Tax has become a highly sensitive political issue recently, with multinational companies (MNCs) accused of not paying appropriate amounts in some of the countries in which they operate. Governments, tax authorities and campaign groups are seeking greater transparency – and this has significant consequences for company boards and their audit committees.

News stories from around the world frequently highlight what is described as “aggressive tax planning.” These stories are fueled by the disclosure of private legal and financial information – for instance, the so-called “Panama Papers” – and have led to public criticism of large MNCs. In response, governments and institutions such as the European Union (EU) have started to act with a level of coordination rarely seen.

The best example is the Base Erosion and Profit Shifting (BEPS) project from the Organisation for Economic Co-operation and Development (OECD) and Group of 20 countries. Under BEPS, a 15-point action plan, described as the “most significant rewrite of the international tax rules in a century,” was approved in November 2015.

Three focus areas for audit committees

It seems inevitable that collective action on corporate taxation will grow, creating a dilemma for global companies as they weigh up the risks and the possible impact of any controversy and bad publicity. Audit committee members need to be aware of the risks associated with tax policies. Changes to tax policy require companies to gather more information, provide it in different forms and report it in different ways.

Greater transparency on corporate taxation is being encouraged on at least three fronts, each having an impact on the audit committee:

Increasing requirements for country-by-country reporting (CbC)

Under BEPS Action 13, companies with group revenues of at least €750m will have to report revenues, profit before income tax, income tax paid and accrued, total employment, capital, retained earnings and tangible assets in each jurisdiction in which they do business. The objective of the CbC report is to provide tax authorities with an overview of global operations, showing where income is earned, staff are located and taxes are paid. The OECD proposal recommends that this applies for fiscal years beginning on or after 1 January 2016, but the commencement date in each jurisdiction will depend on the speed of national implementation. Financial information will be exchanged automatically on an annual basis with the tax authorities where the MNC operates. However, BEPS does not require the information to be reported to the public.

Audit committees will need to be aware of the new tax-related disclosures that are required, make sure that the appropriate data are available and understand the consequences of the information being shared among tax authorities. Sharing of data brings a number of concerns, including issues with translation and context. It should also be remembered that tax-related problems bring a number of concerns, including issues with translation and context. It should also be remembered that tax-related problems are a major element in financial restatements and where material weaknesses are identified in internal controls.

Greater disclosure of information to the public

BEPS may not require public disclosure under Action 13, but this is still a likely outcome in many countries. For instance, on 12 April 2016, the EU proposed legislation that would force companies in Europe with revenues above €750m to disclose publicly their tax and profit information for individual countries. They would also be required to disclose how much tax they pay on the business they conduct outside the EU, as well as other information concerning employees and the nature of the activities performed in each jurisdiction. This is not just an EU issue – it will affect MNCs with European subsidiaries, and often what starts in Europe tends to spread further. Public disclosure of selected information is a phenomenon that already affects banks in the EU (which have been required to make such disclosures since 2014 under Capital Requirements Directive IV) as well as extractive industries.

Audit committee members should assume that financial information will be made public and determine whether there are likely to be any issues to deal with when this happens. They need to help establish the right approach – balancing the desire for reducing tax with reputational concerns – which will involve integrating tax strategy with risk management.
State aid investigations

Perceived deals are being increasingly questioned by the European Commission’s competition directorate. The directorate has highlighted preferential tax agreements that it argues constitute illegal state subsidies. This issue is of particular relevance to US-based MNCs, a number of which have faced probes. This has led the US Treasury Secretary Jack Lew to write to the commission claiming that US companies have been unfairly targeted.

This situation creates uncertainty for audit committee members, who will want to know whether the particular tax treatment of their EU companies could be construed as state aid. The consequences could be significant with companies potentially having to repay any aid received. It has implications for past and future tax liabilities and could also affect decisions on mergers and acquisitions.

Conclusion

Audit committees need to consider the impact of all three issues as part of their risk assessment. Members have to understand the reputational dangers and be aware of the sometimes contradictory forces affecting the company. They should be checking that the company is prepared for this, and can answer the detailed questions.

Committees should also consider whether the company has a robust and transparent relationship with relevant tax authorities. This can create more certainty about tax treatment and, when problems do arise, allow for a faster dispute resolution given greater understanding of the background. It is particularly important in the home country as, in the new environment, that tax authority may be required to argue its position in disputes with other jurisdictions.

Resources are certainly a factor. With companies expected to gather increasing amounts of data and to implement more nuanced tax policies, there could be a requirement for additional skilled staff in the tax department, more sophisticated systems and the creation of cross-functional teams (including representatives from the public relations department). These issues have to be discussed when determining budgets — and it is critical that the audit committee is aware of these decisions.

Corporate taxes are, of course, only one element of the discussion. For most companies, payroll taxes and VAT payments will be more significant, and the penalties for getting these wrong can be severe. So audit committees should make certain they focus on all aspects of taxation.

Demands for greater transparency aren’t going away. Audit committees should assume that tax will continue to be a reputational, as well as a financial, issue. Additional public disclosure is inevitable, with greater demands placed on the tax department. It will require significant oversight from the audit committee and should remain at the top of their agenda.

Questions for the audit committee to consider

- Do you know what tax strategy the company is adopting or the parameters by which it is deciding that strategy?
- Does management know what the CbC report will look like and what questions it will give rise to if and when it goes public?
- What is the company’s exposure to state aid risk?
- Does the tax department have enough resources to operate effectively?
- Are you confident that the tax function is able to clearly identify and manage ongoing risks, disputes and litigation?
- Is adequate investment being made into the tax function to allow the company to meet tax compliance and reporting obligations, and to take advantage of tax planning opportunities?

Endnote