Risk transformation and tax
Securing the benefits
of enhanced tax-risk
management
Facing a complex regulatory environment and vigorous drivers of tax risk, many global financial services enterprises are finding their approaches to managing tax risks unequal to the challenges. At the same time, many chief risk officers (CROs) in the financial services industry (FSI) seek to transform their organizations’ overall management of risk. These CROs aim to drive integrated risk management, aligned with enterprise strategy, into every business unit and function across their organizations.

Meanwhile, methods of managing tax risk, particularly the operational, reputational, and strategic aspects of tax risk, may be underdeveloped relative to those for financial reporting and tax compliance risks. When this is the case, addressing tax risk more effectively can improve overall risk management. It may also bolster the business case for risk transformation initiatives, for example through accessing tax incentives or protecting tax attributes. In other words, addressing tax risk not only can improve management of an important risk that may be undermanaged; it may also help to fund risk transformation initiatives and lead to new approaches to managing enterprise risk.

This paper, written for CROs, tax executives, chief financial officers (CFOs), chief executive officers (CEOs), and board members, summarizes the forces driving tax risk and examines the state of tax-risk management in the financial services industry. It then outlines basic tenets of risk transformation and examines ways and means of transforming the management of tax risk.
A new definition of tax risk

First, let’s clearly define tax risk. Traditional views of tax risk tend to perceive it solely in terms of potential underpayments, overpayments, tax penalties, and assessments—all of which are “unrewarded” risks to be avoided. Traditional views also focus mainly on corporate income taxes (that is, “below the line” taxes) and related technicalities.

While useful, traditional views of tax risk are now too narrow. Tax risks related to “above the line” taxes, such as value added tax (VAT) and other indirect taxes as well as employment and transaction taxes and information reporting, are increasing. Risks to reputation and brand may arise from negative attention from the media and nongovernmental organizations (NGOs), even when a company’s tax policies are appropriate and in compliance. In addition, operational aspects of taxes, such as execution of obligations through systems and access to necessary data, present risks that extend beyond those of the technical tax positions.

Other prominent tax risks include inability to meet tax requirements, unexpected cash taxes, and failure to capitalize on tax savings from business relationships. Financial institutions face the added challenges and costs of stress testing and capital requirements.

Yet there is potential upside value in “rewarded” risk-taking through proper tax planning based upon business and risk management goals. Integrating management of tax risk into overall risk management enables an organization to generate efficiencies, upgrade tax reporting, compliance, and analytical processes, and enhance financial results while reducing tax burdens.

Around the world, the plethora of taxes at national, state or provincial, and municipal levels, which can include income, property, payroll, excise, value added, and transaction-based taxes, guarantees complexity. Yet the ubiquity of taxes gives virtually every organizational function a stake in managing taxes, tax risks, and related processes. By the same token, tax must work effectively with all functions and business units—from the human resources and legal departments to operations and regional finance groups—to determine that all tax risks are identified, monitored, reported, mitigated, and managed.
Drivers of tax risk

While death and taxes may be the only certainties, the current tax environment brings greater uncertainty to tax policy. As always, greater uncertainty begets greater risk.

Prominent features of this tax environment include the following:

- Tax policies are in flux in many jurisdictions, with the goal of enhancing government revenue to close budget gaps or, in some cases, of attracting business activity; recent tax policies have in some instances tended to heighten tax planning challenges and increased tax authorities’ expectations for transparency; examples include closure of “loopholes,” certain international taxes, such as the EU Financial Transaction Tax (FTT), restrictions of loss utilization by banks in the United Kingdom, and changes in the international tax environment, such as the Base Erosion and Profit Shifting (BEPS) project, and reporting associated with the Foreign Account Tax Compliance Act (FATCA), which affects many U.S. companies doing business globally.
- Media coverage of effective tax rates and of seemingly low corporate tax payments increases risks to reputation and brand; executives’ explanations of tax planning methodologies may be lost on a skeptical public.
- Some companies have adjusted their business models in response to changes in tax policies. In addition, tax considerations have motivated certain mergers and acquisitions and location decisions.
- Tax planning can influence decisions of investors, customers, and other stakeholders; for example, government procurement rules may include restrictions on service providers seen as avoiding taxes, such as UK rules which sought to exclude enterprises that had used certain tax avoidance strategies from bidding on government contracts; separately, as of 2014, the Dow Jones Sustainability Index includes tax policy and transparency in reporting on taxes paid in this widely consulted measure.
- Executives now recognize tax as a strategic risk, with respondents to Lloyds Risk Survey 2013 citing it as the number one risk (up from number 13 in 2011); the report states that “perception of the issue has changed from that of a domestic problem to one requiring global action.”

Although the political forces behind changes in tax regimes may vary, the foreseeable fiscal needs of most governments indicate that attention to tax compliance and reporting will intensify (see sidebar), along with interest on the part of media, investors, customers, NGOs, and other stakeholders. Meanwhile, the tax function itself may be less than prepared to address rising tax risks. The latter may stem from tax, of necessity, being structured (and viewed) as a team of specialists who manage a highly technical risk. However, market forces have increased operational and reputational risks associated with tax to the point where tax now poses risks that warrant senior management’s attention.

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**Taxing developments**

Managing taxes and tax risk requires a global approach, given developments around the world, which include the following:

- The Organization for Economic Cooperation and Development (OECD) BEPS project is well underway and is strongly supported by the G20. The project’s chief aim is to examine whether current rules allow for allocation of taxable profits to locations other than those where business activities occur, and what steps authorities can or should take to change this. This effort will almost certainly seek to heighten transparency and may make tax planning more challenging.
- Banks in the United States are working to meet stress-testing requirements under the Comprehensive Capital Analysis and Review (CCAR) methodology. Tax planning can substantially affect these calculations. For example, Federal Reserve rules, which reflect Basel rules, state that deferred tax assets are deducted from tier 1 capital or, in some cases, included subject to limits.
- Asia/Pacific-based financial institutions are strongly affected by demands associated with operational taxes, including technical, governance, and compliance considerations, and reviews. Prominent items to consider include the FTT, capital gains tax and withholding tax on China securities, and the China VAT for the banking industry.
- Rules such as Basel capital requirements and stress testing requirements can affect banks in multiple jurisdictions, and local tax and regulatory policies typically apply to any FSI company doing business in a locale. Insurers are affected by many provisions and may, for example, need to consider treatment of deferred tax assets for the purposes of the EU Solvency II Directive for the insurance industry.

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1 Lloyds Risk Index 2013
2 About BEPS, OECD
4 Operational Taxes in Asia Pacific: Are You Keeping Pace? www.deloitte.com
Tax and risk management may not be prepared

In the environment described above, a sound approach to tax-risk management would imply that the risk management and tax functions are fully prepared to:

- Articulate their understanding of the tax lifecycle—from seeking to evaluate and potentially influence tax law change, through tax planning on prospective business decisions to preparing, filing, and defending tax returns.
- Identify categories of tax risk that arise in this lifecycle—including redetermination of a technical position taken and noncompliance with applicable laws—and how they fit within the organizational risk architecture.
- Understand, assess, monitor, and mitigate their tax risks through effective procedures and processes incorporated within the organization-wide “three lines of defense model” enabling management of operational and cash-flow risks, such as overpayments. (The three lines of defense traditionally include the business units (first), risk management (second), and internal audit (third).)

- Identify, analyze, review, and discuss with management business decisions, processes, and transactions that hold significant tax consequences and tax risks.
- Communicate the overall tax-risk profile, with aggregated data for the exposure by relevant segment, such as jurisdiction, tax type, and counterparty, to assist senior executives, business unit leaders, and board or board risk committee members in assessing and overseeing those risks.

Although rarely reaching so high a profile, tax has long presented a risk management challenge for large financial institutions. Different taxes present vastly different reporting and payment requirements, revenue and expense recognition methods, and valuation and calculation options. This complexity has always given rise to some risks that remained opaque—even to those charged with risk oversight—with often invisible, but damaging consequences. Tax risks have rarely been explicitly considered in discussions of risk capacity, appetite, and profile, as they now should be (see Figure 1).

Figure 1: Relationships among important risk management concepts

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Meanwhile, most organizations maintain a team of tax specialists that is small relative to the complexity of the task. Although tax is among the organizations’ heaviest users of financial data, data available to tax-risk managers and overseers may be inadequate. The pervasive nature of tax generates complexities, with various tax risks stemming from specific functions and the interactions among them.

For instance, compensation specialists may have to decide what percentages of ownership shares awards are taxable or reportable in multiple jurisdictions when employees have changed locations between the award and vesting. Analysts in a local finance team or a shared service center may have to determine transaction taxes or VAT treatments (and deductibility and allocation to tax depreciation rates for income tax purposes). Equity operations personnel may need to determine the ability to access provisions of double tax treaties to mitigate withholding or capital gains taxes.

In addition, tax has been a major source of material weakness under Sarbanes-Oxley (SOX) and restatements in the United States. Similarly, in the United Kingdom, senior accounting officer disclosure requirements suggest that a distressing percentage of large organizations cannot certify that they have appropriate processes and controls in place regarding their UK taxes.

Given that the risks can straddle functions, the related communications and handoffs across departments must be extremely well-coordinated. However, tax cannot control all data and decisions affecting taxes and tax risks in an organization, nor is any other function generally able to do so. Most activities that impact tax risks occur outside the tax function, yet (except perhaps regarding capital expenditures) business units and functions typically view taxes as an afterthought and as an administrative, as opposed to risk management, matter.

For these reasons, risk transformation aims to embed tax-risk management into every unit and function within the enterprise through a clearly articulated three lines of defense model which defines responsibilities across divisions and functions for management of controls over tax risks. Risk transformation is as applicable—and as essential—to managing tax risks as it is to managing any other risk.

Within the context of risk transformation, an array of tools geared to risk analysis and visualization may be used to define, detect, measure, track, and manage tax risks. For example, a tax decision web can enable stakeholders unfamiliar with tax policies to play a role in tax risk assessment and decision making. As shown in Figure 2, a tax decision web displays factors that influence a tax decision and plots a given proposal or decision against each of those factors and the related risk tolerances.

**Figure 2: Sample tax decision web**

<table>
<thead>
<tr>
<th>Decision factors</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Technical strength:</strong> The strength of the technical analysis of the tax planning proposal</td>
</tr>
<tr>
<td><strong>Reputation:</strong> The level of reputational risk for a range of stakeholders, both internal and external to the organization</td>
</tr>
<tr>
<td><strong>Disclosure:</strong> The level of uncertainty relating to the accounting treatment and disclosure requirements associated with the tax planning proposal</td>
</tr>
<tr>
<td><strong>Commerciality:</strong> The extent to which the tax planning proposal’s commercial benefits equal or exceed its tax benefits</td>
</tr>
<tr>
<td><strong>Ability to execute and maintain:</strong> The ability to mount the resources required to implement and maintain the tax planning proposal</td>
</tr>
</tbody>
</table>

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Likewise, a tax-risk map—like the "heat map" in Figure 3—can help teams without tax knowledge and experience to consider the seriousness of specific tax risks. As Figure 3 shows, specific risks can be measured by their likely impact and by the organization's vulnerability to each risk. Additionally, the size of the circle illustrates the likely speed of onset of the risk event. The risks depicted in this tool (Risk A, B, C, etc.) may relate to a specific decision or to a range of tax risks the organization faces.

Figure 3: Illustrative tax-risk map

Another tool, a tax analytics dashboard can enable tax leaders to view multiple analyses, drill down to individual tests, and reference underlying details—all of which can assist in identifying potential problems and in understanding tax and tax-risk positions.
The cornerstones of risk transformation and tax

Risk transformation provides a framework for risk managers, tax executives, business unit and departmental managers, and directors and board committee members to use in understanding the need to improve risk management. This framework also guides leaders in crafting organization-specific responses to risk management needs.

Deloitte member firms have identified four cornerstones of risk transformation: strategy; governance and culture; business and operating models; data, analytics, and technology. These cornerstones translate the goals of achieving risk transformation into actionable terms and highlight cross-functional elements and activities that determine an institution’s approach to risk.

If management establishes these cornerstones, risk management and regulatory compliance can be implemented in an efficient, coordinated manner across the enterprise:

- **Strategy:** Strategy puts the organizational vision and mission into action. The executive team should consider the risks of a strategy and to the strategy. All risks related to transactions and portfolios should be well understood, as should individual and aggregate risk exposures. Enterprise risk management and governance infrastructures should support execution of the business model and capital allocation, based on strategically selected risk-reward trade-offs.

- **Governance and culture:** Governance determines that strategies are properly executed. Culture embodies the values, principles, and beliefs that guide the organization. Governance and culture establish expectations regarding risk taking and risk management, enabling people to discern acceptable and unacceptable risks even when not addressed by policies and procedures.

- **Business and operating models:** The business model defines economic relationships between the organization and its customers, suppliers, investors, and other stakeholders. The operating model structures the ways in which the business conducts its activities with its stakeholders. Within both models, risk should be managed with clear accountabilities, authority, and decision rules at all levels, and well-defined handoffs between business-risk and control functions.

- **Data, analytics, and technology:** Management should determine the data required to address risk management needs and oversee a data strategy to address them. Management should also facilitate integration of finance and risk data for common and reconciled risk and regulatory reporting. An enterprise risk-data strategy can deliver the right data to the right points at the right times to enable consistent, effective responses to business opportunities, risks, and regulatory demands.

In addressing these cornerstones, senior executives create a unifying context for risk management, risk governance, operational enhancements, and regulatory compliance. However, an organization need not work on every cornerstone simultaneously. Depending on needs, priorities, and resources, management can select a single cornerstone or an element of a cornerstone to address, and do so within a given function, rather than launching initiatives along all four.
The cornerstones of risk transformation and tax (cont.)

Here is how these cornerstones might apply in relation to strategic tax considerations.

**Strategy and tax**

For this cornerstone of risk transformation, enterprises should view tax considerations in the context of their overall business strategy. This entails developing an agreed-upon, integrated set of decisions that position the organization to enhance financial returns while addressing tax requirements. To do this, the business needs to be clear on its tax risk appetite and have a set of defined criteria for making decisions that involve taxes and tax risks. This risk appetite should also guide management in establishing processes for implementing these decisions within the organization and enhancing visibility into processes and their outcomes.

**Case in point #1: Major insurer**

A major global insurance company wanted to align tax-risk management with overall risk management.

To do this, the institution needed to:

- Clarify tax decisions and the risks of specific decisions regarding specific taxes
- Translate company-wide risk appetite and tolerance into tax decision risk limits

Accomplishing these goals entailed:

- Analyzing risks associated with specific taxes and tax requirements and with historical and potential tax decisions
- Relating potential tax-risk exposures to the risk limits set by the board
- Tailoring the decision methodology (see Figure 4) to the organization’s needs and objectives by including additional decision criteria (for example, those related to U.S. disclosure requirements)
- Developing “red line” policy limits that defined points at which tax planning methodologies would be automatically rejected without further escalation
- Holding workshops in various global locations to assist the organization in identifying and tracking significant tax risks

Value delivered included the following:

- Clear articulation of tax-risk strategy across the organization and translation of that strategy into daily activities
- Efficient, practical methods of tracking individual and aggregated tax risk associated with business activities and tax decisions

**Figure 4: Sample decision tool**

[Diagram showing various decision factors and their ratings]
The cornerstones of risk transformation and tax (cont.)

Governance and culture and tax

The organization’s tax policy should be commercial in nature and tied to business objectives and stakeholder considerations. Tax policy must also be approved and overseen by the board. The governance infrastructure and organizational culture should enact the tax policy and deliver the desired results. Regardless of its chosen posture, the organization should address tax risks and tax-risk management within its overall approach to governance and its general risk governance infrastructure.

Case in point #2: Commercial bank

A major global bank wanted to:

• Assess the efficiency and effectiveness of its existing tax-risk management framework and processes
• Align tax-risk management to its overarching approach to risk governance and management

Achieving these objectives entailed:

• Analyzing relevant documentation from internal and external sources regarding operations, tax, legal, and reputational risks across business units and functions
• Conducting face-to-face and telephone interviews with key personnel in tax, finance, and other selected areas and units
• Conducting testing to trace previously identified tax risks and their reporting and management
• Assisting the client in locating previously unidentified tax risks and identifying potential detection and reporting mechanisms
• Analyzing the current state of tax and tax-risk management processes and procedures
• Analyzing the current state of relevant processes and procedures against management’s and the board’s criteria and against benchmark criteria of comparable organizations
• Reviewing governance and committee oversight for tax risks and related management reporting

As a result of these activities, this effort:

• Identified gaps between the current state and desired state of processes for consolidating and communicating tax risks, mitigating and managing tax risks, and tracking, validating, and improving tax management processes
• Provided recommendations to improve the existing framework and the efficiency and effectiveness of processes and procedures and to address existing tax-risk management and reporting needs and a scalable platform for future requirements
• Developed a plan to fit the recommendations within the context of the organization’s wider three lines of defense program
The cornerstones of risk transformation and tax (cont.)

**Business and operating models and tax**

Tax operating and control frameworks should align with the corporate control environment and risk architecture. Risk management must have visibility into key tax decisions and, when appropriate, advise senior management, tax, and the business units regarding tax-risk mitigation. Accurate tax forecasting and predictable payments should be high priorities, as should addressing corporate objectives and stakeholder expectations. Incorporating tax-risk considerations into the business and operating models brings tax-risk management down to the level of controls related to the business units and product lines.

**Case in point #3: Investment bank**

A major investment bank aimed to improve the effectiveness of its existing tax-related processes and procedures across diverse product lines in multiple markets.

The institution perceived an urgent need to:

- Confirm local withholding and capital gains tax compliance and U.S. reporting requirements for units in over 70 markets
- Assess the effectiveness and efficiency of the processes and procedures in place to confirm compliance for markets and products

Accomplishing these goals entailed:

- Interviewing senior tax and finance professionals from across the business units to gather relevant data and information
- Identifying high, medium, and low risk markets in relation to the client’s activities, based on knowledge of and experience in the markets and the bank’s activities in each market
- Analyzing the tax operations of each market, reclassifying the markets (when appropriate) and assessing tax-risk processes and procedures; these reviews included specific testing of business-unit awareness of tax issues and of processes needed to comply with requirements (including process design and operational effectiveness)
- Scoring each unit’s compliance against efficient compliance benchmarks to develop a current-state assessment and, as appropriate, determining how far the unit was from achieving efficient compliance and management of tax operations
- Identifying “quick wins” for each in-scope market, and providing longer-term recommendations to mitigate potential exposures and maintain efficient compliance, and preparing prioritized plans for remediation

Value delivered included the following:

- Where a gap was identified, the report quantified historic exposure and provided practical recommendations for improvements to the overall framework—addressing governance, people, processes, and systems
- A scalable, risk-based framework was developed to address future gaps and to accelerate progress toward the long-term vision of effective, sustainable management of tax operations
Data, analytics, and technology and tax

An organization’s tax function requires reliable, timely financial data—and useful analysis of that data. Sophisticated, practical data analytics can dramatically improve the accuracy of tax forecasting, limit volatility in forecasts, and improve tax planning. It can also enhance the CRO’s ability to assess tax-risk and related financial, reputational, and compliance risks.

Specifically, tax data analytics can help organizations to:

- Perform tax benchmarking and data and trend analysis to produce a greater understanding of tax processes and tax risk profiles.
- Manage a proactive audit defense, run efficient tax operations, produce accurate reports and tax accruals, and comply with SOX.
- Ascertain the tax status of the enterprise at points in the tax lifecycle and access tax-sensitized data to enhance tax planning.
- Transform tax processes into an integrated, enterprise-wide model that can enable scenario analysis and assist in stress testing.
- Identify new ways to address evolving tax requirements while gaining potential cost savings from increased tax efficiencies.

Technological improvements in financial and tax data and analysis help the tax function to improve tax reporting and compliance, and provide visibility into related business, transactional, reporting, and compliance processes.

Case in point #4: Global investment bank and fund management group

The group tax department of a multinational bank wanted to better understand the impact of group finance’s accounts payable processes on its indirect tax cash management and compliance operations. Indirect tax determination and accounting processes depended on the efficiency and compliance of non-tax personnel, which presented challenges in assessing the impact at transactional levels.

The indirect tax team wanted to:

- Analyze the accuracy of tax on invoice accounting at the transactional level
- Identify potential opportunities in finance operations, which would ultimately lead to a tax reclaim
- Reduce the need to be heavily engaged in manual line-item analysis

Achieving this called for:

- Extracting, cleaning, and enriching the source data and mapping the data against the bank’s partial exemption VAT recovery methodology
- Applying a data analytics toolset to test transactional-level details across the accounts payable sub-ledger
- Reporting the findings to group tax with recommendations for enhancing the opportunities identified
- Drafting the tax reclaim submission to be provided to the tax authorities, which included the supporting technical basis of the claim

The project achieved the following benefits:

- Analytical testing resulted in a significant accounting accrual based on the existing invoice approval process of group finance
- Support of the enterprise through Her Majesty’s Revenue and Custom’s (HMRC’s) analysis, to HMRC’s satisfaction with the accuracy of the financial accounting process for tax
- Transfer of a structured process to group tax to enable the function to repeat the accrual analysis efficiently within their tax operations
Recent demands on the tax function, emanating from the evolving tax and regulatory environment, have exposed needs and weaknesses that can and must be addressed. This is particularly true for financial services enterprises.

Viewed properly, this is not simply a regulatory, tax, risk management, or compliance and reporting matter; rather, it combines aspects of all four of these matters. Hence, the need for an integrated and transformative approach.

Financial institutions can benefit greatly from a framework for understanding and analyzing their needs and weaknesses in the current environment. The concept of risk transformation and its four cornerstones—and integrating tax into risk transformation and using tax to drive (and, potentially, fund) risk transformation—may enable CROs, tax executives, and CFOs to tackle current tax and risk management demands while positioning the organization to address future demands as they arise.
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