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Responsible Tax
Making changes

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Executive summary

Businesses are not static – they are always evolving to adapt to shifts in their commercial drivers and regulatory environment.

As the strategic goals and operations of a business change over time, so should the tax strategies adopted to support them. In developing these strategies, a close eye needs to be kept on the regulatory environment to ensure that the business not only achieves its commercial aims, but also meets its compliance obligations.

This is particularly important in times like these as change looms at both a national and international level and when there is increasing public scrutiny of large corporates, their advisors, tax authorities and policy makers. Among many other developments, in the UK alone, the last 12 months have seen the introduction of the government procurement protocols; the General Anti-Abuse Rule; and targeted anti-avoidance provisions, while globally there has been the launch of the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan; the introduction of 'transparency' requirements for the extractive and financial services industries; and emerging trends in the way corporates manage and communicate their tax position.

It is too early to assess the impact of all these changes, but it seems unlikely that any large corporate would be totally unaffected. Identifying and assessing the risks and opportunities that these developments bring is critical and requires regular monitoring and review of the organisation's position and options. For some companies the adjustments that flow from such reviews could be relatively small; for example, updating the intercompany pricing for particular transactions based on the latest economic analysis. For others, the changes may be much more significant. For instance, shifting from a commissionaire sales structure to an alternative model (such as limited risk distributer) will involve significant amendments to legal documentation, invoicing and packaging.

The need for continuous reassessment is not just driven by the (currently turbulent) external tax environment. Changing commercial priorities, often focused on identifying and exploiting the most profitable growth areas (markets, geographies etc.) for the business, are also key drivers of tax strategy.

In our previous paper, *Responsible Tax: sustainable tax strategy today,* we discussed best practice and recommended practical steps for setting an appropriate tax strategy and a governing policy for the company, that is aligned with the broader corporate goals and appetite for risk.

In our second paper, *An integrated approach to tax transparency,* we commented on how companies should approach explaining their tax position to stakeholders.

This paper examines how companies can evaluate their options proactively and systematically: helping them to deliver a sustainable tax strategy, remain agile in the face of ongoing change and manage key stakeholder expectations in real-time. Specifically, it covers how business can:

Critically assess the actual or potential tax impact of changes in the environment to provide a 'risk-adjusted' base case i.e. the likely outcomes of the tax strategy if no changes are made;

Review the options and, armed with this assessment and an understanding of any future business plans, determine whether alternative strategies may result in better future tax outcomes; and

Implement and regularly review the chosen strategies which may involve adjustments to the people, processes and systems of the business, both within finance functions and beyond.

Companies should evaluate their options and make the changes needed to enable them to deliver effective tax strategies.

Critically assess: what happens if we do nothing?

Given the nature and the extent of the changes which are in motion within the tax landscape, it seems likely that most large corporates will be affected to some degree. While the significance of the impact for many remains uncertain, it would be a brave move to just 'wait and see'. A more proactive response is needed to get an understanding of the changes in the environment – now and as they evolve – and analyse the potential impact of the associated risks and opportunities for the business. This should enable the tax function to raise awareness within the wider business of the risks of doing nothing.

Understanding the changes

Whatever your views on the long-term impact of the tax debate, it is clear that some change has already occurred and more has been set in motion. Furthermore, these developments have their roots in a number of different tax policy perspectives. For example, in the UK, we have seen many steps taken to attract inward investment, such as the introduction of the Patent Box regime and reform of the CFC rules. At the same time, we have seen a hardening of attitudes toward tax planning reflected in measures such as the General Anti-Abuse Rule.

Internationally, we have seen multilateral action from the OECD to modernise the international tax system through the Base Erosion and Profit Shifting (BEPS) plan, as well as unilateral activity from the US and the Netherlands, among many, to change key aspects of their rules.

Broader regulatory activity has also been significant: the EU recently announced that individual corporate arrangements in certain jurisdictions, including Ireland and Luxembourg, are likely to be reviewed under the state aid provisions. From a reporting perspective, there are also increasing demands for greater transparency around tax. Some of these initiatives are targeted at particular industries and intended for public benefit, such as the EU transparency directive for the extractive industries, whereas others are limited to greater disclosure to the tax authorities.

Evidence of a long-term shift in consumer behaviour is inconclusive, but one significant customer has chosen to act – government. The procurement protocols introduced in the UK restrict those who have engaged in certain tax planning activities which are deemed to be abusive from competing for certain government contracts. Other stakeholders, including investors and employees, remain waiting in the background.

Each clearly has an interest in the tax outcomes of companies and what they may mean for them, but beyond anecdotal evidence of altered buying behaviour, no hard evidence of marked changes in consumer or employee behaviour have yet been noted (in the UK at least).

Given the range of regulatory and other broader developments, it makes sense to put in place a structured mechanism to capture such initiatives as they occur, monitor their progress, and keep analysing their relevance to the business, now and over time.

Analysing the risks and opportunities

Assessing the risks and opportunities arising for the business and its current and forecast tax profile, is key in understanding what steps might be taken in the future. Doing nothing in this environment needs to be a conscious and active decision, backed up by analysis and insight, which has been agreed with key stakeholders.

Where a particular change can be foreseen and its impact is known (or is relatively easily projected), it can be readily overlaid onto the existing tax profile and would clearly help senior management consider future actions in relation to predictable events. The challenge arises, however, when so much of the potential change is still unknown or uncertain.

We know that many Finance Directors and Heads of Tax may be reluctant to devote significant amounts of time and effort to looking at rules which are not yet fully articulated. Not spending this time is a risk, however, as it means that potentially significant factors, for example the withdrawal of a key tax incentive, cannot be built into the development of strategic planning. And when the rules are finally known, it may be too late.

The answer is to undertake some scenario planning – thinking about, for example, what tax legislation is likely to change given what we know now about the political direction and existing consultations in process. In developing scenario analysis, it is useful to think about how different strands of activity may interact and influence one another. For example, it will be important for international businesses to monitor the inter-relationships between the different strands of the BEPS action plan and unilateral changes in national tax policies.

The impact of some developments may be manageable with a relatively short lead time, e.g. financing structures which are affected by changes in the tax treatment of hybrid entities, whereas others will require much longer to respond, e.g. the need to move people, revise legal agreements and update financial systems if a wider business model is undermined.

Again, an inability to respond swiftly may result in competitive disadvantage, and so scenario planning and achieving a state of readiness for emerging change are clearly desirable.

Communicating the outcomes

While scenario planning doesn't provide a crystal ball, it can help overcome the paralysis that can set in when faced with significant uncertainty. It allows the board to develop a view of what the future regulatory landscape may look like and test the assumptions applied in reaching that view. Getting this clarity makes it much easier to communicate with senior management and the rest of the business and helps them make decisions.

For some, the outputs from such analysis might indicate that there is a significant risk for the business of higher taxation and greater regulation. One response may be to lobby for changes in policy, for example the pressures the retail industry is bringing to bear on government in relation to business rates. Another may be to look more closely at their own business and its structure and to alert their key stakeholders to a potential upward trend in their effective tax rate. At the very least, the analysis will feed into future strategic planning, providing a robust platform to develop an approach to managing taxes in a way that recognises that the business is not doing this in a regulatory vacuum.

A large multinational which recently centralised a large part of its supply chain and treasury functions had developed a tax strategy aligned to its business model. However, the tax strategy was developed before the OECD published its BEPS action plan. The group therefore had to review its tax strategy in light of these potential changes to the global tax environment.

The review included identifying a series of 'what if' scenarios and overlaying the potential tax consequences of these onto their existing tax strategy. By modelling the financial impact of these scenarios, they were able to pinpoint the most material risks and develop contingency plans for those areas.

As the tax environment is undergoing changes, the tax function of this group plans to review the tax strategy as well as the 'what if' scenarios regularly to ensure that they are able to manage their stakeholders' expectations proactively.

While scenario planning doesn't provide a crystal ball, it can help overcome the paralysis that can set in when faced with significant uncertainty.

Review the options: a strategic tax review

Doing nothing is an unappealing option because of what is going on in the outside world. Normal changes and adjustments within a business as it seeks to achieve its commercial goals also mean that existing tax strategies need to be re-assessed regularly.

Key commercial drivers of strategic choices

Commercial change can involve any part of the business, but very often relates to its business model, its intellectual property and brand or its treasury activities, including financing and hedging. When evaluating the commercial decisions implicit in these changes, the tax consequences are an important consideration. For example:

- Business model
  Current trends include centralising functions and pursuing growth in new markets; this forces businesses to make choices about their business model. For example, an organisation with substantial operations in Asia, currently supported from a European centre, may consider a centralised procurement hub closer to its Asian markets. Clearly there are a number of choices and considerations: where to locate the hub, what infrastructure to employ, the cost of setup, local skills available etc. Tax is a key factor to include in the overall decision making process and can add real value to business model decisions.

- Intellectual property and brand
  As businesses seek to develop brands for different markets, the desire often grows to have local people to create and influence the brand. Local knowledge of markets is important for driving brand value, but there are also fewer opportunities for distraction by other markets. As part of the business decision to relocate brand development or intellectual property, there are again many factors to consider. Tax is one of them alongside, for example, consideration of where the business already has significant operations.

- Financing
  To satisfy business funding requirements or the needs of external stakeholders, the financing arrangements of a business can be addressed in a number of ways, including for instance centralising treasury activities or resetting capital structure. Whichever choices are available to help manage risk or create future opportunities for the business, having a good understanding of the tax impacts of intercompany flows, as well as future financing needs, is vital for making appropriate funding decisions.

Furthering the analysis

Once it is understood how these drivers are playing out within the business, it is necessary to factor them into the development of the tax strategy. This means overlaying the strategic choices they imply onto the tax model (suitably adjusted for the expected view of the likely future regulatory environment). Doing so should enable the evaluation of choices in setting a new, sustainable direction for the management of taxes within the business.

Very often choices will interact, both positively and negatively, so it is necessary to have a joined-up sense of the associated or competing tax positions so that the decisions taken make sense for every part of the business rather than just one area or policy objective.

It is also important to be forward-looking. Strategic choices should be in line with any changes in direction the business wants to take, as well as the current and future activities it would naturally undertake. This can only be achieved by engaging with others outside of the tax function and having a model which is capable of analysing the variety of scenarios along with their associated benefits, costs and risks.

Making decisions

Any analysis of this nature should result in informed decisions about the way commercial arrangements can be structured from a tax perspective. This is where the group’s tax policy is incredibly significant. Embedded within the policy should be a clear statement of risk appetite which sets context and enables the options to be evaluated in a way which is consistent with the group’s principles. Decisions should rarely be taken in isolation and often require escalation through appropriate levels within an organisation to allow other relevant considerations or dependencies to be identified.

For example, a group that concludes that new IP developed by the group will be located in, say, the UK will be keen to ensure that it has the organisational and operational conditions in place to ensure these arrangements are sustained over time.
On occasion, the outcome is that the tax policy itself and/or the key criteria used to evaluate decisions need to be revisited, as specific decisions highlight considerations which no longer reflect the expectations of senior management.

The overall outcome should be a set of board endorsed strategic actions with a clear plan for their implementation and an understanding of key conditions for their effective maintenance.

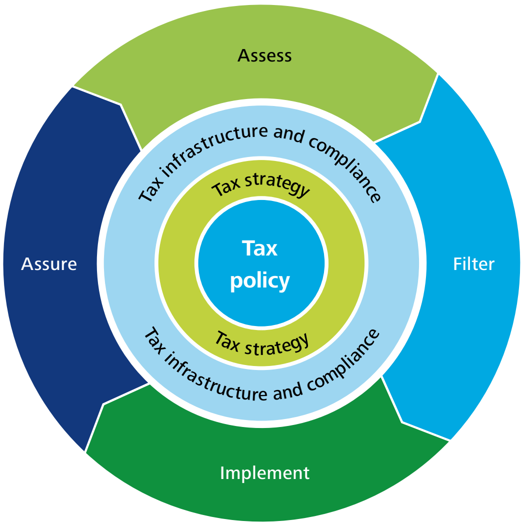
Virtuous cycle

The discipline which comes with undertaking such a structured review should lend itself to becoming embedded within the organisation as part of an ongoing cycle. This kind of process would comprise the following reinforcing steps (see Figure 1):

- **Assess** – updating the view of strategic tax options based on the latest information, including business strategy and forecasts, the latest tax profile, actual and potential regulatory change.
- **Filter** – getting board approval for the plan to implement the chosen strategic options after filtering based on fit with commercial strategy, tax policy and current capability.
- **Implement** – implementing the options while ensuring the risks identified in the process are controlled and monitored appropriately.
- **Assure** – reporting to senior management on the out-turn of the strategic decisions taken, highlighting performance against key indicators, including effectiveness of controls over maintenance risks.

Such a cycle will help ensure that tax strategies remain appropriate for the organisation as its business and environment changes. Many groups will formally schedule this process to coincide with, say, their quarterly forecasting process, giving management the information and insights to direct change where it is needed. Working in this way should also give early warning if there are significant risks with long lead times to respond: for example, the need to move from a Swiss principal or commissionaire-based structure which will not only require tax specialist input, but also significantly impact the people, processes and systems within the business.

Figure 1



One FTSE manufacturer noted that its high effective tax rate (ETR) did not compare well with competitors and that this position was likely to get worse given proposed changes in the international tax system. To help them understand the steps needed to bring their tax position into line with their peers, they undertook a review, informed by a detailed analysis of their own facts (including commercial plans and existing tax profile), of their strategic options.

They prepared a base case tax model to illustrate the potential ETR and cash position if no changes were made, and then modelled the tax impact of implementing possible strategies to quantify the financial impact of these.

They then tested the options against their tax policy and strategic goals, and prioritised a number for implementation. This allowed the group to build a compelling business case to obtain board approval to progress priority strategies. They are now in the process of putting their plans into action.

It is necessary to perform a joined-up review of the associated tax position to ensure that the decisions taken make sense for every part of the business rather than just one.

Implement and regularly review chosen strategies: making changes stick

Once new or adjusted tax strategies are chosen, effective implementation and ongoing monitoring are fundamental to their overall success. While there is no 'one size fits all' approach, there are some consistent themes which leading organisations make sure they understand and act on as part of their overall plan:

Controlling key risks

It is important to assess the critical features of the proposed strategy and identify key risks. For example, where the strategy suggests new locations of activity, will new entities and boards need to be put in place or will they be managed from an existing base? What will be the remit of any new boards and what information will they need to make commercially strategic decisions? Once the issues are identified, an appropriate controlling activity needs to be put in place.

Risk should, however, not just be considered from an implementation perspective. The maintenance of the strategy itself is equally important, as the failure to discharge ongoing duties in relation to the arrangements, e.g. ensuring there are sufficient reserves for expected distributions, could ultimately be costly. Identifying maintenance risks that could undermine the strategy, e.g. the need for sufficient substance in relevant jurisdictions, must be considered along with appropriate controls.

Also, do not forget those risks that may remain as a result of historic strategies or structures. These, too, will need to be managed continually: for example, retaining a now redundant entity which could otherwise give rise to a tax charge if liquidated.

Leading organisations are seeking to address this challenge by streamlining their tax compliance, reporting and related statutory processes.

Clarity and flexibility

For a tax strategy to work, a business needs to have a tax team in place that has clarity regarding its role and responsibilities as well as flexibility to respond to the changing environment.

Governance, roles, responsibilities and processes must be defined clearly and supported in order to achieve success, and tax capability needs to be available in areas where complex issues are likely to arise.

It is likely that, as tax regulation increasingly emphasises economic substance over legal form, tax specialists are going to be expected to spend far more time partnering with the business than in a back office looking at structure charts. This demands different qualities and skills which need be secured and developed if the organisation is going to have the flexibility to respond to future regulatory and strategic challenges.

Streamlining processes and alternative delivery models

The successful implementation of strategic choices will also be impeded by inefficient compliance and reporting processes which consume tax specialist resource that could be focused otherwise on strategy-related activities. This is a real danger at a time when it seems probable that there will be more tax compliance and reporting requirements, both at a national and international level, than ever before.

Leading organisations are seeking to address this challenge by streamlining their tax compliance, reporting and related statutory processes. This can involve the rationalisation of entities, integration of adjacent processes (e.g. statutory reporting and corporate income tax compliance), increasing automation and tax sensitisation of underlying systems, and simplification of reporting outputs. In addition, alternative delivery models are being explored and deployed, including outsourcing to third parties and/or centralisation within (often off- or near-shore) service centres.

All of these initiatives should free up tax specialist resource at the centre and within the business to ensure that tax strategies are put into effect in the way expected at the outset.

Ongoing monitoring

Once strategies have been implemented, it is important to have data to help assess how effective they are and the extent to which they have achieved the business's strategic aims. Key performance indicators, for example a target effective tax rate or balanced scorecard approach, should be considered by organisations as ways to assess the success of any of its chosen strategies.

Assessment criteria should be chosen according to the business's values and in a way that can help to the identify areas for improvement within the business and of the strategy itself, so that the business is adaptable and forward-looking.

Technology and, in particular, the use of data analytics tools are increasingly enabling businesses to monitor strategies; especially for spotting risk areas and abnormal trends that may indicate that the current business model is not performing as it should be and, therefore, providing focus for revisiting the strategy.

One quoted global group had implemented a number of changes to its commercial operations, including the exploitation of its growing IP assets, a consequence of which was a significant change to its ETR. Committed to ensuring that the reporting of its earnings was robust, the group identified a number of key tax sensitive risks which needed to be actively monitored.

Some of these risks related to the activities of senior executives in relation to the management of IP. A framework was put in place to monitor these activities and their impact on the tax outcomes.

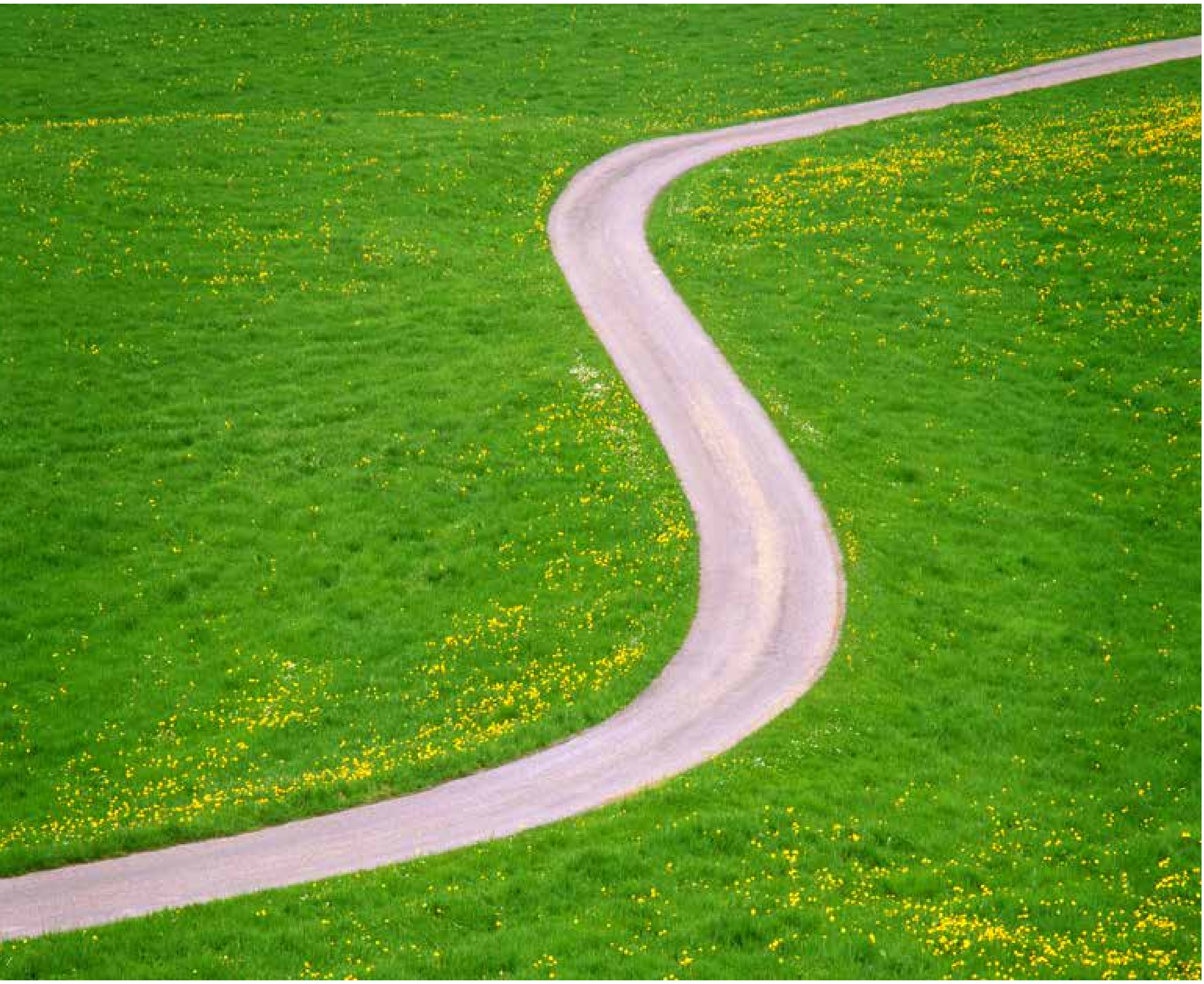
Other risks related to intercompany pricing, and here detective controls were embedded within the group's financial systems to enable monthly reports to provide early warnings of departures from group standards.

A business needs to have a tax team in place which has clarity regarding its role and responsibilities as well as flexibility to respond to the changing environment.

What next?

The story does not end there. Getting the external communication of tax strategies and outcomes right is just important as getting the strategies right in the first place. In the current environment in particular, businesses should be mindful of the need to provide greater assurance to stakeholders that taxes are being managed properly and appropriately. To make matters complicated, different stakeholders in the business will require different information and may have differing views on tax; communicating the strategy and its outcomes effectively will be a crucial part of achieving success.

Our second paper in this series, *An integrated approach to tax transparency*, considers how to provide greater clarity and comfort regarding the organisation's tax positions, both internally to senior management and key stakeholders and externally through financial reporting and other communications channels.



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