security.

The global financial crisis took many by surprise, including, it turns out, some of the largest companies that were subject to collapse. In some cases these were taxpayers from industries renown for being risk averse, and taxpayers who, only days prior to announcing their collapse, had advised authorities that risks were accounted for and their financial position was tenable.

Not only has the global financial crisis highlighted the interdependencies of markets and their shared vulnerability to systemic risk, it has also highlighted the worrying fact that some internal risk management systems seem unable to ask and answer the right questions.

One of the lessons from the economic downturn is that simply having a governance framework in place is not always enough. Many of the companies that were hit hardest by the economic downturn had governance structures in place. Unfortunately, these structures were not robust enough to raise red flags at the appropriate levels.

Warren Buffet, one of the most successful corporate directors in history, made a candid observation when he wrote to shareholders about the strength of his company's risk management approach. He said, it's only when the tide goes out that we realise who's been swimming naked.[1]

Now, as we recover from the downturn, is an opportune moment for us to learn important lessons about corporate governance and how it works best, so that we can rebuild for a stronger future.

As directors, you play a crucial role in establishing and maintaining strong corporate governance structures. You have to manage a wide range of priorities competing for your attention. I know that many of you recognise the need for a tax risk management strategy as part of your governance framework, however, there is still more work we can do in translating good intentions and policy statements into practice.

Today, I'd like to outline the features of a robust tax risk management framework, the demands from the emerging international environment and some of the products and services we have available to support good governance practices.

International regulation

Australian income tax legislation has long imposed tax compliance obligations on companies. While this is not new, what we are observing – both here and overseas – is an increasing focus by regulators on the need for robust risk management frameworks.

[1] Warren Buffet in a letter to his shareholders 28 February 2002

This convergence is bringing many companies' tax risk management into the public arena.[2]

My question for you as directors is: how well-placed are you to meet increased levels of scrutiny, both now and into the future?

In Australia, corporate reporting and disclosure laws[3] have placed greater pressure on directors to be informed about material tax risks. Listed companies must consider the Australian Securities Exchange's Corporate Governance Principles and Recommendations, particularly Principle 7, which states that companies should establish a sound system of risk management.

On the international stage, tax has gained greater prominence due to stricter accounting and financial reporting requirements such as the US Sarbanes-Oxley legislation.[4]

Also in the US, Financial Interpretation Number 48 now requires certain entities to recognise in their balance sheets potential tax risks arising where the entity has taken a position that the revenue authorities would disagree with, assuming they have full knowledge of all relevant information.

IRS Commissioner Doug Shulman took this a step further a couple of weeks ago when he announced that the IRS is considering changes to the reporting requirements of uncertain tax positions. For some large businesses, it will mean disclosing to the IRS their uncertain tax positions as part of their annual business tax return. For the IRS, this proposal is about finding ways to work smarter by cutting down the time it takes to identify issues so it can spend more time and resources dealing with them. Shulman said in a speech to the New York State Bar Association:

> The goals of the proposal are simple: to cut down the time it takes to find issues and complete an audit…ensure that both the IRS and taxpayer spend time discussing the law as it applies to their facts, rather than looking for information and to help us prioritise selection of issues and taxpayers for examination.[5]

Similar changes have been proposed under the International Financial Reporting Standards (IFRS) that would impact Australia. While there is still some uncertainty as to what changes will be introduced and when, there is a general expectation that reporting entities will be required to measure and disclose tax uncertainties in their financial statements. Last year we commenced discussions with representatives from the 'Big 4' accounting firms about these potential changes. If such changes proceed we expect to see a greater focus on the management of tax risk. I note with interest that the IRS is taking new steps in reaching out to corporate board members to highlight the importance of appropriate oversight of tax compliance. [6]

The UK has also made some impressive headway in the governance arena. In 2009 the HM Revenue and Customs (HMRC) introduced a new large business measure called

[2] 'Zen and the Art of tax compliance: The five streams of consciousness and the quest for certainty and voluntary compliance', presentation by David Drummond, KPMG December 2009
[3] Sections 295 & 295A of the Corporations Act
[4] Lavermicocca, C 2009, 'Managing Tax risk and Compliance', *The Tax Specialist,* vol.13(2), p71
[5] 'No shelter from tax now', *Australian Financial Review*, 28 January, 2010, p15
[6] Prepared Remarks of Commissioner Douglas Shulman, United States Internal Revenue Service, before the 22nd Annual George Washington University International Tax Conference, 11 December 2009.

the Senior Accounting Officer (SAO) certification. This measure requires the SAO of a qualifying company to certify that the company has taken reasonable steps to establish, maintain and monitor appropriate tax accounting arrangements.[7]

This measure builds on work already underway within the HMRC to improve tax governance with large business, and is intended to bring the discussion of tax accounting arrangements into the HMRC's risk review and assessment process, and within the HMRC's risk framework.

During 2009 the OECD published an Information Note based on the experiences and lessons of Australia, Canada and Chile in encouraging good corporate governance and continuing to develop approaches to sound tax risk management.[8] The note concludes that tax administrations have a vital role to play in ensuring boards understand that they are ultimately responsible for their business's tax strategies and outcomes.[9]

Australia is taking this forward, leading efforts to have tax risk management included in the OECD's broader corporate governance agenda, and to integrate this with an enhanced relationship with large business.

As Vice Chair of the OECD's Forum of Tax Bureau, and with Vicki Wilkinson (Treasury) who is Australia's Representative on the OECD Steering Committee on the Corporate Governance, we will be continuing to work together to provide guidance on how tax risk oversight might be recognised in the OECD Principles of Corporate Governance.

The place of tax in the boardroom

Australian businesses have come a long way from the days when tax was locked in a 'black box' for the exclusive domain of specialists. As the Board of Taxation's Chairman Richard Warburton put it:

> It's clear that here in Australia, Board members can no longer afford to say that 'tax is something done by people down the corridor'. Board members are beginning to be aware that the consequences of poor tax management could be very serious for all aspects of the business.[10]

This was highlighted by an Ernst & Young's survey of publicly-listed Australian companies in 2008. The survey found that:

- 64% of respondents were considering or already had a broad tax risk assessment program, and
- 60% of respondents had improvement measures in place to better integrate the tax function into the wider organisation.[11]

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[7] KPMG, 'Senior Accounting Offices Certification of Tax Accounting Arrangements – Are you ready?', September 2009.
[8] OECD Forum on Tax Administration, Information Note: General Administrative Principles: Corporate Governance and Tax Risk Management, July 2009
[9] OECD Forum on Tax Administration, Information Note: General Administrative Principles: Corporate Governance and Tax Risk Management , July 2009, p17
[10] Warburton, Richard 2009, 'Tax Risk Management – the View from the Boardroom', Paper presented at the 48th Victorian State Convention of the Taxation Institute of Australia, p4
[11] 2008 Ernst & Young Tax Risk Survey: 'Steady Course, Uncharted Waters: The Australian Perspective' p5

While these results are encouraging, the survey also noted that many areas for improvement remain. For example, the survey identified continuing failures in implementing tax planning and other structures. The survey also found a continuing need to ensure that tax functions are sufficiently resourced. One of the more concerning findings in the survey is that only 24% of respondents said they had sufficient resources to cover tax function activities.

Private companies can also struggle to implement and maintain good tax risk management. All too often we have seen situations where private companies get into strife with their tax because without the external reporting pressures, they simply have not devoted the resources early on to implement a sound tax risk management strategy.

Examples of poor risk management include not having appropriate advice or guidance on tax matters, which can lead to a failure to comply. For example, we are seeing cases where shareholders have assumed there is no capital gains tax (CGT) on the disposal of pre-CGT shares. This may not be the case if the underlying assets within the company have been acquired post-CGT. A thorough tax management system would help mitigate such risks and make tax compliance easier.

The case for a well-supported tax function

What's at stake here? What are the consequences of not investing enough in your tax risk function?

Firstly, the amounts involved in tax disputes can have a major impact on your bottom line, both in the amount disputed, and the resources tied up in litigation or audit activity. If you don't consider the tax consequence of the transaction it could lead to unnecessary litigation.

As David Glen, Tax Counsel for Tower Australia Ltd, notes in his recent paper these disputes can absorb resources that could be better invested in core business, managing your tax risk position, or harnessing tax opportunities.[12] Furthermore, tax litigation cases can have material and significant consequences.[13] In sum, the seriousness of this course of action means it should only be pursued after thorough consideration at the Board level.

Secondly, your approach to tax risk can indicate the effectiveness of your overall governance framework. Harvard Business Professor Mihir Desai points out that approaches in tax planning can be symptomatic of problems elsewhere in an organisation:

> Countering the tempting logic that tax avoidance is good for shareholders is the fact that tax avoidance opportunities require obfuscation and, consequently, open the door to managerial opportunism. Indeed, several high-profile cases of managerial opportunism, including Enron, Tyco, and Dynegy, had their genesis in tax-planning activities. These

[12] Glen, David 2009, 'Overcoming taxation challenges in the current business climate', presentation to the 5th Annual Corporate Tax Forum, May, p2

[13] For example, 64% of cases in 2008-09 were found in favour of the Commissioner.

> activities, and the secrecy they demanded, became the cover for activities that were not in shareholders best interests.[14]

The Australian experience bears out the truth of Professor Desai's observation. Of the large businesses the ATO identified as showing a high prospect of non-compliance, a disproportionately large number were significantly affected as a result of the economic downturn.

Corporate social responsibility

Tax should also figure in the array of issues you consider as part of fulfilling your corporate social responsibility.

There is evidence to suggest that since the financial crisis more people are beginning to perceive tax as an essential part of corporate social responsibility. Consequently, tax issues are increasingly in the public domain.

Director of the OECD, Jeffrey Owens, noted in a speech to the Tax Executive Institute Conference in Washington:

> Tax has ceased to be something that just interests tax directors. The press is taking an increasing interest in tax issues. Newspapers like the *Financial Times* and the *Wall Street Journal* now run front page headlines on the way some companies have been targeted over tax avoidance...[15]

Increasingly other newspapers, like *The Guardian* in the UK, are running tax investigations.

Corporate social responsibility is more than ideals and motherhood statements. It is essential in maintaining your business's reputation and meeting heightened community expectations. To quote the Assistant Treasurer, Senator Nick Sherry:

> While terms like 'corporate social responsibility' … may sound altruistic, they all boil down to sustainable business practices. The kind of business practices Australia needs right now.[16]

Urs Landolf and Susan Symons from PricewaterhouseCoopers rightly note, 'doing the right thing' does not mean paying as much tax as humanly possible.[17] We see corporate social responsibility as lived out in the values which characterise *how* you exercise your tax function: transparency, accountability and stakeholder engagement.

Therefore, a shift in thinking is needed from seeing the ATO simply as a tax gatherer or regulator, to viewing us as mutual stakeholders in an efficient, internationally competitive taxation system that is an asset to you (in helping to minimise compliance costs, in

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[14] Cullen, A 2009, 'Time to rethink the corporate tax', *Governance, Risk and Compliance Handbook*, p79
[15] Owens, Jeffrey 2007, 'Speech to the Tax Executives Institute Conference, Washington DC.'
[16] Senator the Hon Nick Sherry while Minister for Superannuation and Corporate Law, webpage for the Corporate Responsibility Index
[17] See Landolf, Urs and Symons, Susan 2008, 'Applying corporate responsibility to tax', *International Tax Review,* vol. 2, p6

providing you with practical certainty, and in promoting a level playing field) and to the Australian community.

Such changing attitudes are starting to manifest themselves at the coal face of our work with large business. Our compliance staff tell me that they are starting to see two distinct approaches evolving in the large market. On the one hand there are those taxpayers with an open and transparent relationship with the ATO, who generally benefit from quicker turnarounds and mitigate their tax risks more successfully. On the other hand are companies that continue with the old fashioned game of audit hide and seek, thereby prolonging matters, usually resulting in a higher cost to the business.

Products to provide certainty and promote good governance

At an international level strong working relationships are increasingly being seen as key to promoting better governance practices that are of mutual benefit to the regulator and large business. Indeed, I see a mutual interrelationship between good governance that gives prominence to material tax risks in the same way as it does for other material risks, as well as the concept of an enhanced relationship.[18]

In the US, IRS Commissioner Doug Shulman noted that Australia is at the cutting edge in demonstrating the link between good tax risk management and overall tax compliance.[19] What makes us cutting edge, he said, is the engagement and dialogue we have with large business.

Annual Compliance Arrangements (ACA) are the centrepiece of our efforts to build positive relationships with large businesses.

An ACA embodies the principles of corporate social responsibility. Businesses with an ACA can demonstrate transparency through upfront disclosures of key transactions. They do this by certifying that their corporate governance practices are consistent with the touchstone principles set out in our Large Business and Tax Compliance Booklet.[20] And they show positive stakeholder engagement by committing to ongoing dialogue with us throughout the life of the ACA.

ACAs make sound business sense. Businesses with an ACA gain practical certainty that assists them in mitigating compliance risks. Not only that, an ACA can have reputational advantages in that it enables businesses to position themselves at the forefront of good compliance practice.

But the possibilities of integrating tax risk management into corporate social responsibility extend beyond the ACA pathway. Already, we are seeing nascent trends in our engagement with some corporate advisers, who are investing additional time and resources in coming to us early in a more collaborative manner. This has created opportunities for us to explore ways of cascading collaborative risk management below the large business level.

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[18] OECD paper on 'Enhanced relationship', July 2007
[19] Shulman, D 2009, 'Prepared Remarks of Commissioner Douglas Shulman before the 22nd Annual George Washington University International Tax Conference.'
[20] Available online

ATO risk assessment framework

None of us would suppose for a moment that we can eliminate risk altogether – in tax, or in any other aspect of corporate governance. What we are interested in at the ATO is gauging the business's appetite for risk.

As directors, you can determine what aspects of tax risk are within your control and what you consider to be acceptable. Having made a strategic decision on your tax risk tolerance, it is then a matter of ensuring internal processes are in place to give effect to this threshold, including the alignment of your tax and other staff to this threshold.[21]

Your decision on tax risk has an outward-facing aspect. We monitor your tax behaviour and determine your risk profile accordingly. This then directs how we will engage with you. For the majority of you who do the 'right thing', we will work constructively and collaboratively and seek to minimise compliance costs to the extent practical.

For those who demonstrate an aggressive stance we have an escalating suite of responses geared to address the risk of non-compliance. We identify this behaviour through our risk reviews, profiling and audits.

Our work with the OECD forums lets us share developments with other countries. In the Netherlands for example, regulators have shown increasing willingness to look 'under the hood' of a business to ask, 'to what extent is the business in control?'

I also note with interest the voluntary UK Code of Practice on Taxation for Banks, which sets out the principles and behaviours the UK Government expects to see in tax compliance in this sector. The UK Government designed the Code because it believed the unique position of the banking sector imposed a particular responsibility on it to comply with the spirit as well as the letter of tax law, discerning and following the intentions of Parliament, and do so in a way that is transparent and open with HMRC.

We have had discussions with the banking industry around the usefulness of such a Code of Practice in Australia. However, the principles embodied in the UK's Code of Practice, particularly around governance processes, are already embedded in our voluntary Annual Compliance Arrangements. As you may be aware, two major banks currently have ACAs with the ATO and we are in discussion with other banks. A commitment to an ACA obviously impacts on our assessment of taxpayer risk. I would encourage you to seriously look at the advantages of an ACA as part of your overall corporate governance strategies.

The rulings process: managing uncertainty

Tax risk of any kind involves managing uncertainty. Often, one of the major contributing factors to uncertainty is a lack of clarity about how the ATO might apply a tax provision. To help you manage this risk we have a number of services on offer.

[21] Australian Taxation Office 2006, Large Business and Tax Compliance Booklet, p10

Our private rulings process complements ACAs as one of the most practical ways we offer to help you manage risk. Interestingly, some of the critics of the private rulings system have never used it.[22]

It is a shame when people, whatever their agenda, depreciate what is a feature of the Australian landscape that affords businesses certainty on their tax outcomes.

The private ruling service is free, and while we would appreciate your analysis of the facts and law, this is no more than you would already have done as part of your own governance processes. If you engage with us early and provide us with the material facts, the process of obtaining a private ruling can be timely and productive.

Examples of the benefits of this service are numerous. For example, in 2008-09 we responded quickly to the needs of our big banks by expediting rulings relating to capital raising arrangements.

Currently though, a higher than expected percentage of our rulings work involves requests for retrospective rulings. I encourage you to make more use of our rulings service for transactions before they occur.

By seeking our advice early in the piece, you can gain clarity on our position and factor it into your strategic decisions about whether or not to proceed. Essentially, it's about making a decision based on the best information available.

Of course, there is room for us to disagree, but by maintaining a constructive and professional relationship we can seek to narrow the point of disagreement and drive its resolution in the timeliest and most cost effective manner.

Bringing tax risks to everyone's attention

This brings me to one of the other ways the ATO is uniquely placed to assist you. When we see emerging trends in compliance risks across industry sectors, we offer this information to you to inform the decisions you make as directors on your tax risk management. This is part of our prevention is better than cure philosophy.

Our annual Compliance Program provides guidance to you on the tax risks we are currently focusing on.[23] Given the magnitude of the amounts involved, I would expect that, as directors, you would be properly briefed on issues we have identified as areas of concern.

In addition to the Compliance Program, we use a number of other avenues to raise awareness of current and emerging tax risks. These initiatives include our consultative and industry forums, and various communication products such as Taxpayer Alerts. Last year we issued 21 Taxpayer Alerts as an early warning of emerging tax risks. One risk we alerted businesses to was contrived cross-border financing arrangements that attempted to generate a deduction for costs incurred in deriving tax-free dividends from offshore companies. Our aim here was to clearly define the line between legitimate tax

[22] Many of these taxpayers tend to be higher risk taxpayers.
[23] Australian Taxation Office 2009, 'Annual Compliance program: 2009-10'

planning and tax avoidance. It is important to stress that it only takes one extra step which is not commercially justifiable to bring you into risky territory.

Nevertheless, we would like the dialogue to be two-way. We would like the many consultative forums or our one-on-one discussions with taxpayers and their advisers to be more forthcoming about emerging trends or transactions that may not be within the letter or spirit of the law. This would benefit the equity of our tax system by promoting a level playing field. It's your tax system and it is in your competitive interests not to be disadvantaged by unfair practices.

Next steps

In terms of next steps, we are focussing on new ways to help businesses manage risk in the ever-changing environment.

We are constantly exploring new ways of working with businesses across a range of taxes and markets. Increasingly we are engaging with taxpayers on a prospective, co-operative basis to identify tax risk and agree on mitigation strategies. This provides you with greater certainty and can help reduce compliance costs. We are open to co-designing with you how such processes may work.

The Gorgon development is an example of this. It is a major strategic project where we get together with stakeholders to discuss and identify uncertainties in the tax environment. Alternative approaches will be workshopped and sometimes rulings may be sought to minimise risk. This engagement is to take place over a series of meetings and can cover all taxes.

Finally, I am interested in hearing from you about what you need from us to help you meet the challenges ahead. We are particularly keen to work alongside the AICD Corporate Governance Committee to develop a common approach to tax governance. Fundamentally, this requires directors to be comfortable that the way things are done makes commercial sense and reflects the economic realities.

Many of you will also be represented on our Large Business Advisory Group, either directly or through your membership of the Corporate Tax Association. I encourage you to bring suggestions and feedback to this forum.

All of us are used to operating in an ever-changing environment. Tax governance is no exception. If you ask me what tax has to do with corporate governance, I would say that it depends on the decisions you make as directors: whether tax remains obscured in its black box, with all the barriers to identifying and mitigating risks this entails, or whether management of material tax risk is built into the foundations of your business.

Thank you