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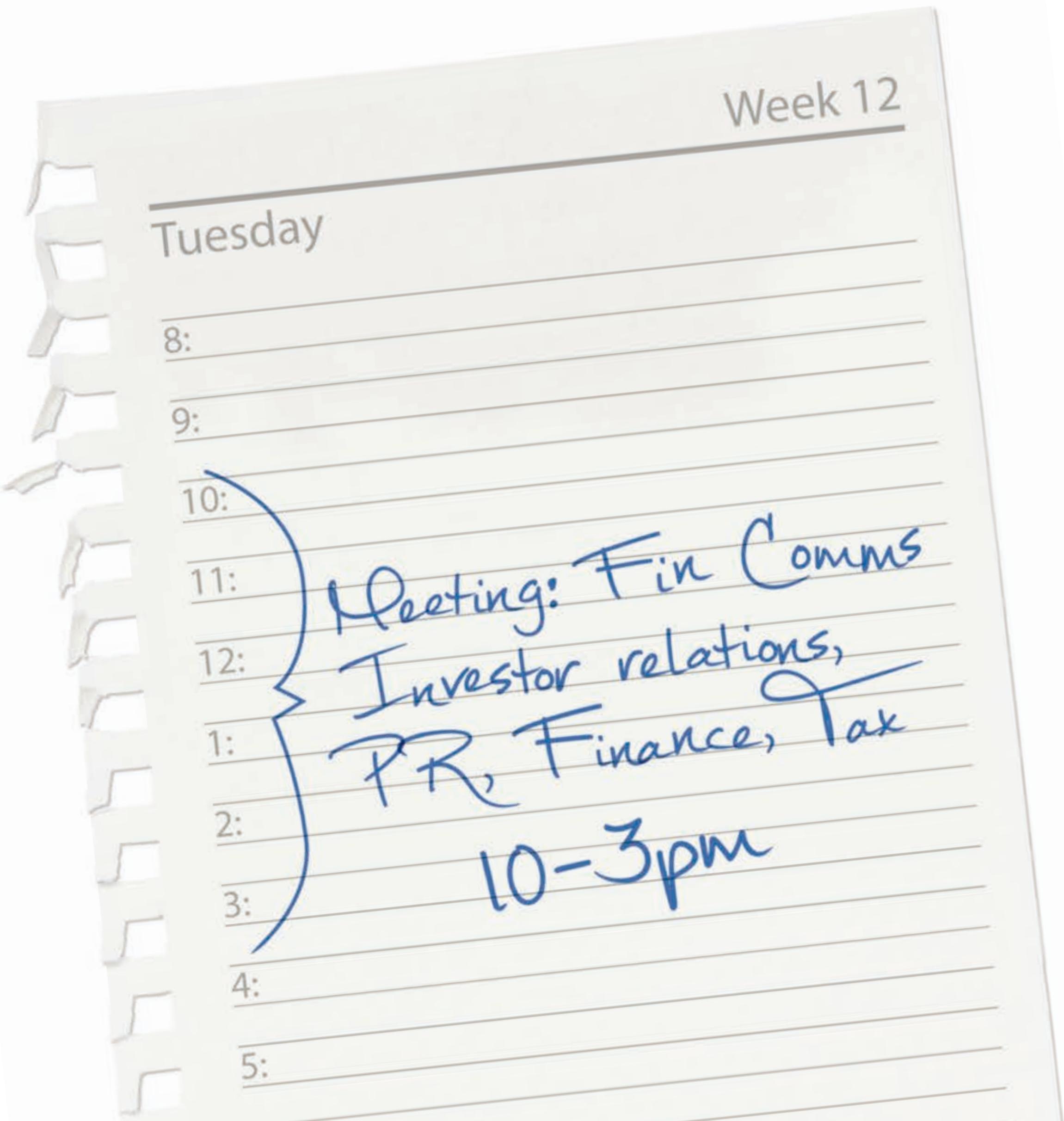
Responsible Tax
An integrated approach to tax transparency



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Executive summary

The information that businesses share about their taxes is being examined by a growing range of interested parties. Some companies have responded by explaining their position more fully in their financial reporting or other communications. At the same time, regulators are looking to require at least some companies to report more tax information. What should you be doing now to be ready and able to describe your organisation's tax position?

In our previous paper in the *Responsible Tax* series – *Sustainable Tax Strategy Today* – we recommended practical steps in setting the right tax strategy and a governing policy for your company, to enable you to continue to deliver the tax strategy in this evolving environment.

In this second paper, we look at how to approach explaining your tax position, and to whom. Firstly, you need to understand who the stakeholders are – the financial community, employees, customers, suppliers, broader society and of course tax and regulatory authorities will all represent potential interested (and potentially challenging) parties. Secondly, each will have different demands and expectations around the nature and amount of tax information they require. Each stakeholder will need a different level of clarity over your tax position, and some will need an overview of all the communications you and your business make about tax.

Tax is no longer limited to business and tax authority relationships – it has very much become a significant strategic business issue. The challenging part is explaining one's tax position: you need a clear and consistent approach to managing tax across all business divisions, companies and countries. This clarity cannot be achieved without a robust, effective communication policy.

We recommend that you set the context first – be clear about the environment in which you operate, including regulatory, commercial and other external factors. The taxes businesses are subject to are hugely dependent on the jurisdictions and fiscal regimes in which they operate, the phases of investment and other cycles and business models – all this needs to be made as clear as possible.

Your tax policy should have board level approval, and the board should have oversight of the tax policy. You should also be able to document all the taxes paid across your business – and make the distinction between the taxes paid and taxes borne. While you may not need to include a breakdown in your financial statements, it would be prudent to have these figures to hand should enquiries be raised by any of your stakeholders.

Finally, regardless of the nature of your communications policy, you need to be able to rely on your internal tax management processes. You need confidence in your numbers, and have a clear sense of how your future business and strategic direction impact your tax profile.

Businesses are not static – they are always evolving to adapt to shifts in their commercial drivers and changes to the regulatory environment. Our final paper in the series – *Making Changes* – will discuss the assessment of potential tax impact of changes in the environment, the options available, and the implementation and review of chosen strategies.

Introduction

The requirements of tax management and reporting have changed fundamentally. The pace of change has been rapid and even the most agile and responsive businesses have faced challenges in adapting to the new environment. The demand for transparency and clarity in tax communication is increasing and, we think, will continue in the coming years.

'Traditional' stakeholders (tax authorities, CFOs etc.) are as curious as ever about tax but there are also whole new groups of people with varying degrees of interest, knowledge and engagement, who want to know about your tax position.

Your key external stakeholders such as shareholders, financial analysts, lenders, customers, suppliers, employees, non-governmental organisations and the general public themselves are all increasingly interested in your tax affairs. And internally, your own boards and Audit Committees, CSR teams, brand management, marketing and public relations teams are also highly engaged in this topic. It's a long and growing list and leaves your tax position open to scrutiny from more sources than ever before.

Businesses have been reacting to this environment and are looking at ways to articulate more effectively how they manage tax. Businesses need to demonstrate that the effective management of tax supports the success of their enterprise, drives economic growth and contributes to wider society. Working out how best to communicate and 'explain tax' in a way which is clear and understandable and which enables all key stakeholders to understand your tax profile can be a huge challenge.

Businesses have been reacting to this environment and are looking at ways to articulate more effectively how they manage tax.

You need to have the right information readily available and, when it comes to communication, have confidence in it. This means you need the right supporting processes and controls in place.

Confidence is also required in tax decision making and, more than ever in this new environment, this is best supported by a clear sense of your future business and strategic direction.

All of this puts more pressure on you – businesses are responding in different ways and that is what is examined in this document.

In our previous paper in the *Responsible Tax* series *(Sustainable tax strategy today)* we recommended practical steps in setting the right tax strategy and a governing policy for your company to enable you to continue to deliver the tax strategy in this evolving environment.

This second paper examines how to 'explain tax' and, specifically, looks at:

Understanding your stakeholders – identifying the key internal and external stakeholders: who they are, what they want and how best to deliver it.

Making and explaining your case: designing and delivering an integrated approach to tax communication which satisfies the breadth of stakeholders and allows the business to manage the public disclosure of its tax management approach as efficiently as possible.

Gathering the information that is required to drive these communications: understanding the people, processes and systems required and how they should work together to provide robust, high quality financial and tax information.

Understanding your stakeholders

You will almost certainly have different demands for tax information from different people. It is important that you recognise the range of stakeholders, that you actively manage the information flow to them and that you have total confidence in all of the data and information provided.

Consistency of messaging is critical. Your employees, your suppliers and customers, the financial community, regulators and tax authorities should all receive a consistent message, even though the depth and breadth of information may vary. Recognising who your key stakeholders are is the starting point.

1. The financial community

Your shareholders, investors, financial analysts and banks are more engaged and interested in tax management than ever before. Tax is not their number one issue, but the financial community is now interested in understanding the current tax charge, the cash tax position and, importantly, the reasons for any differences between the two. They also want information on the key tax risks and the background to any disclosed tax uncertainties.

There is significant demand for clarity in financial statements and for targeted presentations. You need to understand and adapt to trends in reporting and be able to explain uncertainty. The tax note within the financial statements is central to delivering this successfully. The current tax position, risks and uncertainties need to be communicated simply.

> "Many companies aren't clearly disclosing in their financial statements their tax exposures, including the reconciliation of their statutory tax rates with their effective tax rates"

SEC Corporation Finance Associate Chief Accountant Tricia Armelin, December 2013

> "Tax information is generally inadequate for investors to understand how low tax rates have been achieved or assess the level of tax risk"

Citi Research paper: 'Taxing Times' 27 September 2013

There is a growing trend for analysts to ask about the potential impact of prospective tax law change – and so awareness of the changing environment, forecasting, scenario planning and impact assessments will be of increasing importance.

The better you can explain where you stand and where you are headed, the easier your access to funds and the securing of capital may prove to be.

2. Employees, customers, suppliers and broader society

2013 was a year like no other for public interest in tax.

The result is that a clear explanation of tax decisions taken is now more important than ever. For the general public, tax information is sourced from a variety of public places (such as annual reports and now also CSR reports). As a result, there is a growing trend for businesses to include greater disclosure of tax information in these documents. Some businesses have started breaking down tax paid by country, or detailing their tax policy, or explaining the use of so-called tax havens. We expect this trend to continue.

It is important to monitor developments in the public's view of your tax position; clear communication should help reinforce positive customer sentiment and may strengthen brand value. You may not stem the tide of questions but you can respond positively and straightforwardly.

3. The tax authorities

This traditional tax stakeholder remains a critical relationship.

You must remember that the tax authorities will be looking at all the communications you and your business make about tax. The increasing effectiveness of the tax information exchange (TIEA) regime, together with other information sharing methods will mean that your global tax messaging will be open to review and reinforces the need for consistency.

4. Regulatory issues

There are growing demands for tax information from many non-traditional sources. Transfer pricing is central to this and the OECD's Base Erosion and Profit Shifting (BEPS) action plan will be a key issue for multinational businesses. We recommend that businesses begin to consider how this will work in practice and scenario-plan the potential impact on the enterprise.

There are also a number of industry-focused initiatives which may well broaden in their scope. For example, the Extractive Industries Transparency Initiative is now well established and is increasing in importance. It has led to changes in the ways in which energy businesses disclose their tax results. Additionally section 1504 of the US Dodd-Frank Act adopted by the SEC on 22 August 2012 and the EU Capital Requirements Directive IV will also add more to the reporting requirements of the extractive and financial services industries.

These all show that tax is no longer limited to business and tax authority relationships, but that it has become a significant strategic business issue.

In a recent poll* of senior tax professionals, nearly 75% said that they had seen 'some' to 'significant' interest shown in their tax reporting and broader tax communications:

- Some interest from internal stakeholders – 21.3%.
- Some interest from internal and external stakeholders – 18.7%.
- Significant interest from internal and/or external stakeholders – 34.7%.

* This question was asked during a Deloitte webcast in February 2014. 75 attendees voted on this question.

Making and explaining your case

With tax increasingly under the spotlight, it is important that the way in which you manage tax is both transparent and clear across all business divisions, companies and countries. Your tax policy should be understood by all those who have a tax responsibility, right across the business, and should be approved formally by your board.

You cannot achieve this clarity of purpose without an effective communication policy.

Setting the context

In our first paper in the *Responsible Tax* series, *Sustainable Tax Strategy Today*, we recommended practical steps in setting the right tax strategy and a governing policy for your company.

In communicating your tax position, you need to be clear about the environment in which you operate and to explain that context to your stakeholders. There are many regulatory and external pressures on your business which might impinge on your tax policy or profile, but you should not assume that stakeholders will appreciate this automatically and/or understand the impact on your tax policy. It is up to you to make sure that the context for your tax position is clear. For example, we have seen an increased focus on the use of tax havens and many businesses are now disclosing whether they operate businesses in such territories and, if they do, explaining why.

Managing behaviour

It is increasingly likely that you will have an over-arching tax policy. If this is the case, it is important that the policy is clearly a business-owned policy document, recognised and approved at board level and understood by all those in the business who touch tax in one way or another.

Your working tax policy should have:

- Active board level involvement in setting, approving and reviewing the tax policy.
- Corporate social responsibility or similar (non-finance and tax) teams involved sufficiently to ensure consistency with broader CSR objectives.
- Regular board level oversight of tax policy.
- Regular reviews of tax policy.
- 'Extraordinary' reviews of tax policy triggered when new material risks emerge.

You should communicate how the tax policy works, how it supports the strategy of the business and how it fits with, and is appropriate for, the aims and ambitions of the business.

> "A responsible tax policy. A clear, publicly communicated tax policy, which aligns:
>
> - the company on a tax risk management scale;
> - sets out the company's approach to tax negotiations; and
> - rules out specified aggressive tax practices."

ActionAid Tax Responsibility: an investor guide February 2013

> “Tax is an important expense for most companies, and transparent and complete financial reporting is complex because the tax effects of transactions do not always fall in the same period as they are reported in the financial statements”

Financial Reporting Council, 2012

Tax outcomes

You should be able to document taxes paid right across your business. These tax outcomes should:

- reflect the business context;
- clearly link with the business behaviours; and
- demonstrably be the direct consequence of these drivers.

You need to be able to draw distinctions between taxes paid versus taxes borne. Most payroll taxes and significant VAT need to be distinguished as they are areas of contention when determining total tax paid by business. Merely stating total tax paid without a clear breakdown is not enough.

As well as these distinctions, there are other taxes which would not traditionally feature but are a clear contributor to the Exchequer; the most relevant of these (as it is often a significant number) is business rates.

The concept of deferred tax also needs to be considered and, maybe, explained. There is a growing demand for clarity over taxes paid versus any government incentives or subsidies received. Additional confusion can arise through the well-known difficulties in managing legal entity, business division and/or country data complexities. These all need to be addressed.

It is likely there will be some tax facts which may be unclear to a non-tax literate audience so you need to communicate the reasons for your tax results in a straightforward way. These explanations could be complex, but you should also be clear about simple tax concepts including:

- the use of company and/or group losses;
- the validity and impact of group relief;
- the legitimate use of accruals;
- access to incentives;
- the concept of R&D credits; and
- the impact of company or group financing upon tax due and paid.

Awareness of your total taxes paid is important to help in your messaging.

The financial statements

Companies are already required to report their tax position in their financial statements. Increasing scrutiny of tax is leading many to consider how to improve these disclosures through what remains a critical communication channel.

Improved financial reporting of taxes could take many and various forms and we are increasingly seeing examples such as:

- Including a commentary on tax policy and key tax risks in the front half of the annual report.
- Improving and simplifying the explanatory notes to the financial statements to provide greater clarity regarding the tax reconciliation and tax rate commentary.
- Explaining why not all profit and tax is included in the profit and loss account. For example, current and deferred tax on items which are charged or credited to equity.
- Highlighting the total tax paid by the company, i.e. not just the corporate tax detailed in the cashflow, but also items which are included elsewhere in the financial statements, such as irrecoverable VAT, employer's NIC etc.
- Where appropriate, providing clear details of the reasons why there is a material difference between the cash tax paid and the current tax charge.
- Considering expanding and simplifying the captions in the tax charge note to explain what individual items may mean and how they impact the group. For example, rather than having a grouped caption of 'non-taxable income' or simply 'permanent differences', groups could separately disclose 'gains subject to the substantial shareholding exemption' or 'non-taxable dividend income'.
- Considering expanding the information on subsidiary companies, thinking about their activities and jurisdiction and how they affect the group as a whole.
- Making sure that all statutory requirements are being met (for example an ActionAid review of the FTSE100 showed that not all members have complied with the obligation to name all subsidiaries).

Gathering the right information

Regardless of the nature of your communication policy, you need to be able to rely on your internal tax management processes. You need confidence in what you do and you should have a clear sense of your future business and strategic direction. To assist, you need an embedded policy, owned by the board, monitored and updated. You also need a clear view on your approach to tax risk, a thorough understanding of your live tax risks, and access to all the financial data you require to be effective.

When you have all of these critical tools in place, you need to explain the tax position of your business both internally to management and staff, and externally to the financial community, the tax authorities and the regulators.

What to do first

You need to make sure that the basics work, are tested and robust. Think about reporting and compliance: make sure that all taxes are part of your review, consider all the various types of tax return you prepare and submit, build robust monitoring programmes and document the results of your review. If remediation is required, make it clear how and when it will be performed and follow up to test that the agreed action has taken place.

Understanding your numbers

Critical to all aspects of communication (but particularly in relation to the need for high quality assurance) is the need to have confidence in your financial information.

You should be striving continually to improve the robustness of your financial information for tax and consider:

- Improving your data quality: does your ERP system work efficiently for tax? Trying to ensure that the tax function becomes a key stakeholder in ERP design, development and upgrades is important. ERP systems can deliver real value to the quality and reliability of tax data; however their full capability is rarely exploited.

- Ways in which to obtain the information more quickly: are there any tools which can be used to facilitate this? As tax management evolves, the demand for increased tax sensitisation of systems and improved automation will become key. Standardising and integrating reporting, provision and compliance processes will improve quality and confidence and enable better assurance programmes to be designed.

- How the leadership improves visibility and control over tax reporting and compliance right across the global organisation: the development of improved information management is leading to significant improvements in real-time visibility of tax positions, reporting and compliance. It is important that leadership is able to have a strategic, corporate view of tax and to be aware of any issues arising quickly and efficiently.

- How to improve tax insight which may lead to better forecasting and more evidenced-based tax decisions in the future: tax data analytics is the process of using data (particularly tax compliance data) to gain insight about your tax processes and profile. Many businesses and an increasing number of tax authorities around the world (for example the UK with its iXBRL programme) are starting to use tax analytics as the 'next generation' toolkit for tax benchmarking, trend analysis, data mining and predictive analysis modelling.

In a recent poll* of senior tax professionals, the following factors were cited as a concern in terms of the organisation's ability to deliver:

- Gathering data from across the business (32.8%)

- Validating the data for accuracy (40.3%)

- Reconciling data with external reporting (35.8%)

- Developing the narrative for the data (34.3%)

* This question was asked during a Deloitte webcast in February 2014. 67 attendees voted on this question.

Assurance

It is important that you can rely on your tax information. Equally important is the communication of the reasons for your confidence in your declared tax results and the monitoring programmes you have in place to test and confirm this confidence. Think about all the assurance programmes you have in place. For example, you may have your own internal, real-time controls over process, you may have technology tools to help validate information and you will be subject to audit and review by both your own internal audit function and by your external auditor. You will also be subject to review and audit by the relevant tax authority, although you should not be placing any reliance on this line of defence.

You also need to be able to consider the future with more clarity and depth than ever before. The design of your forecasting, modelling and scenario planning must be clear and reliable and also be consistent right across your organisation.

Communicating your position

If you do begin to disclose more tax information, whether through the financial statements or using alternative methods, it is important that you have clear core messages which are consistent and reflect the **context**, your key **behaviours**, are balanced by your tax **outcomes** and receive proper levels of **assurance** testing.

The key then is to establish a clear process for ensuring that you get your agreed messages out through appropriate channels and in a way that is visible and meaningful for the intended audience.

Understanding the different audiences and having different communication channels is important – consistent and clear messaging even more so.

To achieve this clarity you need to establish clear communication protocols to help ensure that only the appropriate or nominated tax and communications specialists approve all messaging at all key gateposts.

We have seen many variations in the way that tax is reported with particular changes in the way financial statements reference tax in three discrete areas. Using the FTSE100 2013 reports as a sample:

1. Governance

90 groups made some disclosure of tax-related governance. Of those:

- 40 made partial reference (e.g. mentioning that the Audit Committee had reviewed tax accounting judgment areas).
- 50 provided fuller details, setting out processes for setting and monitoring adherence to tax policies and strategies.

2. Taxes paid/'contribution'

30 groups disclosed total taxes paid/tax 'contribution'. Of these:

- 16 made partial disclosure, setting out total taxes paid with no further analysis.
- 14 disclosed the split between various categories of tax. Only Rolls Royce made this disclosure in the back-end of the accounts.

3. Geographical split

6 groups split tax payment disclosures on a geographical basis. Of these:

- 5 disclosed payments on a regional basis.
- 1 disclosed payments on a jurisdictional basis

What next?

The story doesn't end there. Once you have designed a tax policy and strategy that is fully aligned to your business vision and risk appetite, and you've communicated the right information to various stakeholders, you may need to make some changes again.

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

The final paper in the *Responsible Tax* series – *Making Changes* – discusses assessment of potential tax impact of changes in the environment, the options available, and the implementation and review of chosen strategies.

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