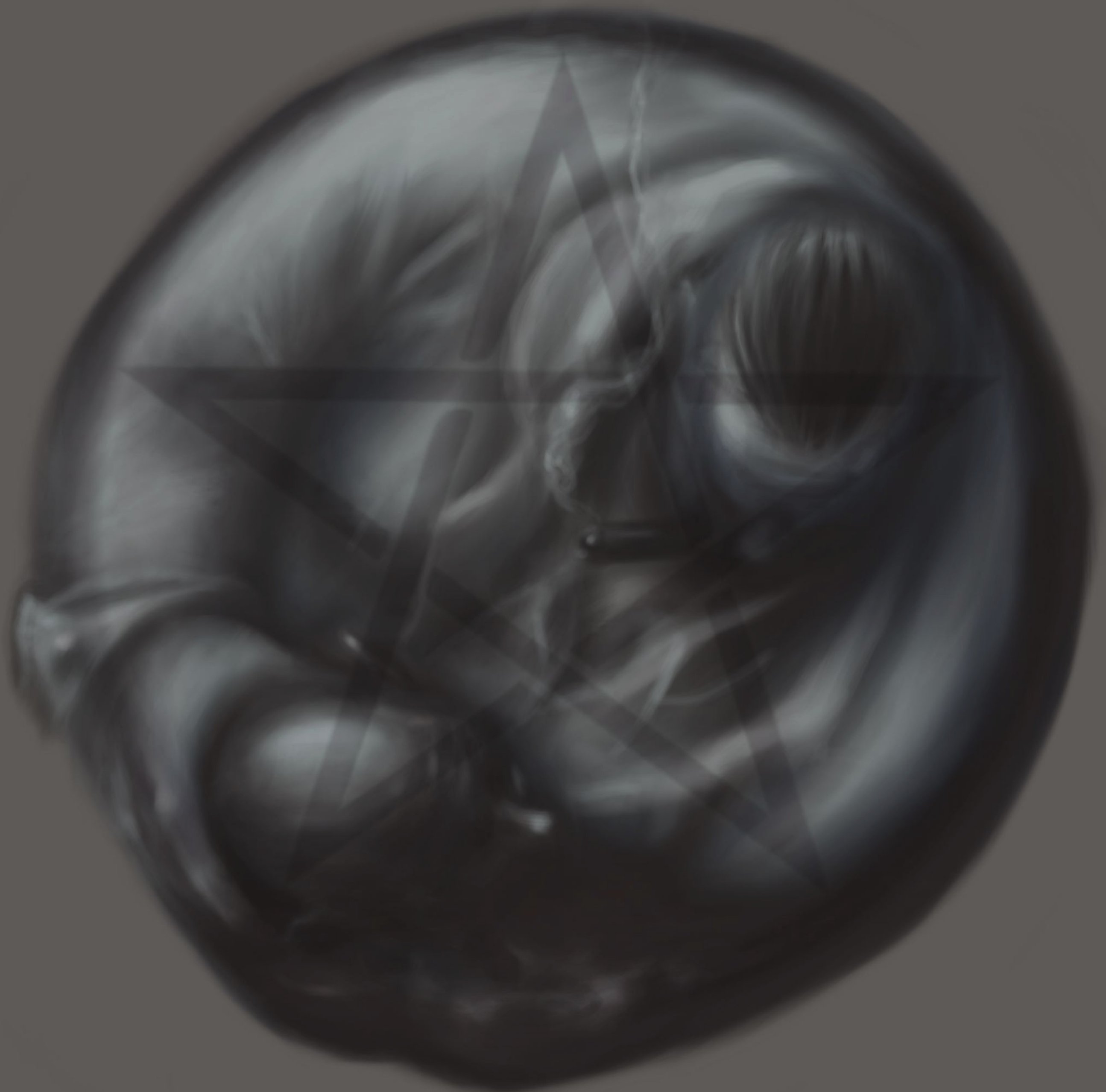
The Pentology

Volume 1

Corporate Tax Ethics



GEORGE ROZVANY

Copyright 2016 ©
The International Society for the Promotion of Ethical Taxation Behaviours (ISPETB)
All Rights Reserved

George Rozvany

Bachelor of Science (Psych) (Monash University)

-

Bachelor of Laws (Monash University)

-

Graduate Diploma in Accounting
(Victoria College)

-

Graduate Diploma in Entrepreneurship & Innovation
(Swinburne University of Technology)

-

Barrister and Solicitor of the Supreme Courts of Victoria, New South & High Court of Australia

-

Fellow of the Taxation Institute of Australia

-

Chartered Tax Adviser

DEDICATION

This volume of the Pentology is dedicated to those good men (and women) in all walks of life who did not stand by and let the bad men thrive.

FOREWORD

This first edition of the Pentology on Corporate Tax Ethics is a welcome addition to the tax literature. It is also timely in that it complements a growing public interest in ethical tax behaviour.

There is little public appetite for aggressive tax behaviour from large corporates. Media reports claiming multinationals avoid paying tax through transfer pricing do little good for the community's perception of big business' role in the tax system. All businesses are there to make money. It would be naïve to suggest otherwise. However, businesses that choose to take risky tax positions teeter perilously close to the threshold of the law. Transparent business practices are unlikely to draw the attention of the revenue authority. Therefore, it is a misconception that aggressive tax planning equates to extra profits. Businesses that base their prospects on questionable tax positions will need to argue their

claims, often resulting in lengthy litigious disputes with the revenue authority. Tax speculation is costly.

Instead, businesses with robust tax controls and governance are both socially responsible as well as positioned for sustained growth and success. Establishing a committed tax value system as part of the organisation's culture will ensure that the business has every opportunity to prevent mistakes as well as mitigate extra costs. There are notable changes around the world that support and reinforce the approval for such ethical tax behaviour. Increasing visibility and transparency of off-shore accounts makes eluding the authorities problematic. Greater digital scrutiny through sophisticated analytics and data matching means greater details of structures and transactions is available, and being shared, by revenue authorities . Tax avoidance is no longer the realm for opportunists.

Tax ethics is undoubtedly a fundamental consideration for both my role as a Second

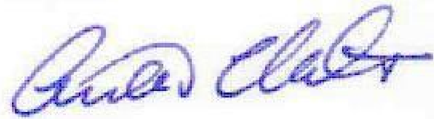
Commissioner for the Australian Taxation Office (ATO) as well as a professional in the field. Encouraging ethical taxation practices is central to my beliefs and my commitment to supporting successful Australian businesses. A substantial proportion of my career has been in providing advice and guidance to ensure businesses are well prepared to meet their tax obligations. I am therefore well invested in seeing practical and informative material such as this book developed.

This book provides a thought-provoking and instructional guide for businesses that are deliberate in their corporate success. Rozvany encourages ongoing dialogue and constructive relationships with the revenue authority. He emphasises the importance of clarity in communication between parties as this reduces the likelihood of misunderstandings and also aids in decision making. He is an advocate for forward agreements, private rulings, establishing methods for interpretation and appropriate application of the law

without leaving shareholders exposed. He also promotes controls that discourage corruption, oppose temptation and prevent potential errors in judgement. These are consistent with the ATO's approach to engagement with taxpayers. When both parties approach engagement from a similar framework productive relationships can blossom.

This book provides the reader with solid criteria for assessing the services of tax employees or alternatively tax advisories. Employees are critical in ensuring the stance of the organisational compliance posture. The tax risk position should be clearly stated and a well-known part of the organisation's culture. Rozvany discusses the characteristics and the values that are required to establish an ethical corporate tax viewpoint. Although ambitious, this book provides the groundwork for businesses that wish to make good tax ethics a non-discretionary part of their ethos. I recommend this book as essential reading for anyone with an interest in good business practices

and for those who want to make tax compliance their minimum standard.



Andrew Mills
Second Commissioner
Australian Taxation Office

PREFACE

Over my lifetime, I have been blessed with a highly unusual set of circumstances that has brought me to the door of taxation writings at seemingly all the right times and with boundless joy and enthusiasm.

My first encounter with the taxation system was in Christmas 1958 in Omeo, Victoria, Australia when my parents George and Ann, as new Australians, were invited to “the Bouchers” for Christmas. It mattered not that Trevor Boucher had not started his tax career on his way towards Australian Federal Taxation Commissioner or indeed that it took another month for me to be born – I was away in my taxation career.

Some 30 years later, I introduced myself (again) Mr Boucher at the Adelaide National Conference of the Taxation Institute of Australia. On mention of Omeo, his eyes lit up (from what was a very, very serious Commissioner’s stare down at a nervous young man who could barely get the word “Omeo” out let alone in something resembling a manly voice) and there began a long term and rewarding association with the Australian Taxation Office that in turn led to a remarkable group of people.

My first two major works, “Transfer Pricing: Regulation, Policy and Strategy for Australian Multinational Enterprises” and “Transfer Pricing” set the foundation for that area of the law and practice in

Australia and remain the only two books published in this critical area of the law in this country.

From my perspective, this current work, which is the foundation work of the Pentology, is the much-needed "missing link" for corporates and multinationals screaming out under public pressure to pursue ethical practices in taxation but not really quite knowing how to approach the subject.

I also hope that the Pentology will promote serious and balanced discussion on what is acceptable corporate and international firm behaviour with respect to taxation and beyond in the belief that such dialogue will result in improved laws and practices by corporates and international firms in line with rapidly emerging community expectations of transparency and accountability.

This volume and the subsequent four volumes in the Pentology would not have been possible without a long list of *the good* people including:

Mr David Balkin, Ms Megan Bardsley, Professor "Bob" Birrell, Mr Aleksandar Boskovski, Mr Trevor Boucher, Mr "Bob" Bryant (dec), Mr Michael Carmody, Mr Nathan Chanesman, Mr Robert Clochiatti, Dr Michael Deeley, Professor Stella Crossley (dec), Mr Frank Drenth, The Hon. Justice Rolf Driver, Mr Joshua Ehrlich, Mr Charles Gibbons, The Hon. Justice Ian Gzell, Mr Charles Harkin, The Hon Justice Graham Hill

(dec), Mr Forbes James, Mr and Mrs Peter and Tammy Keller, Mr Jim Killaly, Ms Sharon Kolkka, Mr Geoff Longney, Mr Ian Longney, Mr Geoffrey Ludowyke, Mr Andrew Mills, Mr Peter O'Reilly, The Hon. Peter I Rose AM QC, Mrs Ann Birrell, Professor George Rozvany (dec), Mr Terry Towell, Dr Ming Zhou and one good person who insisted on remaining aninhamous despite protestations.

I would also like to thank my dear wife Deborah, my brilliant daughter Annaliese and my pet toy poodle Darley who put up with this old grump in day to day living.

Finally, I would like to thank my father, Professor George Rozvany Senior, who passed away during the writing of the Pentology. My father was also my hero! In 1991, he both founded and Chaired for 24 years the *International Society for Structural and Multidisciplinary Optimization* (the ISSMO). This was the start of an engineering school that was dedicated to pursuing the most efficient engineering solution in a wide range of applications including aerospace, automotive, construction and heavy engineering.

This approach has resulted in substantial gains in engineering and human knowledge. My father was also an adviser to NASA over several decades and the US Government on the collapse of the World Trade Centre. Alone this made him one of the great engineers of our times, if not history.

What stood him apart as a human being and made him *truly exceptional* was his personal philosophy of selfless, ethical and rigorous research adding to human knowledge above commercial or personal reputational gain and inspiring others to do exactly the same.

George Senior also had a wonderful sense of humour and loved to play “sock football” in the family home. If there were more people like him, the world would be a far better place.

George Rozvany
November 2015

Chapter 1

The Ethical Tax Framework

1.1 Introduction

What is perceived as ethical by one generation or indeed a different society in the same generation may not be perceived as ethical to the next.

Who would argue today that the capturing and enslaving of free people in their homeland to labour a lifetime in a foreign country under appalling conditions is somehow acceptable? Similarly, the suggestion of returning to a system that denies the democratic vote for women or requires women to give up their careers on marriage would be equally abhorrent today to every schoolgirl. Yet, these views were entirely conventional in the days of our grandparent's grandparents.

In business, the minimum wage, safe working conditions, annual leave, sick leave, redundancy payments and the provision of savings for retirement were all heavily resisted at the time of proposal. Today, they are considered to be the basic rights of all employees in advanced societies.

In today's increasingly transparent Internet world, businesses and their officers are under increasing scrutiny and therefore increased pressure to ensure

that ethical behaviours generally are promoted within their corporate cultures. In the case of companies operating in more than one jurisdiction, the Multinational Enterprises, the pressure is even greater due to the reality of different laws and societal values applying in each jurisdiction in which the Multinational Enterprise operates.

For example, most jurisdictions advanced in the corporation law are moving towards establishing strong positions against "corruption" by banning all forms of financial incentives or "bribes" to secure business contracts. Other cultures may simply view such payments as being in the nature of goodwill and are entirely acceptable. An ethical approach would be to adopt a global prohibition on anti-corruption while a more aggressive approach would be to secure contracts through independent agents familiar with "local customs".

Another example relates to variation in environment protection standards where most advanced jurisdictions will apply strict rules in relation to industrial emissions while less advanced jurisdictions do not. For those old enough to remember, the industrial catastrophes of Bhopal in India in 1984 (over 500,000 people exposed to methyl isocyanate (MIC) gas and other toxic chemicals.) and Chernobyl in the former USSR in 1986 (nuclear power station meltdown followed by uncontrolled radiation release

over much of Europe), the need for tighter emission controls is entirely self-evident.

Nevertheless, international businesses continue to readily seek low cost industrial "solutions" under typically less regulated circumstances in third world countries weighing reputation risk against potential financial gain.

A more contemporary example of poor corporate ethical behaviour was Volkswagen's choice to design, build and sell eleven million diesel motor vehicles that "cheated" United States and other environmental protection standards in respect of motor vehicle emissions. As the United States correctly opened a criminal investigation into Volkswagen on the discovery of the deception, Chief Executive Martin Winterkorn offered his "deepest apologies" and stated that he would be "ruthless" in getting to the bottom of the scandal, further stating that the "irregularities contradict everything that our company stands for". If it did, the manipulation would never have occurred. Most people would probably believe that Herr Winterkorn should have instead offered his resignation and soon after he did under public pressure.

All these outcomes, whether positive or negative, *are the subject of choices or decisions* made by Directors on Boards and their operational management. Ultimately, there is a clear choice for such officers to

act ethically or to act otherwise. Equally, the Lawmakers in every Government of the world have the capacity to also make a choice whether to allow such unethical behaviours or not. In this regard, the control to act ethically or not in the corporate context firmly rests with the independent decision-making of these executives and the Lawmakers.
It is the basic premise of the Pentology that ethical outcomes and behaviours are the product of a conscious decision making process.

1.2 What is Tax Ethics?

In his 1969 book "Adventures in Tax Avoidance", Peter Clyne included the following comments in his introduction

"Tax avoidance has become too sophisticated for such a book to be written with any sense of responsibility. It is a game played by experts, locked in perennial battle with the revenue authorities. No one ever wins or loses. There are no certain answers, no clear cut instant solutions", and further:

"so this book will help you to view the battle ground, understand the weapons used, and enable you to glance at some of the hills that yet remain to be conquered. You may both find this profitable and fascinating".

Clyne made the world of tax avoidance seem so alluring, so tempting, that one could just imagine

oneself driving a luxury sports car along the coastline of a tropical tax haven to a sprawling villa purely funded by one's brilliant tax practices and advisers leaving a befuddled Revenue Authority in one's wake.

For a while this may well have been the case, but the world of tax has changed considerably since then.

Firstly, the taxation law itself has evolved vastly in favour of the Revenue Authorities since 1969 backed by Lawmakers, with the introduction of general anti-avoidance provisions, specific tax loop hole blocking legislation, risk assessment of taxpayers and greater duties on Statutory Taxation Officers signing off on the tax processes of companies.

Secondly, the Revenue Authorities have become increasingly more knowledgeable of the internal taxation practices of companies and tax advisory firms by way of the introduction of senior staff *from both.*

Thirdly, the introduction of Internet based search engines and data analytics has profoundly increased the Revenue Authority's capacity to identify inappropriate tax behaviours by companies and individuals.

Fourthly, international pressure has mounted on countries that essentially peddle tax incentives *without any other economic motive such* as the

development of new businesses to generate employment for citizens conventionally known as “the tax havens”.

Clyne’s practices are now largely considered out-dated in terms of current norms, but there are still firms that continue to encourage aggressive tax practices as “smart” or “well worth the risk”.

It is the view of the Pentology that these practices *are neither smart* nor *worth the risk* and will on average result in an economic loss to an organisation pursuing such practices, rather than the expected windfall tax gain.

There was a momentary temptation to name this volume of the Pentology “Adventures in Ethical Tax Behaviour”. In the end, it was a clear decision to approach the tax function more like a civil engineer by providing the building blocks from which to build a certain taxation position for those organisations or companies wanting to operate ethically from a tax viewpoint.

For the purpose of this book, tax ethics is simply the choice to work on an ethical or no risk tax basis.

Like Clyne, it is hoped that the reader will find this both *“profitable and fascinating*”.

1.3 Why a Principles Based Approach

The taxation law in almost all jurisdictions has now become so complex that a full technical examination as it applies to any particular commercial situation will likely be so lengthy as to confuse the initial purpose of the work. For example, the entire income tax law in 1936 in Australia was less than 100 pages. Today, a Public Ruling in Australia is likely to be of this length or more.

Further, *a principle* will be likely more easily understood than the taxation law that applies to it. A case in point is the "arm's length" principle under the transfer pricing law. The principle essentially requires that international related parties conduct their arrangements as if they were independent. However, the taxation law and rulings in Australia currently runs to over 2,000 pages. When a company officer is dealing with operations in multiple jurisdictions, the analysis becomes even more complex.

Technical taxation detail should be addressed by either internal or external taxation specialists and, as a result, commercial actions determined. However, what is important for *company officers* is that they are in a position to understand a principle and then ask the appropriate taxation question which pertains to it.

For example, the Stamp Duty or transfer duty implications on a major acquisition may be complex due to the array of assets, intellectual property and financial obligations to be transferred and should be addressed by a specialist experienced in that area, but the relevant question for the Company Officer is simply "What are the transfer duty implication for this acquisition"? It is simply a case of *the right* question being worth more than a thousand *wrong* questions.

One *extremely* important objective of the Pentology is to open up the debate on how the *global society* should address *aggressive tax practices* and encourage the introduction in to law of *ethical tax practices* through *ethical tax regimes*. This is not just an issue for the Lawmakers or their constituents, the accounting or legal professions or the universities that train them, or indeed the "Western" or democratic nations. *Everybody* in some way is negatively affected by the outcomes of aggressive tax practices, except those who *choose* to seek financial gain from such practices *to the cost of mankind!!*

From a social conscience viewpoint, what elected Lawmaker would have the moral turpitude to argue *in public* that a nation's foreign aid program to provide housing and education for war orphaned children in Africa should be scrapped to allow the *maintenance* of aggressive tax behaviour by billionaires and global corporates. Yet, this is

precisely what is happening in practice. Answering a clear need for education in respect of ethical tax practices is also an important objective of the Pentology.

Although perhaps with a touch of wishful thinking, I would like to allow the proverbial "10 year old" to understand the concepts contained in this first volume of the Pentology and form his or her own view in the hope that such 10 year olds will be inspired in some way to grow up and one day change society for the better. In the meantime, I encourage the parents and teachers of those 10 year olds to do the same as my parents and teachers did for me and to encourage ethical thinking.
Nevertheless, some concepts will be explained in unapologetically simple terms to broaden the potential readership and awaken social conscience at the risk of offending the intelligence of those who are more technically minded. The reader will also observe that the Pentology will not contain a single footnote for exactly the same reason.

1.4 Taxation Risk

For the purposes of the Pentology, taxation risk is defined simply as any negative consequence arising from non-compliance with the taxation law including financial costs and reputation risk.

It is important to recognise that there are more than just financial costs as downside risks to non-complying or aggressive taxation behaviours.

The focus on reputation with respect to the conduct of taxation matters by organisations has become increasingly important in modern times for at least three reasons.

Firstly, many Revenue Authorities around the world now focus on risk ratings for *at least* corporate taxpayers and high net worth individuals and will increase audit activity and other risk-rated surveillance for such perceived non-complying taxpayers.

Secondly, the public's growing general awareness and lack of acceptance of aggressive tax practices through the Internet and other popular forms of mass communication has forced a retreat (or at least a rethink) on such aggressive tax practices by major corporates and high net worth individuals.

Thirdly, the growth of risk management practices has also meant that reputation risk is commonly identified by major corporates as a key risk with rigorous procedures and controls designed to protect the organisation from any potential matters that could damage its reputation including adverse tax outcomes and aggressive tax behaviours.

It is clearly arguable that the promotion of "ethical" tax behaviour by an organisation or major corporate carries with it not only commercial cache, but also the ability for company officers (and perhaps high net worth individuals who may own them) to sleep soundly at night knowing that there are no tax risks about to haunt them on their awakening. In the limited lifespan we are all subject to, these benefits should not be ignored.

1.5 Who is a Company Officer or External Stakeholder

A primary objective of the Pentology (but not the only objective) is to assist Directors of companies and external stakeholders in understanding the processes supporting an *ethical* approach to taxation and the consequences (costs and penalties) resulting from an *aggressive* style of tax management.

Any officer of the company involved in the taxation process must understand the broad principles of the company's tax policy or Board Tax Mandate and how it applies to their job responsibilities.

This would apply to the Managing Director, the Chief Financial Officer, the Head of Internal Audit, the Chief Risk Officer, the Group Financial Controller and the Head of Tax and their direct staff due to their responsibilities. However, there are many other roles

within a company requiring consideration of the tax process in accordance with the company's tax policy.

This is not restricted to just senior roles such as a Head of Acquisitions role or Head of Distribution, but may also extend down to the most junior secretary charged with properly coding her bosses expense claim on business travel.

In this respect, it is important that all roles *within the company* involved in the taxation process be duly recognised and factored in to the company's ultimate approach to taxation.

There are other interested parties or external stakeholders to the organisation who will have either a *financial* interest and/or a *possible* moral or legal interest on the choices made by the organisation in respect of taxation matters. These include current shareholders of the company, potential shareholders or investors in the company, financial institutions that are currently lending or considering the lending of monies to the company and a range of regulators.
It is important to recognise that such external stakeholders will or should be concerned about any form of poor corporate tax behaviour as an indication of wider indiscretions within the company, a point that should not be lost on the Directors of the company.

1.6 Basic Elements of an Ethical Tax Approach

There are essentially four key elements to an ethical tax approach being:

1. Operating within the taxation law with appropriate support from external tax specialists whether they be conventional or ethical;
2. Working with the Revenue Authorities and Regulators on matters where clarification or certainty is required;
3. Lobbying for changes to the taxation law with Regulators or Policy Makers where considered desirable or where clarification from Revenue Authorities could not be obtained;
4. Not accepting any risk to reputation by way of tax matters.

As will be advocated throughout the Pentology, conducting a company's tax affairs in an ethical or conservative manner does not mean a negative financial outcome. An ethical approach, if appropriately followed, will result in:

1. The elimination of tax penalties, penalty interest and interest on late payment;
2. Reduced fees from external advisers
3. Reduced costs on tax audits and other engagements with the relevant Revenue Authorities;
4. The elimination of court costs;

5. Financial gains through lobbying;
6. Financial gains through reduced internal resources being spent on tax matters;
7. Financial gains through optimising "intended" tax benefits as opposed to "unintended" tax benefits.
8. No short term or long term downside "surprises" for Boards

The next question is how to integrate these basic principles into the normal operating procedures of an organisation or company. This is explained throughout the Pentology.

1.7 Aggressive Tax Behaviour

Aggressive tax behaviour is simply an approach to taxation that is not ethical and introduces tax risk.
At its extreme, aggressive tax behaviour includes tax fraud, however, there are many circumstances less than tax fraud such as reckless indifference or negligent behaviour that will introduce tax risk for a company.

It is arguable that failing to set an appropriate tax policy and not advising one's external advisers about a company's risk tolerance when seeking advice is bordering on negligent behaviour but it certainly should be regarded as loose tax practice. While there is a duty to advise on tax risks for advisors, the matter in terms of its importance is underlined from the

company's viewpoint by clearly articulating its tax policy – particularly if it is an ethical tax policy!

For example if a senior staff member presents as legitimate advice an "advocacy piece" on a taxation matter before the Board this could introduce tax risk as the opinion may not be correct. In such circumstances it is important that reasonable enquiries are made and as to the true basis for the advice and if necessary independent advice sought.
Merely accepting external advice without any internal review introduces tax risk for the same reason.

Clearly, neither seeking external advice, nor internally raising the issue, would be reckless.

Further, poor tax risk management and governance practices can result in a taxpayer being viewed or categorised as taking an aggressive tax approach. Care must also be taken in this regard.

1.8 The Mathematics of Tax Certainty

While probably beyond the day to day focus of a tax specialist or a company officer dealing with complex tax matters, an interesting question arises as to the relationship between ethical tax behaviours and the resultant financial outcome. As mentioned earlier in this introductory Chapter, it is the premise of the Pentology that ethical tax behaviours will produce a

financially profitable outcome over time and over a level playing field.

This operates on the assumption that all taxpayers will commence at a baseline tax liability position and take advantage of tax benefits intended by the tax law such as investment allowances or research and development tax concessions.

The ethical taxpayer will then work with the regulator on uncertain positions or promote changes to the taxation law which only means a potential upside tax position.

The aggressive taxpayer will pursue his legal avenues, but will risk only downside positions in the event of a loss that includes penalties, penalty interest and loss of reputation.

As with the tax avoiders of old, the aggressive taxpayer will initially have the illusion of success that may represent an opportunity for short-term internal political gain. However, this should properly be considered as a potential tax liability and appropriately recognised and reported as such under the accounting standards in the company's accounts.

Penalties, penalty interest, interest and loss of reputation do not occur where a taxpayer has chosen the ethical or no risk or ethical path and hence

represent a permanent difference between the two choices.

This carries important implications for Lawmakers, which will be discussed later in this book.

Chapter 2

Tax Risk Management

2.1 The Importance of Risk Management

"You can't handle the truth", said Jack Nicholson in his masterful portrayal of super marine Colonel Nathan R Jessup in a "A Few Good Men". So engaging was Nicholson's portrayal that many of us (men) could just imagine ourselves sitting in his shoes retorting away with the same gusto and swagger completely ignoring the fact that his character Colonel Jessup was about to be incarcerated for a long period of time. Still Jack is Jack and somehow it just didn't matter, but in reality it actually does!

From a risk management viewpoint, the more relevant concept comes from the immediately preceding demand, *"I want the truth*", and made by Colonel Jessup's equally determined legal interrogator Lieutenant Daniel Kaffee played by Tom Cruise.

The first principle of ethical tax behaviour requires taxpayers to work within the law and to be in a position to expressly state that their tax outcomes are true and correct in fully complying with the taxation law. The tax risk management process described below delivers this.

The earliest models of risk management emerged some 30 years focussing largely on prevention of downside risks or catastrophes for organisations through the introduction of various standards such as the ”ISO” series. With the more recent occurrence of various major world crises including the collapse of Enron and the Global Financial Crisis, the general approach to risk management has become far more holistic and disciplined. This has led to risk management systems identifying all risks of an organisation, determining key risks and carefully over-sighting those risks for downside risk management but also importantly upside gain.

As is implied above, factual support is fundamental to the establishment of a robust conservative risk management framework. As such, solid decision-making by company officers can never be based on even the most impressive of rhetoric. Like Lieutenant Kaffee, company directors and statutory officers must demand no less than “the truth” in managing the risk management process of their organisations.

While there are many risks within an organisation, most organisations will select and focus on somewhere between 20 and 40 key risks. Organisations are at liberty to define their various risks as appropriate to their individual circumstances including taxation risk.

As mentioned previously, taxation risk is defined as any negative consequence arising from non-compliance with the taxation law including financial costs and reputation risk. The tax risk management process provides the tools to ensure that this actually occurs and can be demonstrated to the relevant Revenue Authority. An ethical tax approach consists of the following elements each of which is discussed in more detail below:

Element 1 - Tax Policies and Board Tax Mandates (2.2);

Element 2 - Taxation Procedures (2.3);

Element 3 - Controls to Tax Management Processes (2.4);

Element 4 - Testing of Controls (2.5); and

Element 5 – Reporting (2.6).

Following the establishment of the risk management process, one of the more important considerations is whether to release all or part of the documentation publicly to external stakeholders. Generally, this is considered a positive move for publicly listed companies and indeed all tax paying organisations and is discussed further below in 2.7.

Another important consideration is that the risk management process will generate more relevant tax information than any other process. As part of the ethical tax approach, organisations should carefully examine this data to identify previously unclaimed but intended tax benefits under the taxation law. This is discussed further below in 2.8.

2.2 Element 1 - Board Tax Mandates and Company Tax Policies

A Board Tax Mandate and Company Tax Policy sets down a company or organisation's approach to taxation.

A Board Tax Mandate, as the name implies, is the Board's instructions to a company or organisation in respect of taxation matters.

The Company Tax Policy is also known as the Head Tax Policy or Group Tax Policy and if approved by the Board will be the equivalent of a Board Tax Mandate.

The Board Tax Mandate is one of the key documents of an organisation directing all company staff on tax matters and should be properly examined and discussed with all Revenue Authorities as part of normal disclosures with such bodies.

The Board Tax Mandate must also accord with all related tax documents including the taxation procedures, controls and reporting requirements.

Given its importance, the Board Tax Mandate should be carefully drafted to accurately reflect the Board's taxation position. Key terms must be appropriately used and placed in context. For example, a company that purports to be "ethical" from a tax viewpoint must consistently demonstrate such conduct through its wider tax documentation and behaviour. Attempts to shield *aggressive* tax behaviour behind ethical labels will be extremely poorly received by any Revenue Authority and will have a negative affect on risk ratings. This would particularly be the case if an ethical tax regime were eventually introduced in to the taxation law.

There are a number of matters that should be considered and included in the Board Tax Mandate.

Firstly, the Board Tax Mandate should describe in detail the intended approach of the company to taxation. A clear statement that the company has adopted an ethical or no tax risk position will be a powerful statement before a Revenue Authority.

Secondly, the Board Tax Mandate should advise how major issues are addressed and considered to have achieved the correct result for tax purposes under a conventional or ethical tax approach. This would

generally involve internal consideration by tax staff to gain the "internal view". The internal view would then be confirmed or otherwise by way of external opinion from qualified external advisors, whether conventional or ethical. If uncertainty remains, a referral to the relevant Revenue Authority for a confirming opinion such as a Private Ruling Request would then be required to settle the tax matter and to provide the necessary no risk tax outcome for the organisation. If certainty, cannot be achieved a lobbying strategy should be considered and tax action postponed until the outcome of that lobbying strategy is known

Thirdly, the Board Tax Mandate should advise in what circumstances tax matters should be referred to the Board for approval. These may include any matter involving a potential anti-avoidance provision, tax based financing arrangements or any other major transactions specified by the Board. For example, the Board may specify that all commercial transactions with a tax impact of US$1 million or above be referred to them by way of Board Paper for consideration.

Fourthly, the Board Mandate should specify how the company will approach tax risk management in terms of its normal operational approaches including identification and action relating to tax under-payments through its internal tax audit program. A powerful statement for a Revenue Authority would be that the company would make a

voluntary disclosure on any tax under-payments properly identified and established through its internal audit program. The expected benefit to this approach is that a Revenue Authority will be generous in waiving all or most of the related penalties, penalty interest and interest payments that may otherwise be due.

Finally, it should be noted that most companies typically issue many specific “policies” on a wide range of tax matters. For example, a company may set a tax policy to establish the business usage of a company motor vehicle by way of a properly completed logbook despite several other legal alternatives being available to the company. These policies are more procedural in nature than anything else and probably should be named as such. This ensures the difference between policy and procedure is formally recognised and understood by staff across an organisation.

2.3 Element 2 - Taxation Procedures

The Taxation Procedures of a company or organisation set down the detailed tax processes by which the company or organisation conducts all its tax affairs.

Whether a taxpayer is conventional or ethical in its approach to taxation, there will still need to be a range of tax procedures for in dealing with all direct

tax, indirect tax and advisory tax aspects of the tax function including at least the following:

1. Preparation of the Income Tax Return;
2. Preparation of Indirect Tax Returns;
3. Tax Accounting;
4. Tax Reporting;
5. Tax Planning Policy;
6. Responsibility of Taxation Function in respect of Tax Advisory Matters;
7. Responsibility of Business Units and Individual Officers in respect of Tax Advisory Matters;
8. Procedures for Developing IT Systems relating to Tax Compliance Matters;
9. Engagements with Revenue Authorities including Audit Procedures; and
10. Transfer Pricing (where applicable).

For those organisations desiring to pursue ethical tax practices, an Ethical Tax Practice Policy Statement should be added to the above list.

The tax procedures should also include the various controls, the testing of those controls and the reporting obligations that will be used to ensure integrity under the particular procedure.

Finally, it is critical to ensure that all tax procedures are entirely consistent with the Board Tax Mandate.

2.4 Element 3 - Controls of Tax Risk Management Process

For those less experienced in risk management practices, let alone *tax risk* management practices, a “control” at its most basic level is *an action* of some description to prevent a negative outcome.

It is necessary for conventional or ethical taxpayers to have adequate controls within their tax risk management procedures to ensure a no tax risk outcome, that is actions that will ensure the integrity of the ethical tax process.

At the outset, it is prudent to discuss with the relevant Revenue Authority in each jurisdiction and in relation to each head of tax that the company must comply with in those jurisdictions, the type of controls and the testing of those controls the relevant Revenue Authority believes is appropriate for those particular heads of tax.

It is well possible that the relevant Revenue Authority *may not* have strong views on the type of controls appropriate to a particular head of tax, but consistent with the ethical tax approach this is an opportunity to engage with a Revenue Authority in a positive way and develop relationships to benefit both parties.

It is also well possible that the relevant Revenue Authority *may have* strong views on the type of

controls it believes appropriate to each head of tax in which case engagement with the Revenue Authority will prove invaluable in terms of developing efficient processes to manage their requirements.

The argument often put by the conventional firms is that the relevant Revenue authority may in such circumstances *discover something* (that is a tax exposure) resulting in a large payment to the Revenue Authority. This is just plain fear mongering! The reality is that the tax exposure before the relevant Revenue Authority would have existed anyway and it is naïve to believe that a competent Revenue authority would not have identified it as such during a normal cyclical audit. Where any Revenue Authority identifies an exposure (as opposed to a voluntary disclosure), there will certainly be additional unbudgeted primary tax, penalties and penalty interest that would not have arisen in the case of a voluntary disclosure.

In preparation for the risk management meeting with a authority Revenue, the current tax risk management controls of the company should be identified from the current tax procedures and examined with the internal audit function, the risk management function or the external auditors to the company.

Improvements to such controls should then be discussed with a view to presenting the improved model to the relevant Revenue Authority along with

the current model and then waiting for comment from that Revenue Authority.

It is generally wise to accept any recommendations of e Revenue Authority following an opportunity for comment to build a positive relationship.

2.5 Element 4 - Testing of Controls of Tax Risk Management Process

Once the framework of controls has been established with the intention of ensuring the integrity of the tax risk management process, it is necessary that such controls be tested or reviewed to ensure that they are operating effectively for their pre-determined purpose.

This is not specifically a question to be addressed by an ethical tax specialist, but one that can be addressed using normal risk management processes.

The only ethical tax considerations that require inclusion are the relevant Revenue Authority agreeing to the controls required for the tax risk management process and that such controls be appropriately tested to the satisfaction of that Revenue Authority and the Board.

Otherwise such controls would be tested externally to the tax function using the normal processes for such testing either by way of the internal audit function,

the risk management function or the external auditors to the company.

2.6 Element 5 – Reporting and Communication

Accurate and complete reporting and communication on taxation matters at all levels within the organisation is critical to the integrity of the tax risk management process.

As discussed earlier with respect to the Board, the Board Tax Mandate should advise in what circumstances operational tax matters should be referred to the Board for approval. These may include any matter involving a potential anti-avoidance provision, tax based financing arrangements or any other major transactions specified the Board.

The Board should also receive an annual Tax Board Report as part of the year end process advising on material issues addressed during the year, tax audit activity, the effectiveness of tax risk management strategies, the tax environment of the company, recommendations of any changes to the Board mandate and a summary of taxes paid for the year compared with the prior year.

The Board will also be the recipient of other lines of Governance-related reporting on tax matters including reports on the integrity of the various tax processes from the Internal Audit Department and tax

risk issues from the Corporate Risk area. It is important that these additional reports are independent, objective and factually based in their views, but depending on the subject matter may or may not involve the input of staff within the tax area. This will require some explanation.

Where the Internal Audit or Risk Reports relate to either lack of probity or gross incompetence and can be objectively examined and independently verified then no input will be sought from personnel in the taxation area. Typically, these circumstances will be limited to either criminal activity or matters that border on criminal activity (such as tax fraud) or situations where reckless tax behaviours are considered to have occurred such as providing incorrect verbal advice on a major transaction and then not following it up with written advice of any nature potentially exposing the organisation to large financial losses. In light of such serious allegations, it is strongly recommended in such circumstances, that both a peer review be performed and that independent advice be obtained.

Apart from these extreme circumstances, consultation with the Statutory Taxation Officer by the Head of Internal Audit or the Chief Risk Officer is strongly recommended. The reason for this is that taxation is complex and while simple communication is desirable, *miscommunication* is common and needs to

be eliminated as part of the tax risk management process.

Assuming the general requirements of accuracy and completeness in communicating all taxation matters, there are *three* other reporting lines that require special consideration.

The first reporting line of special interest is communication *within* the taxation function itself. It is extremely important that the Statutory Taxation Officer set a culture of openness and transparency within his team to ensure an ethical or no risk tax position. At some point in time, every professional will do something in terms of procedure that may be then missed on review. It is very important for the Statutory Taxation Office *not* to blame, admonish or ridicule a tax staff member for making an error, but to thank the staff member for his or her honesty, as the risk will now be eliminated by due process or disclosure to the relevant Revenue Authority. It may also assist the “one team” spirit for the Statutory Taxation Officer to encourage the staff member to suggest a solution or to work with the staff member in finding a solution. The real key from an ethical taxpayer’s viewpoint is to *identify risks* and eliminate them, not punish staff.

The second reporting line of special interest is communication *between* the taxation function and the business units. It is particularly important that the

responsibilities for the business units and the taxation function be set down clearly. One area of potential risk that should be noted is where the taxation function provides taxation advice to the business unit but there is a change in fact situation or a change in law that changes the tax outcome. The risk is that a downside tax adjustment may result also incurring penalties and penalty interest or that a potential upside tax opportunity may be missed. The simple rule to avoid this challenge is that the business units should not act without first obtaining tax sign off and once advice is received should inform the tax function of any material fact changes that can then be examined by the tax function. The duty of the tax function is to monitor the law, advise the business of any potential or actual law changes and then reissue the advice. Both lines of responsibilities should be embedded in tax policy and individual position descriptions.

The third reporting line of special interest is communication *between* the Chief Executive Officer and the Statutory Taxation Officer. This is discussed in quite some detail in terms of the ethical tax structure.

2.7 Public or Private Board Tax Mandates?

Once the suite of risk management documentation has been finalised between senior management and the Board of a company in support of an ethical tax

approach, the question arises as to whether such documentation should be disclosed in whole or in part to all stakeholders.

The advantages of an ethical tax approach should be recalled. If properly executed, an ethical tax approach *inter alia* will provide tax certainty for the company within the taxation law.

If a company is private, disclosure should have a positive impact on the reputation of the company potentially increasing its economic performance. It is a powerful statement to customers to say that a company is not in the business of tax risk, but in the business of providing outstanding products and services.

The ethical stand will also not be lost on all regulators charged with the responsibility of ensuring compliance by the organisation and who regularly examine all statements released in this regard. Such statements, whether tax or otherwise, will be seen positively and suggest both probity and competence.

If a company is publicly listed, the additional advantage should be a likely and immediate positive impact on the share price for three very good reasons.

Firstly, analysts will immediately recognise that there are no downside tax liabilities.

Secondly, stated ethical positions tend to indicate wider ethical positions in respect of regulatory matters. This will likely indicate lesser statutory penalties of any kind compared to more aggressive competitors.

Thirdly, ethical positions tend to indicate a quality management team prepared to examine complex issues and appropriately handle them enhancing the company's reputation.

It is probably not advisable to release the entire suite of tax risk documentation to all stakeholders, just the over-riding tax policy or board mandate. Parts of the risk documentation are likely to be commercially sensitive and no additional gain is likely by their release. The only proviso to this is that the balance of the risk documentation be consistent with the released policy or mandate to ensure integrity and regulatory approval.

2.8 Using the Tax Risk Management Process to Identify Intended Tax Benefits Previously Unclaimed

As mentioned in the introduction to this Chapter, the risk management process will generate more relevant tax information in terms of facts than any other process of a company. This represents a clear opportunity to examine all transactions of the company with a view to identifying previously

unclaimed but intended tax benefits under the taxation law.

As an ethical taxpayer, the importance of claiming all intended tax benefits such as Employment Tax Rebates, Research & Development Tax Concessions or Investment Allowances must be noted and should be clearly differentiated from unintended tax benefits or “tax loopholes”.

In simple terms, Lawmakers want taxpayers to take advantage of tax concessions that encourage certain specific types of commercial behaviour. Accordingly, it is clearly ethical tax behaviour to take advantage of these concessions to the full extent of the law. Further, it should be considered a key objective for the ethical taxpayer to ensure that all such tax claims are appropriately pursued.

Notwithstanding, it is common for many organisations to not claim intended tax benefits as a result of lack of awareness of facts or law. The data provided through the tax risk management system with the assistance of specialists in those areas, the regulators themselves and internal resources such as the management accounting area should allow the appropriate analysis of data and capturing of all such “risk free” claims.

As noted earlier, purported “tax loopholes” or unintended tax benefits are definitely not what was

intended by Lawmakers but are proposed by aggressive tax advisers to create the illusion of “smart” tax planning.

However, appropriate tax planning is the product of a careful and studied analysis including the mapping of accounts and facts to the tax law and then claiming intended tax benefits with full regulatory approval.

Chapter 3

Setting Up the Ethical Tax Risk Structure

3.1 Introduction

Whether an organisation follows an ethical, a conventional or an aggressive tax approach, the corporate tax division is a key function in any major corporate or organisation. The establishment of a robust structure is fundamental to its operation and particularly so in achieving an ethical or no risk tax outcome. Whether an organisation elects to follow this path or not, the recruitment of appropriately qualified taxation professionals must remain a key objective of the organisation.

Given the typically high level of taxation imposed on major companies and the skills sets required including both high level technical and commercial skills, it is imperative for the organisation to select and recruit tax staff who will be able to precisely follow the Board Tax Mandate and company tax policies to deliver a no tax risk outcome. It must be recognised that any person employed in making binding tax decisions for the organisation is a senior level recruit with statutory taxation responsibilities and likely personal penalties in the event of improper taxation behaviour.

If the organisation selects either an under-qualified candidate or one lacking sufficient probity through a weak recruitment process, it will likely result in substantial *tax risk* if not substantia*l financial loss* to the organisation. Selecting and working with an appropriate external specialist corporate tax recruiter experienced in all aspects of tax recruitment is critical to the success of this process. Tax is a high stakes game and recruitment errors will be costly. Staff selection and recruitment is discussed in Section 3.2.

It should also be remembered that there are a range of roles and seniority within a corporate tax function requiring different professional skills. These different roles are discussed below in Section 3.3 and the importance of setting clear accountabilities is discussed below in Section 3.4.

Finally, it should be noted that there are a number of relationships between the tax function and the rest of the organisation that require special consideration. These relationships are discussed below in Section 3.5.

3.2 Staff Selection and Recruitment

It is critical that the organisation follow a process that will deliver appropriate tax staff to meet the directions of its Board Tax Mandate and corporate tax policies.

It *must* be recognised by the senior finance executives and HR personnel involved in the recruitment process that any person employed in making *binding tax decisions* for the organisation is a *senior level recruit* with statutory taxation responsibilities *and not* a “tax form filler” with low level clerical responsibilities.

Accordingly, it will be necessary to carefully consider how the desired outcome will be achieved with minimal risk to the organisation.

There are two important steps in this process being:

1. Selection of recruiter (Section 3.2.1); and

2. Selection of candidate (Section 3.2.2).

3.2.1 Selection of Recruiter

The selection of an external specialist corporate tax recruiter should be viewed and undertaken with the same discipline as the selection of the external tax adviser, which is discussed in detail in Chapter 6.

It must be recognised that an under-qualified candidate or one lacking sufficient probity will likely result in tax risk if not *substantial financial loss* to the organisation. This should be borne in mind throughout the selection process and underlines the importance of selecting an appropriate tax recruitment specialist to the circumstances.

It is important to note at the outset that many recruiters in the marketplace will purport to be specialists in a particular discipline when in reality they recruit across a number of disciplines. If they are recruiting for a finance role they will refer to themselves as “finance specialists” and if they happen to be recruiting a tax role, they evolve into “tax specialists” seemingly overnight.

Such general recruiters will normally be working at large, volume based recruitment agencies that are built on out-dated recruitment models with sales targets dictating how they behave and interact with their clients and the wider marketplace.

It is strongly recommended that a *genuine* corporate tax recruitment specialist be used for all engagements within the tax function. A genuine corporate tax recruitment specialist will be able to both manage risk and add significant value to the recruitment process by:

1. Clearly identifying to the relevant hiring executives the candidate pool that is available in the marketplace specific to the requirements of that role;

2. Providing both relevant information and insight in to current salary trends, recent appointments and, further, developments in tax legislation that may affect the organisation’s industry sector;

3. Being able to access candidate pools (including "out of the box" but relevant experience) that internal recruitment teams and other agents won't have access to by way of exclusive working relationships and engagement with their candidates on a regular basis;

4. Having access to candidates who aren't actively looking for a new role;

5. Having access to candidates that more general recruiters are not allowed to approach due to "conflicts" in their relationships with their competitors or service providers;

6. Saving *senior management* time by pre-screening candidates for a role before including them on a short-list;

7. Saving *senior candidate* time by only putting them forward for roles that genuinely align with their career development goals and expertise; and

8. Working to the requirements of an Ethical Tax Mandate where specified by the client.

Once the corporate tax recruitment specialist has been recruited, an appropriate candidate or candidates for a larger corporate tax practice requires selection.

3.2.2 Selection of Candidate

Although the corporate tax recruitment specialist will be well aware of the recruitment requirements for a particular tax position, in more general terms, it should be noted that there are both a range of roles and seniority within a corporate tax function requiring different professional skills.

These different roles are discussed below in Section 3.3 and the importance of setting clear accountabilities in accordance with the Board Tax Mandate and the company's tax policies is discussed below in Section 3.4.

Given the large potential financial downside, getting the recruitment process right first time is critical to the organisation. It is important to agree and clearly communicate on the boundaries of the job search, how the role will be positioned in the market against other roles currently being recruited that require similar talent and an assessment of the "must-haves" versus the "nice to haves" in terms of skill-set and behavioural attributes. Additionally, the corporate tax recruitment specialist should be able to help the hiring executive make the distinction between the two.

At interview, the hiring executive's ability to share and communicate the vision of what is trying to be

achieved in the tax function is essential. The interview should focus less on what is written on the candidate's curriculum vitae and more around where the candidate sees their career heading and their ability to combine their core technical skills with critical thinking and analysis.

This line of questioning will allow the hiring executive to get a sense of a candidate's ethical barometer or compass and how closely it factors into their decision making around tax matters they may encounter within the role. Furthermore, when assessing candidates, hiring executive should work with a specialist tax recruiter to determine if the candidates can develop the skills that the business might need in 3-5 years time. This is particularly important as companies evolve and become increasingly complex due to globalisation and as markets become more volatile.

The term "corporate tax ethics" does need to be specifically raised as such through the recruitment process. However, it is important to raise questions around this issue and assess the approach taken by the potential candidate. At all times, it must be remembered that to ensure a no tax risk outcome, appropriate engagement should be undertaken with Revenue Authorities to ensure compliance with the taxation law and with Lawmakers to encourage positive lobbying outcomes for the organisation.

3.3 Structure of Tax Division

Although the size of any corporate tax division in terms of personnel will be dependent on both the size and complexity of the organisation, there are a number of functions or roles that ensure the overall integrity of the tax function including (together with a brief description of the function):

Statutory Taxation Officer – Responsible for final sign on all taxation matters before the Revenue Authorities. Either the Chief Financial Officer or the Head of Tax may be the Statutory Taxation Officer. Given the greater tax skill set, the Head of Tax will also typically be the Statutory Taxation Officer.

Head of Tax – Where the Head of Tax is also the Statutory Taxation Officer, responsible for *final sign* off on all tax matters including advisory, compliance and audit matters. Where the Statutory Taxation Officer is the Chief Financial Officer, responsible for *making final recommendations* off on all tax matters including advisory, compliance and audit matters.

Head of Tax Advisory and Support Staff – Responsible for preparation of all advice relating to direct tax (income tax), indirect tax (VAT or GST, transfer duties, employment taxes and other taxes) and international tax (transfer pricing, withholding taxes). Depending on the size of the organisation, the Head of

Tax Advisory will be supported by a number of direct, indirect and international tax specialists.

Head of Tax Compliance and Support Staff – Responsible for preparation of all direct, indirect and international tax returns, tax accounting, tax reporting and related tax audit matters. Depending on the size of the organisation, the Head of Tax Compliance will be supported by a number of tax accountants specialising in one or more of the above compliance areas.

3.4 The Importance of Setting Clear Internal Responsibilities

The responsibilities of each role within the corporate tax division should be defined in terms of:

1. Position description (Section 3.4.1); and

2. Annual accountabilities or targets (Section 3.4.2).

3.4.1 Position Description

In general terms, the position description of any role including the tax role should clearly define a number of conditions about the role.

Firstly, the required *skills, competencies and experience* for the tax role should be appropriately addressed. In most organisations, such aspects for tax roles tend to be defined more in human resources or personnel terms rather than the *actual tax* skills, competencies and experience required for the position. Accordingly, the corporate tax recruitment specialist should be used to help define these requirements in the context not only of the recruitment market but internally as well.

Secondly, defining each tax role correctly in terms of job grade or equivalent within the corporate structure is also important. While a role may be required to be graded a certain way for internal purposes due to human resources requirements and therefore reflect a certain salary band within the organisation, such a grading may be completely at odds with the realities of the market. It should be recognised that these job grades are often done on mass by quite junior staff totally unfamiliar with taxation matters. There is also the perceived requirement of minimising salary costs. Again, the corporate tax recruitment specialist should be used to properly assess and test the assumptions made by human resources to ensure an appropriate grading within the organisation.

Thirdly, it should be recognised the position description will also be used at the basis for the

employment contract for the tax role. Accordingly, the Board Tax Mandate and all relevant tax policies relating to the position should be specifically referred to in the Position Description. This will provide clarity as to the exact requirements for the role in terms of the specific tax tasks, review processes and other risk management practices to be followed.

Fourthly, the position description if properly structured will form the basis for setting the annual accountabilities or targets for each tax role and managing performance. Amongst a number of things, it is important that there be at least one target for each area of responsibility, which is discussed in Section 3.4.2 below.

Section 3.4.2 Annual Accountabilities or Targets

As noted above, it is important that there be at least be one target for each area of responsibility. Equally, one cannot have a target without an area of responsibility. The targets also need to be meaningful, realistic and preferably ethically based from a tax viewpoint.

For example, it makes little sense to set a target that simply states that a *specific company tax rate* should be achieved. Even if there is an industry average company tax rate available, each company's circumstances will be different and the optimal tax rate will vary from company to company. What is

required is assurance for the Board that all proper processes have been followed for making claims including intended tax benefits under the risk management practices of the company. From an ethical or risk management perspective, setting a tax rate below what is achievable and optimal under ethical tax practices will encourage aggressive tax behaviours resulting in tax risk with associated unbudgeted primary tax adjustments and penalties and lowering of risk ratings.

Similarly, setting a target in respect of tax audits that *no adjustments be recorded* is also unrealistic. Although ethical tax practices will potentially result is this objective through appropriate discussions with the relevant Revenue Authority, attempting to force such an outcome through aggressive tax practices such as non-declaration of known tax exposures and tax risks will result in a negative outcome for taxpayers including a less desirable tax risk rating by the relevant Revenue Authority and risk to reputation.

The objective of annual targets or accountabilities should be to create an ethical and optimal tax outcome for the organisation, not create tax risk. Targets must be appropriately discussed and agreed and any potential tax risks eliminated and discussed.

3.5 Internal Relationships

There are a number of relationships between the tax function and the rest of the organisation that require special consideration.

3.5.1 The Chief Executive Officer and the Statutory Taxation Officer

As discussed specifically in Chapter 5 and also throughout this book, tax lobbying is one of the key strategies to support an ethical or no risk tax strategy.

The relationship between the Chief Executive Officer who carries the responsibility for setting the overall culture of the company including tax lobbying and the Statutory Taxation Officer who under an ethical tax approach is charged with the responsibility of identifying areas of potential tax reform and then pursuing those opportunities in a measured and balanced way is potentially one of the powerful in commerce in delivering logical and effective tax reforms.

It is extremely important for the success of the tax lobbying process under an ethical tax approach that the Chief Executive Officer and the Statutory Taxation Officer meet on an appropriately regular basis to identify and discuss potential areas of tax reform. Such reform proposals do not need to be necessarily "major" as such, but normally would be relevant in some way to the company's operations. As noted previously, tax lobbying under an ethical tax

approach will result only in an economic gain to the organisation *without downside risk* and at times such gains can be *very* large.

It is not necessary that the Chief Executive Officer be at all expert in tax matters but his or her knowledge of the organisation, the impact of taxation on competitive positions, the capacity to harness wider internal and external resources in facilitating law reform proposals and the general recognition of the importance of the tax lobbying function as a significant opportunity for economic gain to the organisation is *nevertheless critical*.

In preparation for and to create an appropriate foundation with respect to such “think tank” discussions, it is strongly recommended that the Statutory Taxation Officer ensure and encourage his or her staff to build and maintain a wide network of internal and external parties that may provide insights or inputs into this process. This may include but is not limited to other senior internal managers, within the company, related company experiences around the globe, Statutory Taxation Officers from other “friendly” companies, relevant industry associations and the various Revenue Authorities.

It is also important that objectivity in the exercise and mutual trust be maintained to optimise the outcomes of the lobbying process.

For highly experienced and long serving Chief Executive Officers and Statutory Taxation Officers, the meetings also represent an opportunity to informally discuss and provide candid feedback on a range of other matters. These may include perceived performance of staff members not just in relation to ethical tax practices but wider risk issues as well within the company such as a new Chief Financial Officer lacking either sufficient probity or competence or both.

For 19 years, I worked for two outstanding Chief Executives Officers, whom through their cultural management of their respective organisations created the foundations for me to exhaustively test the power of the ethical tax practice concept over this time delivering some $1.2 billion of additional tax benefits below the corporate tax rate without a single material adjustment in respect of any category of tax.

While both Chief Executives Officers are acknowledged elsewhere in the book, I did observe that both these gentlemen (and I use the term quite deliberately) bore remarkably similar personal characteristics despite their different backgrounds, educational levels and industries. Both inspired their staff by *not* playing position power games, listening carefully and making time to listen carefully, were prepared to back the ideas of their staff based on their records, were men of some altruism in helping those less fortunate than themselves, visibly built the

strength of their businesses and fully respected my statutory role in signing off tax matters.

A successful example of the Chief Executive Officer and the Statutory Taxation Officer working together is discussed in 5.3.4.

3.5.2 The Chief Financial Officer and the Statutory Taxation Officer

The Chief Financial Officer and the Statutory Taxation Officer should ideally work as a team respecting their own individual responsibilities to the Board and individual statutory responsibilities to Regulators and the various Revenue Authorities.

Typically, the Chief Financial Officer will sign off on all accounting matters including tax accounting matters. As the title suggests, the Statutory Taxation Officer will sign off on all taxation matters to the various Revenue Authorities.

As discussed in 10.6, it is critical that coercion not occur between these positions although this is more likely to occur if the Statutory Taxation Officer reports to the Chief Financial Officer. If such coercion does occur, the Statutory Taxation Officer should stand down, draft a detailed report of the coercive action and immediately submit the report to the Board. If the Board does not take appropriate action, it is necessary that the Statutory Taxation Officer

report the matter to the relevant Regulator and the relevant Revenue Authorities. Otherwise, the Statutory Taxation Officer will risk prosecution for potentially breaching a statutory duty.

While it is also possible that the Chief Financial Officer may have competency concerns with respect to the performance of the Statutory Taxation Officer, such issues should normally be addressed through direct communication between the Officers. If concerns still prevail, a resolution process should be agreed.

Within an ethical tax framework, the resolution of potential issues between the Chief Financial Officer and the Statutory Taxation Officer is fortunately very straightforward by following the normal ethical tax principles for a no risk tax outcome of external advisors, engagement with Revenue and lobbying the Lawmakers.

3.5.3 The Statutory Taxation Officer and the Business Unit Heads

It is absolutely critical that appropriate discussions on tax matters including tax risk management occur on a regular basis occur between the Statutory Taxation Officer and the Business Unit Heads.

This is necessary to ensure meaningful tax communication on the various commercial activities

being undertaken by the company including current and planned projects, acquisitions and divestments, financing arrangements, restructures, sales conferences etc.

Such meetings may or may not involve the Legal Department but often do to gain an improved understanding of the commercial aspects of a transaction.

It is also important that the respective duties of the Statutory Taxation Officer and the Business Unit Heads be clearly recorded in a tax policy as part of the tax risk management process.

The tax risk management process between the Statutory Taxation Officer and the Business Unit Heads is discussed further in Section 2.6.

Chapter 4

Working with a Revenue Authority - Tax Audits and Other Engagements

4.1 Introduction

What is often over-looked by many corporates and organisations is that a Revenue Authority is not only the regulator charged by the Lawmakers with full responsibility on all taxation matters, it is also the richest direct source of relevant information relating to the tax decision making process of any company.

If a Revenue Authority does not agree with a position taken by a company, then it does not matter how convincingly an aggressive or conventional advisory firm argues the case before the client or how much the client has paid the advisory firm for that advice. Ultimately, a Revenue Authority will take the action it considers appropriate against the company and its advisers. More so, a Revenue Authority will do so because it is under a strict statutory obligation to act as such in accordance with the taxation law.

The fundamental difference between the aggressive tax approach and the ethical tax approach is that the ethical taxpayer pursuant to its Tax Board Mandate will discuss and confirm tax positions with a Revenue Authority where there is tax uncertainty thus eliminating tax risk completely for the organisation.

The aggressive or conventional taxpayer will not approach a Revenue Authority as a matter of practice but take on tax risk *by choice* in not doing so.

As discussed in Chapter 6, one of the “myths” promoted by the aggressive tax firms is that a company should never speak directly to a Revenue Authority on the basis that it is somehow very risky or dangerous to do so. This is outrageously over-played by the aggressive tax firms and contrary to any sensible tax risk management or commercial behaviour. The real tax risk arises in not speaking to the relevant Revenue Authority on a matter where there is tax uncertainty and acting without guidance from the Revenue Authority. An experienced corporate tax practitioner will know exactly how to approach a Revenue Authority without tax risk to discuss and clarify taxation matters under an initial or established Revenue Authority relationship.

More importantly, discussions with any Revenue Authority are always on a confidential basis and required to be so at law. The same cannot be said with the aggressive taxation firms as advice is typically shared amongst a list of clients that can lead to embarrassing disclosures and loss of commercial knowledge resulting in actual financial loss and loss of reputation for those clients. This can never happen under the ethical tax approach, which is one of its many strengths.

A basic premise of the Pentology is that working with a Revenue Authority is one of the key actions to support an ethical or no risk tax outcome and should be considered the optimal taxation approach for any company.

4.2 Establishing the Working Relationship with a Revenue Authority Under an Ethical Tax Approach

The Board Tax Mandate, whether it be in the public domain or not, should clearly state the company's intention to work with the various Revenue Authorities it must legally attend to under an ethical tax approach. Such an approach should also be reflected in all relevant tax policies, staff position descriptions and staff annual targets of the company.

The primary person from the organisation's viewpoint in leading the initiative with any Revenue Authority should be the Statutory Taxation Officer who is otherwise responsible for the overall relationship and statutory sign off on all taxation matters before the Revenue Authorities.

Initial contact and discussions with any Revenue Authority should be focussed firstly on explaining the purpose and operation of the Board Tax Mandate, the related tax policies of the company and how the company intends to work with the various Revenue Authorities from an ethical tax perspective. It is

important that the relevant Revenue Authority leave the initial meeting with the company clearly understanding the company's desire for a no tax risk outcome and the company's undertaking of obligations to commit to this process. Accordingly, it would be advisable to have an ethical tax practitioner present at the meeting to address any questions or issues of concern by the Revenue Authority relating to the ethical tax approach.

As discussed in Chapter 5 in respect of tax lobbying, a softer and more engaging presentation style tends to be highly effective with most Revenue Authorities. This is particularly the case where the company has already stated its commitment to work with the Revenue Authority to achieve a no tax risk outcome under an ethical tax approach. The company's tax team should respectfully and carefully listen to the questions put by a Revenue Authority and be prepared to stop at any time to carefully and address those questions appropriately with the assistance of the ethical tax practitioner.

Apart from the introduction of the Board Tax Mandate and ethical tax approach, general discussions on matters of mutual interest are preferred at the initial meeting, rather than anything too controversial that may distract from the objective of the meeting.

4.3 Private Ruling Requests and Other Approaches to a Revenue Authority

Once an ethical tax relationship is established with a particular Revenue Authority any matter that the company believes should require clarification to ensure a no risk tax position would be the subject of an approach by the company to the Revenue Authority. This should be done in conjunction with the taxation opinion of the internal taxation staff of the company and on more important matters the additional support of an external opinion based on the directions for external advice contained in the Tax Board Mandate.

Over time, there is likely to be range of taxation matters to be considered by the company and confirmed by the relevant Revenue Authorities. This would extend from minor matters that may require a relatively informal approach to major matters requiring extensive submissions. However, the objective is always the same, that is, to obtain tax certainty from the Revenue and eliminate tax risk for the company.

A few rules should be followed to ensure the integrity of this process. Typically, such rules for approaching Revenue Authorities will be referred to in the Tax Board Mandate and in various tax policies of the company, but for the purposes of this discussion are set out in simpler terms below.

Firstly, it is important that all matters requiring clarification with the various Revenue Authorities be identified, logged and tracked by way of a general control to ensure that all uncertain matters are appropriately dealt with.

Secondly, it is important that the Statutory Taxation Officer be informed and approve of all proposed approaches by his staff to the various Revenue Authorities to ensure veracity and appropriateness.

Thirdly, it is absolutely critical that all approaches to the relevant Revenue Authority be made in writing with all material facts disclosed by way of discussion and agreement with that Revenue Authority together with the company's tax technical opinion and supporting documents.

Fourthly, all responses by the Revenue Authority should also be in writing and discussed with company tax staff to ensure a correct understanding of the response of the Revenue Authority and to ensure that the Revenue Authority has addressed all relevant matters.

Finally, implementation within the company of the tax matters raised and confirmed with the relevant Revenue Authority should be agreed with the various business units and follow up monitoring organised through the normal tax risk management processes.

4.4 Tax Audits and Other Investigations by a Revenue Authority

Unlike aggressive taxpayers, the outcomes of tax audits and other investigations for the ethical taxpayer by a Revenue Authority such as specific issue income tax audits, transfer pricing reviews and tax risk reviews should be generally predictable and largely uneventful due to the high levels of tax compliance and tax risk management activities adopted by such ethical taxpayers.

Typically, all previously uncertain positions with the auditing Revenue Authority will already have been addressed and the audits will therefore be or should be largely in the nature of a review meeting on execution of matters on positions already agreed with the Revenue Authority.

For example, I will cite as an example of efficiency under the ethical tax process a full tax risk review audit meeting with an income tax Revenue Authority that I was involved in some years ago taking some three hours to complete. The risk covered both domestic and international tax matters and a number of complex transactions. At the end of the meeting, the Revenue Authority verbally confirmed their opinion of an exceptionally high level of tax compliance by the company and no recommended actions by them. The formal letter from the Revenue

Authority confirming these matters was sent the next day by email. This should be compared with the usual months and often years experienced by aggressive taxpayers in resolving their tax audit investigations and outstanding matters with considerable external fees.

Further, given the general stance of voluntary disclosure by ethical taxpayers and the favourable acceptance of this by Revenue Authorities generally, the ethical taxpayer is likely to incur minimal or possibly zero penalties if an inadvertent or incorrect tax treatment is identified on audit.

It should also be recognised that it is preferred for taxpayers to uncover possible tax exposures early to avoid a build up of primary tax adjustments over a longer period of time.

In most jurisdictions around the world, the ethical taxpayers will be audited *far less* than their aggressive tax contemporaries due to their conservative, *or no risk*, tax positions. The benefits of this process are discussed in several places in this volume of the Pentology and include the virtual elimination of all tax penalties, penalty interest and interest on late payment, reduced fees from external advisers, the virtual elimination of court costs and no short term or long term downside "tax surprises" for Boards.

4.5 General Approaches by a Revenue Authority

From time to time, a Revenue Authority may approach a company confidentially to seek its views in relation to specific taxation matters or how to address an issue of industry or wider concern.

As noted above, the aggressive taxation adviser would consider any contact with a Revenue Authority as an undesirable option for a company and advise against it.

The ethical taxation adviser will take the exact opposite position. Any opportunity to build relationships of trust with a Revenue Authority will only assist in opening up effective channels in furthering the company's tax risk management strategy.

The direct communication with the Revenue Authority also presents an opportunity to discuss the poor taxation behaviour of competitors operating in the market. While some may consider this action "talking out of turn", it must be remembered that a competitor illegally paying less tax than it should will give that company an unfair competitive advantage over your company and damage your company's commercial prospects. The Board will, or should be aware, of similar situations from past dealings and be prepared to discuss it. If there is any initially uncertainty as to whether to take such action directly

with the Revenue, then the matter should be addressed with the Board immediately in framing the Board Tax Mandate.

4.6 Revenue Authority Risk Ratings

As noted in the opening comments of the Pentology, many Revenue Authorities around the world now focus on risk ratings for corporate taxpayers and will increase audit activity and other risk-rated surveillance for perceived non-complying corporates.

Further, the introduction of senior staff from tax advisory firms and major corporates to Revenue Authorities and the development of Internet based search engines and data analytics has profoundly increased the Revenue Authority's capacity to identify inappropriate tax behaviours by companies and individuals.

Low tax risk ratings will translate in to lower taxation costs for the company but must be supported by appropriate behaviours.

4.7 Ethical Considerations Relating to Improper Revenue Authority Conduct

It should be recognised that most Revenue Authorities around the world and indeed most individual Revenue Authority Officers are subject to very strict codes of conduct regarding their behaviour

towards taxpayers and tax matters generally. As such, improper behaviour is generally unlikely. Nevertheless, the question arises as to what an ethical taxpayer should do with respect to improper behaviour by a Revenue Authority Officer.

There are clearly a number of unacceptable behaviours by a Revenue Authority Officer that may arise in practice. This may extend from not referring to the law in providing a ruling on a taxation matter, to clear bias against the taxpayer, to solicitation of bribes or other inappropriate benefits.

Normally, an ethical taxpayer should provide a written statement of the taxation position to be confirmed. A clear failure to refer to the law would normally be dealt with by way of referral to a higher level Revenue Authority Officer or to use the normal mechanisms of appeal under the local taxation law. Equally, the same process will apply in cases of perceived bias.

The ethical taxpayer in any circumstances should simply not tolerate solicitation of bribes or other inappropriate benefits from a Revenue Authority Officer. The correct position is to immediately withdraw from the discussions and report the matter to the highest level tax official in the jurisdiction with a request that the original matter now be appropriately dealt with. Any tolerance or acceptance of solicitation of bribes will typically fall under the

criminal law in most jurisdictions and must be avoided at all costs even if it results in a negative tax outcome in that local jurisdiction. Reputation risk and potential damage to global tax risk ratings must remain the paramount concerns of an ethical taxpayer.

Chapter 5

Tax Lobbying

5.1 Why Tax Lobbying is a Highly Effective No Tax Risk Strategy

All taxation law and indeed *all law* within a democracy is born from the free thought of a single individual inspired by an idea to make a difference to the society in which the individual lives. Such ideas may come from any person within that society from the highest to the lowest born, from the richest to the poorest and from the most educated to the least. It is one of the basic rights and great strengths of the democratic system that such ideas *may* become enshrined into the legal system of that country.

It is also an important control within the democratic process that such initial ideas are rigorously tested through committees, party rooms, two houses of parliament and the executive before becoming *law* as such. Nevertheless, the occasionally humble origin of laws should not be forgotten and should act as an inspiration to all citizens within our society.

Lobbying is also one of the key strategies to support a ethical or no risk tax strategy. Unlike advocacy pieces that are filed for a *certain* future tax audit and carry *much* risk, proposed changes to the taxation law are

openly advocated for and only have upside gain to taxpayers.

It should also be recognised that companies or organisations which are considered by the various Revenue Authorities and Lawmakers to be "conservative" and measured in their tax thinking, carry little tax risk and do not undertake tax arrangements of an aggressive nature are likely to be highly regarded when it comes to their tax law reform proposals. In this way, an *ethical taxpayer* may be considered a respected advisor when it comes to proposed taxation law reforms of mutual interest.

Lobbying initiatives that result in major reforms to the taxation law or indeed even minor ones are also very likely to increase the *reputation* of the company or organisation which proposed it with the relevant Revenue Authorities, Lawmakers and the wider society.

This Chapter examines some of the principles for effective tax lobbying and a number of case studies that the author has been directly involved in resulting in significant changes to the taxation law.

5.2 Elements of Successful Lobbying

In considering an organisation's approach to a particular lobbying exercise, one must be focussed on who exactly *the target audience is*.

It should be recognised that if one is writing to an over-worked Lawmaker or politician who is dealing with myriad issues at the one time, it is not the same as writing to a Federal or State Law Reform Commission. A Lawmaker or politician will tend to be attracted towards shorter sharper explanations or "grabs" while a Law Reform Commission and similar bodies tend to prefer much more detailed theses exploring the current law, overseas experience, potential options for changes to the law and then a series of recommendations.

Further, lobbying is definitely *not* about demonstrating one's intellectual prowess to one's academic peers to gain hierarchical status even though it is a laudable objective within the world of academia and may stimulate ultimately much beneficial thought. However, what law reform is about is reaching the conscious mind of your target Lawmaker or decision maker and through persuasive and robust argument causing a shift in the target decision maker's core beliefs in the direction of the desired legislative outcome.

Generally, simpler messages and description of key concepts work far better than complex more academically styled work. Typically, the senior decision-makers of the law will be oppressed by the burdens of limited time, multiple conflicting tasks and their general responsibilities to their constituency. By

precisely and concisely defining the key aspects of a law reform proposal, the target decision-maker will be in a superior position to understand the proposal, make a decision as to whether the proposal has "prospects" and refer the matter to his staff or relevant Government Department for further consideration.

Further, softer and engaging presentation styles tend to work far better than the guffawing "professional" styles naively pushed by many of the big firms in grandiose public forums. The simple rules are:

1. Reduce "the message" to its most simple explanation in the context of the everyday life of a typical constituent or voter.
2. Be prepared to stop at any time to carefully and respectfully listen to the questions raised by the senior decision-maker, as this will usually indicate interest and this interest needs to be acknowledged.
3. Be prepared to "go with the flow" with the objective of building a foundation for further discussions.
4. Good humour tends to break the ice but should be used in a measured way appropriate to the personality of the senior decision-maker.

In summary, the aim of the first approach is to be concise and effective and not bombastic or over-intellectual. A great example of this is physicist

Professor Brian Cox whose extremely personable presentations on the universe are available on the Internet. If I had a choice, I would have Professor Cox present *all my* lectures.

It should always be remembered that further detail on a proposal might always be sought at a later time from the afore-mentioned "staff". Ideally, the lobbyist would like to hear from the decision-maker at the end of the first approach:

"I understand you. I am interested. I believe this proposal has real potential"

Timing should always be considered a friend of the lobbyist. Lobbying at the point in time when the Lawmakers are considering an issue will in all likelihood be extremely effective. For example, a Government may be introducing a major law reform package at a certain point in time that may have unexpected or unintended adverse tax outcomes. An appropriate action in such cases would be simply pointing that the tax law is consistent with the policy objectives of the wider legislation under the law reform package. Another opportunity may be a forthcoming election campaign where the Lawmaker is seeking initiatives to present to his constituents as party policy for the next term of Government.

Recognising *changing social values* or indeed scientific discovery may also be a rich source of opportunity for

successful tax lobbying. For example, a breakthrough product that improves the recovery of a certain ailment would be a perfect opportunity to lobby for a reduction or exemption from sales tax for that class of product to which the breakthrough product belongs.

Provided it is a *reputable*, lobbying through a trade association or professional body will generally add weight to a submission as it is considered to be the *collective view* of the members of that association or professional body. Notwithstanding, there may be circumstances where it is preferred to lobby as an individual company or organisation.

Consistent with an ethical approach, it should be recognised that most Revenue Authorities will be well inclined to favour those companies or organisations who are conservative in nature, are measured in their representations and consequently have desirably low risk ratings. Where such companies or organisations are also the dominant player in their industry or a significant player with specific knowledge or expertise on a particular issue then an individual submission should be considered. This does not mean that a small player should not lodge an individual submission, but usually the typically lesser resources of a smaller company or organisation mean that an industry representation may be more successful.

Finally, it should be recognised that the stronger the internal processes are within a company to identify,

develop and properly “bench test” lobbying initiatives, the better the outcome will be in terms of upside gain and importantly without any risk to the organisation whatsoever.

5.3 Case Studies

The following case studies are examples of successful lobbying involving the principles discussed in 5.2 that I have been personally involved in over my career.

Importantly, each of the examples below were achieved by way of processes *entirely consistent* with the ethical tax practices espoused in this book, were initiated through internal processes in major corporates and resulted in major improvements to the taxation law.

From my perspective, lobbying for a positive change to the taxation law is one of the most interesting and rewarding aspects of taxation practice. It both challenges the mind and allows one to travel back through one’s career from the first day of law school when one was introduced to the basic principles of the law to the latest complex matter one was dealing with as an experienced practitioner.

Law reform is important and if this practitioner can make substantial inroads in this area, I would encourage all those of a like mind to do the same.

5.3.1 Changing Social Values – Environment Protection Tax Legislation

From the 1960's, there has been a growing awareness and concern internationally that the interaction between man and his environment is causing long-term damage to the planet and ultimately our possible destruction.

This has lead to virtually all the major economies first initiating, but then adopting much stricter environment protection legislation over time as a result of a number of influences including public pressure and various international meetings and agreements including the Kyoto Accord.
By 1990, environment protection legislation was well advanced in Australia with the introduction of both general and specific laws relating to various aspects of the environment protection process. However, the taxation law at the time was *not at all* fiscally supportive of these measures with a number of key business expenditures relating to environment protection either not being tax deductible or being the subject of an unworkable set of taxation law principles or both. These expenditures included expenditures on environmental feasibility studies at the *beginning* of the business cycle, rectification or modification of existing production plant to meet emerging environmental standards *during* the business cycle and rehabilitation (or remediation expenses) including any compensation payments to

restore environmentally friendly land usage at the *end* of the business cycle.

At the time, the inland waterways and waterfront land to the west of the Sydney Harbour Bridge were blighted with very large and decaying industrial production plants of various kinds including heavy chemicals facilities that had either completed their business cycle or were near completing their business cycle and were not properly maintained. As the corporate tax rate at the time was 49%, it was simply not economically viable to "clean up" these disused industrial sites for the companies who owned them and they represented a monument for poor environment protection behaviours.
In respect of feasibility studies, my considered position was to allow for an outright deduction where an industrial project *did not* proceed and for an arbitrary three-year write-off *where it did*. In respect of the rectification or modification of existing production plant to meet emerging environmental standards, the proposal was to allow for an outright tax deduction where there was no increase in the production capacity of the plant or to allow for a three-year write-off where there was. For environmental rehabilitation expenses, the proposal was for an outright deduction as there was no justification for *amortising* the expenditure as the business cycle had already concluded.

The question then arose as to what lobbying strategy should be used to achieve this no doubt laudable and publicly popular outcome? The argument was developed along the following lines.

While the Lawmakers and the public considered environment protection expenditure highly desirable generally, the emergence of environmental regulation added significantly to the costs of many Australian businesses operating in what was becoming an increasingly competitive international marketplace. It was noted that the industrialised nations of North America and the European Community were fiscally far more supportive of environment protection measures than the Australian Government. It was argued that a clear anomaly had arisen where the Government was enforcing large amounts of capital and operating expenditure to be incurred by corporations in protecting the environment but was "twice penalising" them by not allowing a tax deduction for what was "compulsory" expenditure.

The "hook" was to point out the completely obvious that while the Government purported to encourage environment protection, it was doing the complete opposite by treating such environment protection expenditure on the same basis as other fiscally *undesirable* non tax-deductible activities such as entertainment, spouse travel and club fees.

This message (in what was just a 5 page original paper) was promoted and very solidly put to the Australian Treasury by the Taxation Institute of Australia, the Business Council of Australia and the Institute of Chartered Accountants and passed in to law within an extraordinarily short period of time.

The passing of the environment protection expenditure tax law resulted in a clear acceleration of projects for remediating and beautifying the previously unloved waterways in the western Sydney Harbour (and many other former industrial sites around Australia). This was the result of the industrial owners of the land being in a position to economically re-evaluate their previously uneconomic positions to now justify remediation of heavily polluted sites and sale to developers who in turn with the guidance of State and Local Governments turned the sites in to attractive waterfront residential areas.

While I did get a "tick" on that particular target for the year and the odd "well done", I remain somewhat bemused to this day as I ride my bike around those now transformed waterfront waterways that a five page double-spaced paper on a quiet work afternoon may well have resulted in the greatest "green" achievement in Australian corporate history.

I will emphasise, however, that this achievement would not have been possible without the

outstanding leadership and mentorship of three of the "good folk" at ICI Australia (now Orica Australia), then by far the largest and most diversified chemical company in Australia and before a number of parts of the business were "floated off " and publicly listed. Importantly, these three rigorously promoted and practiced ethical tax behaviours before anyone had even considered and coined the concept. As the Pentology also considers desirable behaviours in support of the ethical tax process their contributions should be considered and noted for action by Lawmakers and industry leaders around the world as an example of such behaviours.

Firstly, Dr Michael Deeley and John Eddey who as Managing Director and Chief Financial Officer respectively mentored an open culture of deep thinking and ideas promotion within and external to the company. This was an extremely powerful tool for a company that was at the time the leading company for research and development in Australia with hundreds of staff with PHDs leading both innovative and developmental research efforts. This approach also fostered a culture of outstanding thought leadership in all other areas of operation including taxation. Later in his career, Micheal Deeley furthered his green credentials by becoming Chairman of Parks Victoria (his home State) and President of the Victorian Environment Protection Agency Board.

Secondly, I would also like to thank Charles Harkin who recruited and trusted and backed my judgement in respect of taxation matters. Charles Harkin also selected, recruited and gave the ethical and commercial foundations to a young Michael Andrew, whom ultimately became the Global Chairman of the "Big 4" accounting firm KPMG.

5.3.2 Founding a New Area of the Taxation Law – The Development and Expansion of the Transfer Pricing Law in Australia

In 1981, Australia introduced what was to *ultimately* become its first effective "transfer pricing" (or anti-profit shifting) regime replacing the previous regime that was interpreted out of existence by a decision of the High Court of Australia, which as the name implies is the highest jurisdictional Law Court in Australia.

The concepts underlying the transfer pricing law and how it operates are explained in Chapter 7 and those who may be a little confused as to how the transfer pricing actually works should visit that Chapter first before returning to this case study. The revision of the transfer pricing law was the initiative of a rather young Australian Federal Treasurer, John Howard, who later became one of Australia's longest serving Prime Ministers and an international Statesman of some considerable repute. At that time, John Howard also introduced the first *effective* general

anti-avoidance provision under the Australian tax law as the prior regime (similar to the prior transfer pricing law) was also considered to be ineffective by the High Court of Australia.

Despite the introduction of these seemingly robust anti-avoidance provisions, neither the Taxpayer nor the relevant Revenue Authority tested the legislation before the Courts.

This may have been due to perceptions by the relevant Revenue Authority of a difficult and taxpayer friendly High Court who might have again restricted the breadth of this important legislation or that the companies themselves chose not run the gauntlet of the Court system. Indeed one wonders how the Judiciary would have handled such a case at the time, presumably only with difficulty given the complete lack of guidance from any source. There were presumably settlements over this period with the relevant Revenue Authority in respect of both provisions but no substantive detail emerged. One can only presume that "horse trading" rather than technical analysis was the basis of these settlements.

In the late 1980's, there was a move internationally to examine the transfer pricing arrangements of the pharmaceutical companies in the belief that the ethical pharmaceutical companies who develop new drugs and patent them were overcharging their foreign subsidiaries for drugs distributed through

those foreign subsidiaries. This view was based on the observation that once the patent owned by the ethical pharmaceutical companies had expired, the generic manufacturers without any development capacity could produce and distribute the same drugs at a fraction of the cost that the ethical pharmaceutical companies had done previously.

At this time, I was contacted by the relevant Revenue Authority regarding a *draft proposal* to issue an adjustment notice in respect of four pharmaceutical and agrichemicals locally distributed by the company but sourced from the overseas parent company which would have amounted to more than one half of the company's annual profit.

The argument proposed by the Revenue Authority (which on the face of it looked quite reasonable) was to mark up the cost of production of a commercial quantity of the pharmaceutical products obtained through a quote from an independent producer of such generic products by 50% and then to adjust the "transfer price" from the parent to the subsidiary to that amount resulting in the abovementioned large adjustment.

The first step at the behest of the Chief Financial Officer, Mr John Eddey, was to seek advice within the jurisdiction but there were no advisers except a rumour that a former leading barrister had given "some advice" on the area but was then a Judge on the

High Court of Australia. With little advisory capacity from overseas either with respect to transfer pricing arrangements, the matter then became one to be resolved by way of internal resources with the words of John Eddey lingering in my memory to this day: *"You're a smart young, find a way to win this. Take as much time as you need".*

The first submission to the Revenue Authority with the support of the parent company outlined in great detail the differences between the ethical pharmaceutical manufacturers with their vast research and development programs and the generic pharmaceutical manufactures who in the classic "vulture style" would wait to "pick off" the best pharmaceuticals at the expiration of the patent and manufacture then distribute them for considerable profit. The Revenue Authority accepted these points, but the question still remained as to what the transfer price should actually be between the parent and the subsidiary.

The eventual key to the problem was delivered by way by of an article entitled *"Nightmare on Elm Street – the Chill of the Transfer Pricing Rules"* published by both the Institute of Chartered Accountants in Australia and the Taxation Institute of Australia in their respective journals.

Amongst a number of points, the article advocated that the Australian Revenue should consider adopting

the transfer pricing methodologies set down in the then fledgling 1979 and 1984 reports on transfer pricing of the OECD. To the considerable credit of the Australian Revenue, this position was not only accepted, *but also embraced,* and led to Australia being one of the lead nations within the OECD in developing the global transfer pricing program. Within Australia, this resulted in a comprehensive publicly released statement of the transfer pricing law. It also allowed the opportunity to write the only two comprehensive works on the transfer pricing law in this country to this day, which would not have been possible without the considerable support of the then Commissioner of Taxation, Michael Carmody, and his staff.

This also led to the successful resolution of the original transfer pricing matter without adjustment using the transfer pricing methodologies established by the OECD Reports.

5.3.3 Rolling Out the Managing Director – Political Influence and Persuasion in the Introduction of GST Laws in Australia

In the early 1990's, Australia was in the midst of a deep recession caused by a number of international and domestic factors including the collapse of a major financial institution that was causing considerable competitive pressure on the company I worked for at

the time, the afore-mentioned publicly listed ICI Australia (now Orica Australia).

Our analysis of the taxation imposed on the company by the various levels of Government disclosed a *real tax rate* of some 74% of ICI Australia's pre-tax profit after adding back all taxes paid. This figure was extraordinary high by any international measure and was well in excess of the corporate tax rate that is the usual measure for comparing "taxes" used by the OECD and other public institutions across the various jurisdictions of the world. This real tax rate was so high that it effectively removed the incentive to earn profits by the efficient management of conventional businesses. For example, Payroll Taxes alone for ICI Australia's staff of 10,000 comprised one third of the net profit of the company in the year before the speech.

While the Managing Director at the time, Dr Michael Deeley, held *only an interest* in the outcome of tax reform measures he bravely fronted as keynote speaker a seminar jointly hosted by the Law Institute of Victoria and the Law Reform Commission of Victoria on tax reform at the behest of his young Tax Counsel supported by the Company's Chief Economist, Mr Claude Piccinin.

At the outset, Dr Deeley acknowledged that he was not a tax expert, but he still had to deal as a businessman with a taxation system that was

internationally anti-competitive in nature. He explored three broad themes being:

1. An overview of the many taxes imposed on companies by the poorly connected and inefficient *three* levels of Government in Australia;

2. An explanation of why the current structure of the taxation system was anti-competitive when compared internationally with similar economies; and

3. Recommendations as to how the tax system in Australia could be made to more competitive.

Some of the proposals Dr Deeley advocated although completely valid unfortunately did not hit the mark and more or less remain today such as the distortion in the tax system away from the acquisition of income producing assets whereby repairs to old plant and equipment are fully deductible when occurred whereas new plant and equipment purchased has to be depreciated or amortised over its useful life.

Nevertheless, four proposals stunningly hit the mark including:

1. The *removal* of the Sales Tax Regime that had multiple rates depending on the product;

2. The *introduction* of a broad based consumption tax or GST at a single rate;

3. The winding back of the many State taxes; and

4. The introduction of a private binding rulings system that created certainty for the taxpayers in relation to their transactions and is one of the basic principles of the ethical tax system.

While it took almost nine years for these game changing tax measures to be introduced, there is little doubt that the public profile of Dr Deeley speaking with authority as a business leader in relatively simple terms with the press present was clearly influential in policy development in this country and resulted in real change for the better.

Business leaders in every country should be encouraged to follow Dr Deeley's lead and do exactly the same.

5.3.4 Changing Laws as a Result of Recognising Potential Efficiency Gains – Aligning the Labyrinth of Taxes

In the mid 1990's, I represented the Law Institute of Victoria on various external committees. There was a view amongst a number of delegates on these committees that a direct liaison group should be set up with the new combined Victorian State Revenue Office that had been recently formed from the three separate offices that had previously existed and was

charged with the responsibility of administering all taxes in that State.

As a result, the State Taxes Consultative Council (the Council) was established to essentially examine Victorian State Taxes in a commercial context and suggest areas for improvement. It was the first Committee specifically addressing State Taxes of its kind in Australia.

The Chairman of the Committee was the Victorian State Commissioner of Taxation, Mr Denzil Griffiths. Although a long-term senior bureaucrat, Mr Griffiths was extraordinarily forward in his thinking and was genuinely passionate in removing impediments to business through the reform of State Taxes. Debate was encouraged and was rigorous and in fact so rigorous that there was at least one letter of complaint addressed to the President of the Law Institute of Victoria.

Nevertheless, the Council with the backing of Denzil Griffiths set the environment for discussions between the various Australian States on harmonising or better aligning State Acts that had a similar purpose.

For example, the Payroll Tax Acts of the various States each had their own definition of *fringe benefit* (tax on employee benefits provided by the employer) that meant a company operating nationally in Australia had to deal with nine different definitions of fringe

benefit including the Federal definition of fringe benefit. This was clearly very onerous on such companies, but the solution was to simply align the definitions of the various States with the Federal Tax Act.

Other achievements included the alignment of various machinery provisions of the various State Acts such as penalties, rights of objection etc.

The important aspect to note was this process arose simply as a result of business and the Revenue Authority recognising that they had a mutual interest in simplifying the law to improve compliance.

It is a model that can be used in many situations around the world to improve the overall administration of taxes to the benefit of taxpayers and society alike.

Chapter 6

Management of External Advisers

6.1 Introduction

One of the basic principles of ethical or no risk tax behaviour is to ensure that independent and accurate tax advice is available to support the more complex tax positions taken whether this advice is gained from an ethical tax adviser or a conventional tax adviser.

Such certainty in advice is necessary to determine whether there is any potential tax risk that would then require referral to the relevant Revenue Authority to clarify the position by way of discussions or by way of a Private Ruling Request. Where doubt is recognised in such discussions, lobbying with the potential support of the relevant Revenue Authority may be required to eliminate all tax risk.

The management of external advisors is therefore an important step, if not a critical step, within the corporate taxation function.

While many conventional global firms purport to be "one firm", most are more likely to be a federation of national or local partnerships connected under one global banner by various fee-sharing arrangements. The partnership structure itself is far weaker in terms of controls than most corporations, a point rarely

extolled by the firms. The structural issues relating to conventional firms are discussed further in section 6.2.

One of the great challenges in selecting an appropriate firm is that virtually all conventional firms are well schooled in professional sales. Every conventional firm purports to be “the best” in one way or another or uses similar terminology in their sales pitches. Such subjective measures while perhaps sounding impressive in the mind of the presenter does create “noise” in the selection process for the corporates requiring accurate taxation advice and lacks objectivity. Objective standards must be used in assessing and comparing conventional advisers and firms with confidence. These subjective and objective measures and the general approach to the selection process are discussed further in sections 6.3, 6.4 and 6.5.

Once a firm or a panel of advisors has been selected, the question arises as to how a corporate or organisation using a conventional or ethical tax approach should work with their tax advisors. Fortunately, this is generally an easier exercise than the selection process itself. Working with external advisers under either a conventional or ethical taxation approach is discussed in section 6.6.

6.2 The Structural Issues of International Firms

At the outset, it should be recognised that conventional international firms are not structured the same way as the Multinational Enterprises they seek to service.

A discussion on this area is best addressed by comparing the most common structures for a Multinational Enterprise and the international accounting and law firms.

Broadly speaking, Multinational Enterprises are structured in a similar the way with shareholders, a Board, a Chief Executive Officer, Senior Executives and Operational Staff. There is clear line accountability with shareholders electing and monitoring a Board, a Board appointing and monitoring a Chief Executive Officer and so forth down the structure.

Additionally, there are a number of roles responsible for critical support functions that add to the overall integrity of the corporate structure including (together with a brief description of the function):

Chief Financial Officer – Responsible for statutory accounting, management accounting, financial analysis, budgetary reporting and treasury operations (although other functions may be added or subtracted depending on the overall experience of the Chief Financial Officer.

Chief Risk Officer – Responsible for identifying risks to the organisation and appropriately advising the Board and developing risk management procedures for "key risks" specified by the Board.
Head of Internal Audit – Responsible for monitoring all company procedures including financial and operational procedures, identifying weaknesses and improvements to these procedures and making appropriate recommendations to the Board.

Chief Legal Officer – Responsible for all legal matters relating to the organisation including compliance (although usually not taxation) and advising the organisation and Board accordingly.

Chief Taxation Officer – Responsible for all taxation matters within the organisation and signing off from a statutory viewpoint after appropriate consultation with the Board.

Some of the above roles will vary according to whether the organisation is a licensed entity (such as a general or life insurer or a trading or merchant bank) or whether the above roles are required to perform a statutory duty in the relevant jurisdictions in which the Multinational Enterprise operates.

It should be noted that each of the above roles relate to the *whole* of the organisation with strict accountability, targets and the capacity to be removed at any time for inappropriate behaviours. Each of the

roles will have substantial support mechanisms and relies heavily for its success on transparency and excellent communication at all levels. Overall, this is an extremely robust management model if undertaken correctly.

As noted in the introduction to this Chapter, many conventional global firms purport to be the “one firm”, but most are a federation of national or local partnerships connected by various fee-sharing arrangements.

The present structure of the leading conventional international accounting and law firms is one largely of historical accident with the history of these firms being adorned or perhaps littered with the names of the founding individual or founding Partners.

While there are some successful examples of conventional firms electing to “go public” such instances are rare and so far is yet to occur on a global basis. This is quite surprising given the difference in multiples of earnings paid on private trade sales which are generally much lower than their publicly listed equivalents. Further, the temptation of senior retiring partners to convert equity in a firm to easily disposable shareholdings in a publicly listed company at a time of a market high would seem very attractive.

There are several reasons as to why this may not have occurred.

Firstly, the conventional firm would then become subject to the strict listing requirements of one of the major bourses presumably either the London or New York Stock Exchanges. Generally, this would then require the conventional firm to make appropriate disclosures on price sensitive matters including the outcomes of lawsuits against the firm.

Secondly, the conventional firm would have to consolidate all partnership interests in to a single entity from the current position of mere fee sharing between the member firms.

Thirdly, a publicly listed entity of this scale similar to the licensed insurers and banks would require an appropriately tough regulator to ensure that the conventional firm would comply with appropriate regulatory standards.

Fourthly, the conventional firm would need to introduce the roles appropriate to a publicly listed entity with the same or very similar accountability and sanctions for underperformance including dismissal.

Finally, the reward structure within a conventional firm where an equity Partner may earn six to ten times the income of a salaried Partner or other senior staff would be clearly inappropriate and could not be matched within a conventional corporate structure.

Each of the above measures would no doubt prove challenging for a major conventional international firm desiring to list, yet it is precisely the above requirements that would attract the leading Multinational Enterprises from a Governance viewpoint to be their service provider.

It is also the structure that would attract those corporates and organisations wishing to pursue an ethical or no risk tax approach.

6.3 Debunking the Myths – Professional Behaviour and Other Untruths

As discussed in the opening comments, professional sales techniques have become a major part of conventional international firms with virtually all conventional firms employing large teams of sales and marketing professionals. There is little doubt that sales and marketing are critical functions in the modern world, but an international corporation should not choose a salesman or a marketing person as its primary external tax advisor.

At one time, many major investment banks used financial jargon and spoke quickly amongst the presentation team in proposing deals on the basis that the client would be so impressed with the confidence and knowledge of the presenter (while perhaps also not wanting to look foolish in not really

understanding what was actually being proposed) that they would buy "the deal". At that time, many investment bankers took the position that their role was to present the big ideas (and earn the big fee) while it was the corporation's role to work out the lesser issues such as the taxation, regulatory, legal and accounting issues.

In today's regulatory environment, company officers are very much responsible for their actions and must understand each and every aspect of a transaction before signing off and recommending approval to a Board. Accordingly, investment banks today typically resolve all issues and questions by working with the client each step of the approval process to ensure that the Board is appropriately and fully briefed before signing off on transaction.

From a prudential viewpoint, the external support for the taxation function should proceed on a similar basis. For an ethical or no tax risk corporate or organisation, it is an absolute necessity that all external tax advice be correct and fully understood by the Statutory Taxation Officer before advice is signed off.

The world of sales and marketing is about building an illusion of confidence and desirability in the product or service to ensure a sale. Given the fierce competition between the various "Big 4" firms and indeed the international law firms, any approach from

either side of the tax advisory fence will involve a level of sales and marketing to position the firm favourably. This is not to say that *everything* in the sales presentation will be irrelevant, but a corporation must ensure that the necessary filters are in place to focus on the end game of appropriate tax advice in accordance with the Board Tax Mandate.

Before considering the more objective measures, there are a number of "myths" or "traps for young players" that should be noted and dismissed in the assessment process.

While the comments below are meant to be illustrative in nature to awaken the reader's mind to this issue, they are based on actual comments made by the major conventional firms.

"We are the best!"

Virtually all conventional firms will purport to be the best both internally to staff and externally to customers. It is part of the "tribal ethos" that every conventional firm believe this to be the case.

However, unless a conventional firm can establish objectively as to why it is the best with comparative data from the performance of other firms to support that conclusion, the comment by and large is vacuous and in fact will probably do more damage to the conventional firm's case than assist it. Further, no

firm can realistically purport to be the best in all areas given the partnership structure and the variation in performance of individual equity Partners.

"We have all the contacts!"

This is one of the greatest conventional firm myths born in the days of the tax avoidance industry that such firms have a special capacity to gain access and privileged outcomes not available to others.

While it is true that most firms will be aware of the appropriate Revenue contacts on a particular issue, any Revenue Officer providing a privileged outcome to a particular firm will in most jurisdictions be guilty of a criminal offence, which the Petroulias case in Australia illustrated.

The reality is that most major corporations will have or should develop their own Revenue Authority contacts for each specific head of tax that applies to the organisation. This is not difficult to do – it is merely a question of picking up the telephone and initiating discussions, which is one of the principles of ethical tax behaviour.

"Do not approach the Revenue!"

While completely contrary to ethical tax behaviour, this conventional firm myth is really about protecting

the illusion of special “value adding” purportedly only possible through the firms.

There is little doubt that the risks of approaching a Revenue Authority are largely over-played by many conventional firms. An experienced corporate tax practitioner will know how to approach a Revenue Authority without risk to discuss matters within an established Revenue Authority relationship and this is often the preferred course of conduct where there is uncertainty on a tax matter rather than adding the extra complexity and cost of going through a conventional firm.

“We are highly professional!”

This seems to be the war cry mostly of the older Partners of the accounting firms. Again, this seems to find its origins during the tax avoidance industry era when aggressive tax schemes were heavily sold to unsuspecting professionals and high net worth individuals as “tax planning” by these firms.

The “highly professional” stance was essentially used to provide the appearance of legitimacy to these aggressive tax schemes while in reality such schemes ended up with a highly negative financial outcome for the client.

The question arises as to why this approach would even be used today. If a dentist, doctor, pharmacist,

engineer or any other professional *guffawed* about how *professional* he or she was, it would greet most with a feeling of distinct uneasiness.

Again, the real question is can accurate advice be provided in a clear manner in accordance with the Board Tax Mandate, not whether the tax adviser is highly professional or not in his presentation.

"We will do a scoping study first"

While scoping studies are often presented as a cost saving measure to focus on "material issues", in reality they are often a way of building up fees for the firm. There are other tricks of the trade to increasing fees for a firm including the "slow drag". Under this method, the most certain tax aspects of a particular transaction are established initially to build up fees through detailed advice and then the "deal-breaker" usually as a result of an offshore issue is presented at the end. This begs the question in these days of instant global communication how this could *possibly* occur, but I guess that the international firms should address this question as part of the selection process.

Uncertainty is undoubtedly the friend of the conventional firms in terms of fees on complex transactions, but organisations, ethical or otherwise, require advice on risk areas as early as possible in a project to establish deal-breakers and avoid unnecessary wastage of resources.

******

While the rather unsophisticated sales techniques illustrated above would be more unlikely to be used today by the conventional firms, it should be recognised that much more advanced techniques with the support of in-house psychologists will have been developed. This is particularly the case of the major accounting firms as the ratio of “staff “to equity partners is much greater than the major law firms and the partners ability to “win work” is typically the primary performance measure.

This is entirely reasonable from the perspective of the firm. Nevertheless, there is a clear mismatch between the objectives of the organisation seeking taxation advice and that of the firm. This should never be forgotten by an organisation during its selection process of an external taxation adviser.

6.4 Objective Measures in Assessing Firms

While there is little doubt that an international rating system for individual tax advisers within the major conventional international firms would be highly beneficial and indeed prized by Multinational Enterprises in seeking appropriate external advisers, such a rating system is yet to be developed.

This is somewhat surprising in that rating systems are available and are normally required in relation to

virtually every product purchased, so why not a service costing $1,400 per hour? The reality is that a rating system could easily be developed and be available to prospective clients, but the conventional international firms have either not thought of it or more likely chosen not to disclose it.

In considering how such a rating system would operate, the objective criteria for selection begin to emerge. As noted in the introduction of this Chapter, objective standards must be used in assessing and comparing advisers and conventional firms with confidence. Each major corporate or Multinational Enterprise should develop its own specific objective criteria depending on its organisational needs. Nevertheless, the following criteria should be considered as part of the selection process.

It should be noted that the Global Ethical Tax Practice proposed in 13.2.3 *will have all the following measures as part of its normal disclosures.*

6.4.1 Tax Advisory Performance Measures

Given that the objective of an ethical taxpayer is to ensure a no risk tax position based on correct tax advice, the most important objective factor is the individual adviser's (or firm's) overall success rate in providing taxation advice that has been reviewed and agreed by the relevant Revenue Authorities.

There are a number of statistical ways of addressing this issue including:

1. Number of matters accepted by the relevant Revenue Authorities on Audit divided by the total number of matters reviewed by the relevant Revenue Authorities.

This is arguably the most accurate measure of the overall performance of the taxation advisor. It discloses both the number of matters addressed and the overall success rate. It is reasonable to limit a “matter” to written matters above a certain amount (say US$100,000) to provide a meaningful comparison on higher value tax matters (although prudence requires that all clients of a firm should only rely on advice confirmed in writing).

The reality is that such information is clearly and readily available based on the internal sign off procedures of the conventional major international firms including peer review sign offs. Such information can be system generated as part of the audit review process. This information would be far more useful in selecting external advisors than any amount of information or sales techniques dreamt up and implemented by the most brilliant of sales or marketing executives of the international accounting and law firms.

More importantly, under the Ethical Tax Firm model the heavy costs of the sales and marketing departments of the major international firms are no longer borne by the client resulting in considerable savings and a greater level of profitability for the shareholder.

Further, it should be noted that the less successful the record, the more likely the firm is to be sued thus increasing the risk of large payouts and/or insurance premiums which are also ultimately borne by the client

2. Dollar value of matters accepted by the relevant Revenue Authorities on Audit divided by the total dollar value of matters reviewed by the relevant Revenue Authorities.

This may be used, but is not as effective as the first method immediately above as large individual matters either to the upside or the downside may distort the overall statistic.

For example, a *ten billion* matter will somewhat distort a running average of *one million* dollars either to the upside or the downside depending of the outcome of that matter.
3. Tax Benefit delivered per $1,000 dollar of fees paid to the firm

Although this method and its variations are considerably better than relying on the *"we are the best"* line in the selection process of an appropriate taxation advisor, there are still some problems with the approach.

Firstly, what exactly is a *tax benefit* and can it be consistently defined across conventional firms from a *no risk* tax perspective. The answer is that is likely not the case as most conventional firms will want to put their individual spin on their own performance.

Secondly, determining the *baseline position* from which the tax benefit is ascertained or calculated may also fluctuate considerably depending on the quality of the internal taxation function or the matter under consideration. For example, a strong internal tax opinion may still require external confirmation by way of Board Tax Mandate but may add no additional value as defined to the bottom line.

6.4.2 Education

While there are no absolute rules in examining the quality of education of the individual conventional taxation advisor, there are still some fair and reasonable observations that may be made.

With all due respect to the University of Northern Queensland, potential clients will not view a Bachelor

of Commerce degree from that university in quite the same light as a Law Degree from Princeton and a Harvard MBA. Notwithstanding, I do personally rather like the concept of setting up a Masters in Corporate Tax Ethics Program at that University as the environment and climate is perfect for considering ethical questions from a purely selfish viewpoint.

Post-graduate and a diversity of educational experiences in seemingly unrelated areas should be considered *highly* desirable. For example, a mining engineer who transitions his career to become a tax lawyer and advocate for change will provide invaluable insight into a submission for accelerated depreciation on heavy mining machinery to be installed in jurisdiction that has not fully contemplated a mining regime for tax purposes.

From the viewpoint of the ethical tax practice proposed in 13.2.3, post graduate or additional technical qualifications such as science and engineering will be a requirement.

6.4.3 Work History

Diversity of work experience is as important as diversity of education and arguably more so if the potential conventional or ethical tax adviser is to effectively deal with a range of Revenue Authorities and Governments in a number of jurisdictions.

While no doubt adept at internal politics, anybody who has spent 30 years in the same conventional firm and has had no other experience will likely lack flexibility or understanding in terms of other firm or corporate cultures.

A real understanding of different cultures is generally only gained through direct experience for meaningful periods of time in senior roles within those organisations. Ideally, a tax adviser should have senior role experience with:

1. The Revenue – to gain an understanding of the inner workings and key sensitivities of a bureaucracy;

2. A Major Corporate – to understand how matters are identified, communicated, implemented and managed from a risk viewpoint; and

3. A Major Firm – to gain a strong technical foundation in the taxation law itself.

From the viewpoint of the ethical tax practice proposed in 13.2.3, senior role experience in two of the above areas will be a requirement.

6.4.4 Original Research and Publications Work

Original research and publications work in any field of endeavour is the means by which human knowledge is productively expanded.

Continuing work with respect to the taxation law in this regard is important to keep abreast of current issues and maintain credibility with Lawmakers and the relevant Revenue Authorities. While this does not appear to a major factor in many of the conventional international firms, this discipline encourages the development of robust arguments to support changes in the law through the lobbying process, which is one of the key principles under the ethical taxation approach.

From the viewpoint of the ethical tax practice proposed in 13.2.3, publications work will be required on an ongoing basis to maintain the skills necessary for effective lobbying. While is hoped that the provisionally named “*The International Society for the Promotion of Ethical Taxation Behaviours (ISPETB)*” will be able to commence its own publication within a reasonable period of time, external publications work will and should also be encouraged including articles for the popular and green press.

6.4.5 Insurance Arrangements and Claims History

One indication of the strength or otherwise of the advisory capacity of a conventional firm is the insurer of the firm for professional indemnity purposes and the number of claims made under that policy.

The major insurers have a very strong understanding of risk, objectively assessing risk management practices within an organisation and then pricing such risk for the purpose of setting the insurance premium for the relevant organisation. Due to the right of subrogation (a standard clause under insurance policies whereby the insurer effectively steps in to the shoes of the policyholder for the purposes of litigation), insurers are also extremely effective at managing and settling claims against the insured (the person or organisation insured). The suggestion that an in-house or self-insurance scheme run internally within a particular organisation can operate at a lesser cost than a major insurer is more likely based on folly rather than fact.

If a major conventional firm *does not* have its insurance policy with a *major* insurer, the reasons why this is the case should be carefully examined as part of the process of selecting a taxation adviser.

The reasons for this line of questioning are fundamental to the integrity of the risk management processes of an organisation. A large unprotected risk position with a third party service provider through lack of adequate insurance cover can cause bank covenants to be breached and in circumstances where a large tax liability is triggered as a result of incorrect advice, potential cash flow difficulties for the organisation.

The first question should be whether the conventional firm had in fact sought insurance cover or not and the reasons why such insurance cover was not accepted by the firm and/ or rejected by the major insurers.

If lack of acceptable insurance cover cannot be adequately explained, then the next question that should be addressed by the conventional firm is how your organisation will be protected in the event of incorrect advice being provided by that firm.

Inadequate insurance cover or lack of adequate financial protection to the full extent of any potential adverse tax liability arising from negligent taxation advice including statutory penalties, penalty interest and late payment interest must not be accepted by any organisation seeking taxation advice from a conventional firm.

It should also be recognised that disclaimers to advice are not there to protect your organisation, they are there are there to protect the firm. Accordingly, it is extremely important that your internal legal team examine such disclaimers in detail to ensure that they are appropriate to the circumstances of the engagement.
From the viewpoint of the ethical tax practice proposed in 13.2.3, insurance cover should be available from all the major insurers given the

extremely disciplined risk management practices to be adhered to.

6.5 Preparation for Selection Process Meetings with Potential External Advisors

The selection of external taxation advisors from a conventional firm should be treated with all the caution of a due diligence, rather than a “meet and greet” with an incidental service provider.

The choice of the wrong taxation advisor can have serious, and possibly catastrophic, implications for an organisation in terms of financial outcome, risk ratings with the relevant Revenue Authority and Reputation Risk.

In preparing for such selection meetings with potential advisors from a conventional firm, a number of factors should always be borne in mind:

1. The objectives of the conventional firms and your organisation are not aligned;

2. The conventional firms will use a range of advanced selling techniques in such selection meetings that should all be largely dismissed; and

3. Your organisation must control the agenda in establishing your organisation's taxation requirements and setting the objective criteria to meet those requirements.

This Chapter is intended to assist your organisation in arming you with some of the tools required for this process. There are other considerations that your organisation alone can define including acceptable risk tolerance and the specifics of your Board's Tax Mandate.

The strength of the ethical tax practice model is that the ethical tax firm will establish common goals with the client to establish a common set of objectives and then work closely with the client to achieve those objectives.

While the ethical tax firm concept is one of *not for profit* whereby all profits of the firm will be used either for research in to the promotion of ethical tax behaviours or for charitable pursuits, the lower cost structures of such a firm will mean that the select group of ethical tax practitioners will be commercially well rewarded but highly focussed in achieving the agreed mutual objectives of their clients.

6.6 Working with the External Taxation Advisors Once Appointed

Once a firm or a panel of advisors has been selected, the question arises as to how a corporate or organisation using either a conventional or an ethical tax approach should work with the appointed taxation advisors of the organisation.

Fortunately, this is generally a much more straightforward exercise than the selection process of the taxation advisor itself. Under a conventional or an ethical taxation approach, the terms of the engagement must be clearly specified, fully agreed and followed between the organisation and the external taxation advisers with appropriate controls in place to ensure that the process is rigorously adhered to in accordance with the Board Tax Mandate.

Under the ethical tax approach, only one tax adviser working with the Board and senior management is required to ensure a no risk tax approach because of the top down nature of the advice and the removal of the "greed factor" in terms of building a fee base. The ethical tax adviser will be expert in ensuring that a no risk tax outcome is achieved backed by a very strong risk management process including a triple peer sign off within the firm. Therefore, fewer controls will be typically required from the viewpoint of the client or organisation to ensure absolute integrity in the process.

Under the conventional tax approach, rigorous controls will be needed to meet the necessary integrity standards in terms of the risk profile, the management requirements and the Board Mandate. Such controls should be both stated and agreed between the organisation and the conventional tax adviser. Any variation to this process should cause an immediate cessation of the engagement until the matter is dealt with.
If the client requires a *no tax risk* position consistent with an ethical tax approach, the conventional tax adviser must clearly state the process by which this is achieved. Even if a modest tax risk position is considered acceptable, the conventional tax adviser should explain how the accepted tax risk of the organisation will be managed within the required parameters of the organisation with any variation being immediately reported to the organisation.

The organisation must also advise the conventional tax adviser what is acceptable in terms of *managing* the engagement. Fee extraction methodologies including a number of persons from the firm attending a client meeting and otherwise sitting around at $1,400 an hour each should be avoided. Further, the use of juniors may be good for fees but add little or nothing to the quality of the tax advice no matter how such use is justified. If the conventional tax adviser before the client cannot give clear taxation advice then the conventional tax adviser should be replaced with one that can.

As is emphasised throughout the Pentology, business requires certainty in terms of its tax matters and does not exist to meet the profit motives of the major conventional international firms.

Chapter 7

Case Study 1 in Ethical Tax Behaviours - International Related Party Transactions

7.1 Introduction

Despite growing holes in Revenue bases internationally resulting in the slashing of health, education, welfare and foreign aid budgets, Governments seem reluctant to construct and implement the obvious changes to the taxation law that would prevent aggressive taxation practices from occurring. Such inaction and misplaced action by Governments has placed considerable pressure on otherwise ethical businesses to follow the practices of the aggressive taxpayer.

The role of Government in internationally co-ordinating such efforts is vital in ensuring that taxation laws are drafted in such a way so as to avoid these confronting ethical questions for major international corporates from arising in practice. No individual director, senior executive or of a major corporation or indeed any organisation should be placed in a position where they are asked to *pursue* aggressive tax practices merely to compete "on a level playing field". If this is allowed to continue without any action by Lawmakers, this should be regarded as a shameful dereliction of the duties of the Lawmaker.

Notwithstanding, it is the strong belief of the author that most politicians and Lawmakers enter the public service to improve society despite the odd scandal or two.

One of the great difficulties of public life is that career terms in office for politicians and Lawmakers tend to be much shorter than career taxation specialists in the major companies and advisory firms Thus, it is extremely difficult for Lawmakers to gain a deep understanding of taxation matters generally, let alone tax reform matters on the international stage.

Short political careers and even shorter periods in office tends to encourage conservatism by politicians for fear that they might fall outside what are perceived to be the parameters of international competitiveness when it comes to strong action on aggressive tax practices internationally.

As discussed in Chapter 6, despite their clear expertise the focus of the international firms is firmly centred on the perceived financial interests of their clients and their own profit motives so it is difficult to rely on their *independence* to address ethical questions including *no risk tax positions*. Equally, law reform commissions and academics tend to lack the knowledge to provide meaningful advice in this regard.

There is little doubt that effectively addressing aggressive tax practices should be the number one international tax issue for Governments generally, but considered, sustained, knowledgeable and co-ordinated action is required. As this Chapter and the following two Chapters demonstrate there is a clear need for ethical tax practices to gain ascendancy internationally. The need for the ethical taxation practitioner to take centre stage has never been more important.

7.2 The Economic Importance of Tax Ethics in Relation to Transfer Pricing Arrangements

As has been often stated, international related party transactions make up more than half of all international trade. Applying this figure to the World Trade Organization estimated global exports of US$50,000 billion in 2013 suggests that international related party transactions are now in excess of US$25,000 to US$30,000 billion per annum.

Assuming that just 5 to10 per cent of these transactions are the subject of aggressive tax behaviours, the amount of tax in dispute in any one year from a tax avoidance viewpoint is simply vast. When multiple years are taken into account and potential penalties and penalty interest considered in relation to these years, the total amount “in play” is simply extraordinary.

While the exact amount is extremely difficult to quantify due to the many veils of secrecy involved (and I believe more than the traditional seven have been employed here), let us assume for the purposes of economic comparison that the figure is around a conservative US$1,000 billion per annum.
When this figure is compared to the global foreign development aid budget in 2013 of US$134.8 billion, the extent of the tax avoidance problem strongly emerges and should or ought.to be recognised by the Governments of all major economies.

There will no doubt be critics of foreign aid programs and legitimate arguments as to how such programs could work more effectively, but no amount of validly critical points in respect of foreign aid programs can ever justify US$1,000 billion per annum of international tax avoidance through illegal transfer pricing practices. The scale of the international tax avoidance industry is a crushing indictment on the Lawmakers of the major economies and the firms that promote such practices. Such matters must be dealt with the highest of priorities and the toughest of outlooks. The promotion of such activities is tantamount to tax fraud and should be viewed as such.

7.3 Transfer Pricing in a Nutshell

Transfer pricing is the mechanism by which a Multinational Enterprise trades internationally within itself.

From the perspective of a Revenue Authority, a Multinational Enterprise must allocate its total profit among the jurisdictions in which it operates on an arm's length basis.

The arm's length principle is the key driving principle under the transfer pricing law. The principle essentially requires that the various members of a Multinational Enterprise conduct their international related party transactions on the same basis as would independent parties.

Further, the arm's length principle is designed as an integrity measure to ensure that there is no "profit shifting" out of a jurisdiction causing a reduction in taxation takings in that jurisdiction.

In the context of a particular jurisdiction, profit shifting will occur from that jurisdiction where the local operation of a Multinational Enterprise;

1. Pays in excess of the arm's length consideration for what is acquired from the offshore related entity;

2. Sells for less than the arm's length consideration what is supplied to the offshore related entity; or

3. Has been allocated an excessive share of global, headquarters or other group expenses.

Such profit shifting may occur in relation to a number of international related party transactions, which are discussed below in Section 7.5.

7.4 Policies and Procedures

As discussed in Section 2.3, the taxation procedures of a company or organisation set down the detailed tax processes by which the company or organisation conducts all its tax affairs.

Whether such a company or organisation is conventional or ethical, if it has international related party transactions, then the Board must set clear transfer pricing policies and procedures to appropriately govern these transactions.

If the taxpayer is a conventional taxpayer, a clear transfer pricing policy should be drafted aligned to the relevant transfer pricing law of the various jurisdictions in which the Multinational Enterprise operates. The associated transfer pricing procedures should clearly state the various international related party transactions undertaken by the Multinational

Enterprise and the methodologies used to establish the arm's length price for these transactions. The transfer pricing procedures should also include the various controls, the testing of those controls and the reporting obligations that will be used to ensure integrity under the transfer pricing policy and procedures.

The ethical taxpayer will have a similar transfer pricing policy and procedures, but will add the requirement that all transfer pricing methodologies in respect of the various international related party transactions will be agreed prior to implementation.
Some jurisdictions have highly developed regimes for agreeing transfer pricing methodologies with a Revenue Authority prior to implementation. These are typically referred to as Advance Pricing Agreements. Unfortunately, some jurisdictions place extreme requirements under these procedures that have placed considerable pressure on their effectiveness. If available in a particular jurisdiction, a shorter form procedure would be more desirable from an efficiency viewpoint.

7.5 The Ethical Tax Management of the Various Related Party Transactions

After many years of consideration, one of the most burning questions faced by the Revenue Authorities, the Lawmakers and the major corporates remains what is or what should be considered acceptable in

terms of *price* from the viewpoint of the transfer pricing laws.

The problem is *not* with the actual transfer pricing law itself, which is essentially robust in terms of basic principles and is entirely workable *at law.* In most countries, there is a strong argument for retention *albei*t with some obvious improvements. Accordingly, one must question many of the current initiatives of the OECD that seek to replace or rewrite the transfer pricing law without any substantive practical experience. It is the view of the author that this will only create confusion and greater opportunity for aggressive tax practices to emerge by replacing a fundamentally sound position with an uncertain and untested one.

The real issue is how the major corporates address such issues in terms of their Board Mandates, working with their internal tax teams and external tax advisers and their position on an ethical tax approach.

There is unquestionably an economically correct price for each international related party transaction based on what jurisdictions the major corporate has located its functions, assets and commercial risks. What is clearly being misunderstood is that the transfer price or indeed an acceptable range for that transfer price is determined by this location process and this is *entirely unrelated to any tax question.* It is

then a question of establishing a transfer price based on normal commercial principles.

This is where the choice of the Board guided by senior management and the external advisers becomes critical in the overall tax risk management of its international related party transactions.

If the Board forms the view guided by its senior executives that it should locate the company's functions, assets and risks in various jurisdictions for sound commercial reasons, then this approach is entirely acceptable from a transfer pricing viewpoint provided there are no other legal issues or impediments presented. Such an approach can also be easily managed *without any tax risk whatsoever* through the ethical tax approach.

If the Board forms the view guided by its senior executives that it intends to lower the company tax through artificial means by way of arguments provided by external advisers, then the Board has made a conscious decision to step away from ethical tax practices to an aggressive tax approach. By implication, the Board has made a clear decision before the relevant Revenue Authority to subject itself to any penalties under the law as a result of the inevitable tax audit. Generally, it is the strong view of the author that this is an extremely poor decision from a competency, tax risk management and Governance position.

There is little point during an audit in Boards pointing at their advisers and their advisers pointing back blaming the other and arguing that communication was inadequate or indeed that the excessive value attributed to functions was somehow reasonable. Both the Boards and the external advisers have an independent obligation to manage tax risk on behalf of the organisation and should make proper enquiry on such matters. A Revenue Authority are not foolish and any attempt to justify absurd positions before them will only result in a far worse outcome by way of damage to reputation and tax risk rating.

The Board, however, is ultimately in control of the process and must undertake its own due diligence and make sound tax decisions in relation to such matters. This is not difficult to do, hence the second volume of the Pentology, “Transfer Pricing Made Easy”.
Notwithstanding, some guidance is provided in this work below as to what should be considered ethical or aggressive from a tax viewpoint in respect of the normal range of international related party transactions.

7.5.1 Services

As Multinational Enterprises have grown in both size and complexity, it has become usual to concentrate teams of service specialists either at the head office level or in service hubs across the globe. The role of

such teams is to provide dedicated “in-house” or “on-call” services to the various business units of the organisation as and when required. Such services may relate to the areas of marketing, logistics, human resources, legal, actuarial, taxation, intellectual property, mergers and acquisitions and financing. It is not uncommon for such teams to be located in special purpose companies or other special purpose entity.

The question from the viewpoint of the transfer pricing law is how should these specialist teams charge such services to the various business units.

The primary rule under the transfer pricing law of most countries is that such services should provide a *real or tangible benefit* to the recipient of the services *or* at least at the time the services were requested were intended by the service provider to provide a real or tangible benefit even if the anticipated benefits did not arise.

Further, it should be noted that there are generally two categories of non-chargeable expenditure under the transfer pricing laws of most countries being:

1. Expenses incurred by the parent company in managing and protecting its investments as shareholder (shareholder costs); and

2. Other expenses incurred by the parent company that are prima facie incurred for its own benefit.

Examples of such non-chargeable expenses include:

(a) Cost of activities relating to the legal structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company and costs of the supervisory Board;

(b) Cost relating to reporting requirements of the parent company including the consolidation of reports and auditing of the head office operation;

(c) Cost of raising funds for the acquisition of its participations; and

(d) Cost of managerial and control (monitoring) activities related to the management and protection of the investment.

Some "service" activities are more challenging from a transfer pricing viewpoint such as expenses relating to the central co-ordination and control of the Group. For example, the decision-making activities of top management of the parent company may, depending on the nature of the decisions, arguably be for the benefit of the shareholder alone or partly for the benefit of the subsidiary. The litmus test for charging for such services is whether the subsidiary would in the circumstances purchased such services, if available, from an independent third party service provider. This involves some judgement but also some common sense.

The next question for consideration is how charges for services would be typically undertaken under:

1. An ethical tax approach (Section 7.5.1.1); and

2. An aggressive tax approach (Section 7.5.1.2).

7.5.1.1 Ethical Tax Approach in Charging for In-house Service Arrangements

The ethical tax or no tax risk approach in relation to charging for in-house or on call services is relatively straightforward and uncontroversial.

Essentially, the first step is to calculate the total or "fully absorbed" cost in providing such services. This involves an accounting calculation of all direct and indirect costs in relation to the service charge. Typically, this will involve the internal taxation department working with the internal management accounting department by way of direction to advise on the "base cost" of providing the service. This figure will not include non-chargeable expenses such as shareholder costs and expenses incurred by the parent for its own benefit.

The next step is to decide an appropriate allocation key for apportioning the fully absorbed or base cost across the various business units that receive the service charge. Such an allocation key may be at an

hourly rate based on cost or perhaps an allocation key based on the relative revenue of each of the subsidiary operations to which the services are provided. As a general course of action, the justification for a particular allocation key should be discussed and cleared between the taxation and management accounting departments.

The third step is to apply what is considered to be an acceptable arm's length mark up on the cost of the services charged to the subsidiaries. Most jurisdictions around the world will allow or possibly require a mark up in the range of 5-10 per cent with some jurisdictions allowing a "safe harbour range" or a mark up range automatically accepted by the Revenue Authority of that particular jurisdiction.

In accordance with ethical tax principles, the final step to obtain tax certainty and, therefore, a no risk tax position is to agree the above arrangements with the relevant Revenue Authority in each of jurisdictions to which the charging arrangement applies. Indeed, this may require some effort and some time, but all tax risk will be eliminated through this process. If there is an issue from the Revenue Authority's perspective, it is important that the matter be identified and discussed prior to the arrangement being implemented to avoid a potential tax exposure.

7.5.1.2 Aggressive Tax Approach in Charging for In-house Service Arrangements

The objective of the aggressive tax approach in relation to the charging of in-house or on call services is to charge as high a price as possible for such services from a low taxing jurisdiction to a high taxing jurisdiction. In this way, profits are shifted and taxes lowered *albeit* illegally and in all likelihood temporarily.

The basic strategy for a major corporate is to either argue with the Revenue Authority that the pricing of the service arrangements are acceptable from a transfer pricing viewpoint or for the major corporate to simply avoid any examination from the relevant Revenue Authority at all through blocking or other subversive tactics. One suspects that the latter is the more common approach. Nevertheless, both these strategies seem to be still around well past their use by dates against all common commercial logic and sense of risk. There is a range of methods that are generally employed in pursuing such an aggressive tax approach in relation to internal services.

The most common method used by the aggressive taxpayer is to compare the in-house services with those available in the market from third party service providers and then align the internal prices to the external prices identified as “comparable transactions”. Given that most external service

providers will charge out their services at several times cost to generate profit for the equity owners of the firm, there is a clear distortion caused by using this method.

Despite the possible similarity in the services provided, the operation of an internal service function is quite different to that of a consulting firm. The primary commercial reason for a firm's existence is to provide advice and make profits for its owners. As noted previously, these firms rely on extensive support functions including large teams of marketing and sales professionals to further the objectives of their organisation. The major corporates in which the in-house service teams reside typically run businesses *unrelated* to the provision of such services. There is no imperative for profit other than to charge out the cost of providing the service. More importantly, the companies and their advisers who argue the third party service provider case *well know this.* It is a deliberate misrepresentation and should be looked at in no other way by Directors and senior management.

The other approaches used to shift profits under purported service arrangements tend be a little more covert in their style. One such method is to inflate the cost base of the services provided from a low tax jurisdiction beyond what is normally justifiable and then charge a specific high tax jurisdiction for those

services, thus shifting profits to the low tax jurisdiction.

Another approach is to simply charge for a service from head office that does not actually provide any real benefit to the subsidiary and should not be charged for at all, such as a head office think tank. Think tanks are more in the nature of a non-chargeable shareholder activity to do with the strategic direction of the parent company rather than providing any direct or indirect benefit to the subsidiary. Accordingly, it is not appropriate to charge for such activities.

Such approaches in respect of internal services are not difficult to do for a major corporate but may be extremely difficult for the relevant Revenue Authority to detect in practice even on a full audit. This is particularly the case where an acceptable or indeed no mark up is charged. This tends to throw a less experienced auditor from the relevant Revenue Authority off the scent of tax avoidance.

Notwithstanding that it may be possible to make such arrangements difficult to audit with the possibility of not being identified by the relevant Revenue Authority, such behaviours are clearly not ethical and must be avoided as part of an ethical tax policy by Directors and the senior management of the company.

7.5.2 Loan Arrangements

It is beyond question that at one time or another just as an independent business will require some form of external funding, so will the discrete functions of a major corporate or multinational in the jurisdictions in which it operates whether through a branch or subsidiary operation.

In the context of a major corporate's or multinational's financial affairs, loan arrangements will be generally more common than equity raisings, given that the formal requirements for loan funding are typically much simpler and such organisations typically raise money centrally through their in-house finance companies or centralised treasury operations.

The issue that immediately arises in respect of such intra-group loans when considering the impact of the transfer pricing rules is the establishment of an arm's length interest rate for the loan arrangement.

Generally, the transfer pricing rules for calculating arm's length interest rates on intra-group loans are basically *the same* as for third party loans. The principal factors include the nature and purpose of the loan, the market conditions at the time the loan was granted, the amount, duration and terms of the loan, the currency in which the loan is provided and

the currency in which the repayment has to be made, the security offered by the borrower, guarantees involved in the loan, the credit standing of the borrower, the location of the borrower and lender and the prevailing interest rates for comparable loans. Therefore, the approach for a “vanilla” type loan arrangement is relatively clear.

As discussed in Chapter 9, a challenge has been presented by the emergence in international commerce of a considerable number of financial instruments including those promoted by the large number of emerging investment banks. These include hybrid instruments that have blurred the distinction between loans and equity contributions. While some countries have adopted “debt / equity” rules to characterise such arrangements at law, many countries have not. This has created opportunities for the aggressive tax advisers to peddle their wares to unsuspecting major corporates.

As a general rule in the absence of such rules, the following factors may be used as a guide for distinguishing a loan agreement from a contribution of equity. These factors include the legal effect of the transaction, repayment of principal, purposed of the contribution, debt-equity ratio, factors affecting the form of the investment in a particular country, written loan agreement and the ability to obtain finance from an unrelated third party. Such matters

including the attaching tax risks should be carefully considered before contemplating such arrangements.

As part of this general discussion on the transfer pricing rules around loan agreements, there are two further areas of special interest.

The first area of special interest is with respect to trade credits between related companies. The general rule is that it is usual for Revenue Authorities to impute interest on intercompany indebtedness arising from non-payment of accounts for periods *in excess* of that allowed for third parties under normal trade credit arrangements. Commercial practice in respect of trade credit arrangements does vary between countries, however, there is unlikely to be any dispute with any Revenue Authority if outstanding credit balances are cleared well within commercially acceptable periods of time.

The second area of special interest is with respect to a related company in financial difficulties either during its start-up phase or at a later point in time when the operation is well established but due to an adverse change in trading circumstances additional finance is required..

With regards to intra-group loans during the *start-up phase*, the general rule of most Revenue Authorities is not to accept an interest free intra-group loan merely because the related company is in its start-up phase.

The general view is that interest should always be charged unless a third party lender would not have charged interest in similar circumstances. There are generally no circumstances under which this would occur between an arm's length lender and borrower.

With regards to intra-group loans to an established related company *in financial difficulties* due to adverse trading circumstances, some jurisdictions are more sympathetic to waiving or deferring interest in respect of either emergency or outstanding loans where a third party lender would have similarly acted. Notwithstanding, it would be prudent to engage with the relevant Revenue Authority prior to executing such loan arrangements.

The next question for consideration is how charges for internal loan arrangements would be typically undertaken under:

1. An ethical tax approach (Section 7.5.2.1); and

2. An aggressive tax approach (Section 7.5.2.2).

7.5.2.1 Ethical Tax Approach in Charging for Internal Loan Arrangements

The ethical tax or no tax risk approach in relation to internal loan arrangements again is relatively straightforward and uncontroversial.

Once it has been decided to fund a subsidiary by way of a loan arrangement, rather than an injection of equity, it is then a question of calculating an arm's length interest rate. This can be done by way of engaging with the company's relationship banker or bankers recognising the above-mentioned factors set down by the Revenue Authorities for establishing an appropriate arm's length interest rate and any other factors that the bankers believe are relevant to the transaction. The opinion of the bankers on the interest rate calculation should be confirmed in writing and the terms of the loan arrangement recorded in a *draft* agreement for discussion with the relevant Revenue Authority.

In accordance with ethical tax principles, the final step to obtaining tax certainty and a no risk tax position is to agree the draft loan agreement *before execution* with the relevant Revenue Authority in each of jurisdictions in which the loan arrangement will apply. Again, if there is any issue from the relevant Revenue Authority's perspective, it is important that the matter be identified and discussed prior to the arrangement being implemented to avoid a potential tax exposure.

All other financing arrangements will be more complex than the vanilla loan arrangement described above and should from an ethical tax viewpoint be the subject of confirmation with the relevant Revenue Authority to ensure a no tax risk outcome.

7.5.2.2 Aggressive Tax Approach in Charging for Internal Loan Arrangements

An aggressive tax approach in respect of debt servicing on loan arrangements should be considered of particularly high tax risk given its “traditional” link with profit shifting either from subsidiary to the parent or vice versa depending on whether the lender charges an excessive rate of interest or the borrower pays less than normal interest.

Such simple arrangements for profit shifting have long lost their effectiveness giving way to a much more sophisticated world of aggressive financing arrangements. Even the more sophisticated structures such as hybrid structures are well under attack by Revenues around the world and are likely to be totally ineffective as tax based financing instruments within a short period of time.

The following financing arrangement is one that may test the boundaries between what may be considered ethical from a tax viewpoint and one that may be considered aggressive and therefore is interesting to examine from a theoretical perspective. Of course, it is the premise of the Pentology that the ethical taxpayer would discuss the financing arrangement with all relevant Revenue Authorities before execution to eliminate risk while the aggressive taxpayer would not.

As mentioned earlier, it is the usual practice of a major corporate or multinational to centrally manage the finances of its operations. This may be done by way of capital raisings or borrowings that may be then used to fund subsidiary operations by way of capital injections or borrowings. Equally, it is not unreasonable to repatriate capital from the subsidiaries to the parent operation for group financing purposes.

Let us assume that a parent company elects to run its subsidiaries with the minimum possible capital and chooses debt over equity as its own primary source of funding. The reason for choosing debt over equity is that it can source debt cheaply using its strong parent company balance sheet in its home jurisdiction and the obligations of debt are considerably less than for equity in terms of required return on capital hurdles for shareholders.

The parent company then decides to charge its subsidiaries with an ”arm’s length” interest rate commensurate with the poor credit rating of its subsidiaries that have little in the way of equity and no parent company guarantee. The interest rate is backed by an opinion from the parent company’s relationship banker and is much higher than the interest rate charged through the external funding arrangement.

The parent company also resides in a much lower tax jurisdiction than any of its subsidiaries but was legitimately founded with publicly raised capital in that jurisdiction. The Board of the parent company has formed the view that this is an entirely reasonable arrangement for repatriating profits to the low tax home jurisdiction and has deliberately “bled the subsidiaries dry” of capital to achieve this result.

The question arises for the Lawmakers as to whether such an arrangement should be considered a legitimate use of the taxation rules of the various jurisdictions in which the company operates or a tax avoidance scheme when looked at in totality. I will deliberately leave this an open question.

7.5.3 Internal Technology and Trademark Transfers

The increase in importance of intangibles in international commerce has matched the rise and rise of the multinational conglomerates. The development, use and protection of intangibles relating both to technology and the more nebulous marketing intangibles are now critical factors in the commercial success of virtually every company in this increasingly internet based world.

The diverse nature of an intangible is also an aspect that has lent itself to opportunistic and aggressive transfer pricing behaviours and arguably represents

the most difficult area in transfer pricing both for the Revenue Authorities and international companies.

For the purposes of this volume of the Pentology, the general discussion on intangibles has been limited to the more common transactions within an international company being the transfer pricing aspects of patents and know-how and the transfer pricing aspects of trademarks.

By way of brief explanation, a *patent* may be defined as giving a legally protected monopoly right to an invention Normally, this is for a legally restricted period of time, but this may be the subject of a "patent extension" case to extend the period to recover costs or make profits from the relevant "discovery". For example, an ethical pharmaceutical company running a full research and development program will need to recover the cost not only of the *successful* discoveries but also the *unsuccessful* programs.

The term *know-how* is more difficult to define and is a broader concept but for practical should be considered to be knowledge and experience of a technical, commercial, administrative, financial or other nature that is practically applicable in the operation of an enterprise or the practice of a profession.

There are three main methods for making patents or know-how available to a related party:

1. Payments by the various members of the international company for patents or know-how once developed by one member of the group (licensing arrangements);

2. Payments by the various members of the international company that contributes to the cost of research and development undertaken by one member of the group (research and development cost contribution agreements); and

3. Payments by one member of the international company to another member of the international company to carry out specific research and development on its behalf (intra-group services – see 7.5.1 generally).

The transfer pricing rules in most jurisdictions in respect of related party licensing arrangements, involve three considerations being:

1. The justification of benefits;

2. The requirement for arm's length pricing; and

3. The form and the amount of the consideration.

In broad terms, the transfer pricing rules operating across most jurisdictions are in respect of these three considerations are:

1. Tax deductibility of payments under intra-group licensing arrangements may only be expected where a real benefit has been conferred or could reasonably be expected to be conferred on the licensee at the time the relevant agreement is concluded. The term "real benefit" should be read as a real *commercial* benefit for practical and economic valuation purposes;

2. The licensing agreement should be reduced to writing describing the nature of the intangible property employed and the benefit sought in order to provide a basis for assessing the benefit conferred. The form of the agreement should be on the same or similar basis to an arm's length agreement of intellectual property between unrelated parties;

3. Supporting evidence should be available to tax authorities in order to demonstrate the benefit sought had in fact been conferred on the licensee;

4. The evidentiary requirements justifying the benefits sought under the licensing agreement should not be confused with the separate matter of what is the appropriate rate of payment to be made for the benefit;

5. While the form used will depend on the particular circumstance of the transaction the following forms of payment are generally acceptable:

- A recurrent payment based on the user's output, sales or, in some circumstances, profits (a royalty payment);
- A lump sum payment, sometimes combined with a recurrent payment;
- Reciprocal licensing arrangements (although individually recognised); and
- Including the compensation for the use of intangibles in the price charged for the sale of goods.

6. In terms of the methodology to be employed in determining the amount of the arm's length consideration in relation to royalty or similar payments, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. There are a number of methodologies by which an arm's length consideration may be obtained including:

- Using evidence provided by comparable third party or unrelated transactions. ;
- Comparing intangible property provided by the same developer to unrelated parties. These are referred as "internal comparable transactions";

- Comparing profits earned by the developer against profits earned by unrelated parties in the same or similar circumstances; and

- The cost plus method whereby a mark-up is added to the cost of developing the intangible property.

Trademarks or trade names are a category of intellectual property worth special discussion in a transfer pricing context. Trademarks are essentially marketing intangibles that confer on their owners the right to use them as distinctive signs to identify specific products or services of a particular manufacturer or dealer and to prohibit the use by other parties for similar uses. Examples include the well known McDonald Hamburgers Golden "M" trademark and Apple Computers "Apple" logo.

From a Revenue Authority viewpoint, international related party transactions involving trademarks are of particular concern due to the risk that a Multinational Enterprise will over-value the trademark and then shift profits to a lower tax jurisdiction. As such "profit shifting" in relation to arrangements involving the use of trademarks will occur out of the local jurisdiction of a Multinational Enterprise where:

1. The local operation pays in excess of the relevant arm's length transfer price for the use of the trademark owned by an offshore related entity; or

2. Charges an offshore related entity less than an arm's length price for the use of a trademark owned by the local operation.

In general terms, the following principles apply to the transfer pricing arrangements of trademarks:

1. The value of a trademark or any changes to the value of the trademark will depend on how effectively the trademark is promoted in the relevant market;

2. The share of the obligations and the expenditure necessary for the effective use of the trademark between licensor and licensee in an arm's length situation will mainly be influenced by the relative benefit expected between the parties;

3. The arm's length price for the right to license a trademark may be established by using what is referred to as Comparable Uncontrolled Price Method if a trademark or trademarks with similar effects is licensed to unrelated parties in the market;

4. The costs incurred in developing a trademark will not be as useful in establishing the arm's length price

rather an examination of the costs of maintaining the value of the trademark should be used; and

5. Guidance in establishing the arm's length price may be found by comparing the volume of sales and the prices chargeable and profits realised for trademarked goods with those for similar goods that do not carry the trademark.

The next question for consideration is how charges for internal technology transfers would be typically undertaken under:

1. An ethical tax approach (Section 7.5.3.1); and

2. An aggressive tax approach (Section 7.5.3.2).

7.5.3.1 Ethical Tax Approach in Charging for Internal Technology Transfers

Generally, it should be recognised that the establishment of an arm's length valuation in respect of international related party transactions for the use of technology and trademarks is a highly complex discipline. Accordingly, it must be undertaken with the greatest of care.

Further, Revenue Authorities typically have considerable concern about how such transactions are valued for transfer pricing purposes, particularly where the transaction has a connection with a low

tax jurisdiction, a tax haven or a jurisdiction with an extremely favourable tax regime for the tax write off of intellectual property.

Given this background, the approach of the ethical taxpayer must be both measured and conservative. The valuation of the relevant intellectual property should be undertaken with an appropriately qualified independent valuation firm specialising in intellectual property. All instructions to the independent valuation firm should be framed in accordance with the Board Tax Mandate to ensure a no risk tax outcome.

Once the independent valuation has been completed and internally approved by the ethical taxpayer, the next stage is to approach the relevant Revenue Authority to discuss the proposed implementation of the arrangement. The Revenue Authority should have full access to the independent valuation and, if necessary, the valuation firm to allow all matters raised by the Revenue Authority to be appropriately addressed.

It should be remembered at all times that the objective of the ethical taxpayer is for the Revenue Authority to sign off on the arrangement to ensure a no risk tax outcome.

7.5.3.2 Aggressive Tax Approach in Charging for Internal Technology Transfers

The objective of the aggressive taxpayer is precisely to shift profits to a low tax jurisdiction, a tax haven or a jurisdiction with an extremely favourable tax regime for the tax write off of intellectual property.

In circumstances where a Revenue Authority in a particular jurisdiction is not strong on examination of internal technology transfers, an opportunity for the aggressive taxpayer may well exist. Apart from the all important ethical tax considerations, it is relatively easy to construct an apparently legitimate intellectual property transfer supported by a purportedly favourable valuation. This may be by way of an excessive charge for the use of intellectual property or for the use of a trade name.

From the perspective of a Revenue Authority, large payments for intellectual property transfers to international related parties combined with a low taxable income or indeed tax losses should draw appropriate concern. This is particularly the case where the low taxable income or losses extend for a number of years.

Another approach is to sell the relevant intellectual property to a favourable tax jurisdiction and to licence the intellectual property back to the original jurisdiction. This may be particularly attractive where there is no capital gains tax in the original jurisdiction and a tax deduction is obtained for the

licence fee for using the technology. General anti-avoidance provisions in most jurisdictions would typically prevent such an arrangement from succeeding for tax purposes but may work in some jurisdictions. A similar arrangement could be argued in respect of a trade name although it would be questionable whether a trade name could be transferred in isolation of the underlying goodwill of the business.

7.5.4 Goods

The transfer pricing law in relation to "goods" covers raw and processed materials, semi finished products and finished manufactured products including mass produced goods and custom made goods.

Internationally, there are generally five accepted methodologies for establishing the arm's length price being:

1. The Comparable Uncontrolled Price or CUP Method

Under this method, the transfer price is set by reference to comparable transactions between a buyer and seller who are unrelated. These are referred to as uncontrolled sales, which include:

- Sales by a member of a Multinational Enterprise to an unrelated party;

- Sales by an unrelated party to a member of a Multinational Enterprise; and
- Sales in which parties are not related to each other.

The method requires that the uncontrolled transactions be carefully reviewed for comparability with controlled transaction. An important step in this process is to perform a “functional analysis” which compares the functions undertaken, the assets utilised and the risks undertaken between the two sets of transactions.

A number of other comparability factors should be considered including:

- Economic comparability in terms of markets etc;
- Comparable market levels (wholesale, retail etc); and
- Comparability of goods including physical comparability, comparability of intangibles utilised and other comparability factors

The Comparable Uncontrolled Price Method is the most commonly used transfer pricing methodology.

2. Resale Price Method

Under this method, the arm’s length transfer price is established by deducting from the price at which goods are sold to an independent purchaser the costs

and profit (gross margin) of the reseller. Essentially the method is a gross margin analysis .

Some aspects of the method that should be recognised are:

- The method does require close physical similarity;
- Where comparable resellers cannot be identified, an appropriate profit mark up may be determined by way of a functional analysis 0f the company reselling the relevant property services.
- The method is best suited where there is a high degree of similarity of process between the taxpayer and the independent parties, where the property or services sold are not used in the manufacturing process or where the reseller does not add substantially to the value of the product.

The method is not commonly used.

3. The Cost Plus Method

Under the Cost Plus Method, the arm's length transfer price is established by adding to the suppliers cost an appropriate profit mark up.

Typically, the "cost" used under the method is fully absorbed cost including all direct and indirect costs.

The management accounting staff of most major corporate will be able to calculate the fully absorbed cost relating to a particular transaction based on normal cost accounting principles.

In terms of an appropriate mark-up, the general approach is to examine the seller's mark-up on similar items in relation to third party transactions. These may be difficult to find in relation to services provided internally within a Multinational Enterprise. Nevertheless, the method remains the usual method for the in-house services with the usual mark-up being in the range of 5-10%, which is generally considered acceptable by most Revenue Authorities.

4. The Profit Split Method

Under the Profit Split Method, the combined profit from the relevant related party dealing is split between the international related parties based upon an economically valid basis that approximates the division of profits that would have been that would have been reflected in an unrelated party transaction.

The method is generally attractive where no third party information is available to allow other methods to be used or the transaction has certain unique elements which occurs no where else in the market.

5. The Transactional Net Margin Method

The Transactional Net Margin Method (previously known as the Comparable Profits Method) compares the net profit margin of a taxpayer in respect of a related party transaction with the net profit margin earned by an unrelated party on the same or similar transaction.

This may be based on a range of transactions or alternately used at a whole of enterprise measure.

The method has gained considerable prominence as the extent of publicly available information with respect to net margins earned has increased through databases and other similar sources.

The next question for consideration is how charges for internal transfers of goods would be typically undertaken under:

1. An ethical tax approach (Section 7.5.3.1); and

2. An aggressive tax approach (Section 7.5.3.2).

7.5.4.1 Ethical Tax Approach in Charging for Internal Transfer of Goods

As is the thesis of this Chapter and throughout the Pentology, the objective of the ethical taxpayer is for the Revenue Authority to sign off on the transfer pricing methodologies relating to the relevant transfer of goods to ensure a no risk tax outcome.

The approach by the ethical taxpayer will be to work within the taxation law of the relevant jurisdiction by identifying the relevant international related party transactions, selecting and applying an appropriate transfer pricing methodology, preparing complying transfer pricing documentation and then approaching the relevant Revenue Authorities to confirm the arrangements.

The majority of transfers pricing studies use either the Comparable Uncontrolled Price Method or the Transactional Net Margin Method, both methods being well understood by the Revenue. Authorities. These methods also tend to be well supported by available evidence that can be appropriately examined and verified by Revenue Authorities.

As mentioned previously, there are typically both formal and informal methods available in most jurisdictions for the taxpayer to confirm the acceptability of transfer pricing methodologies and studies.

7.5.4.2 Aggressive Tax Approach in Charging for Internal Transfer of Goods

The aggressive taxpayer has the objective of reducing taxation in high tax jurisdictions and recognising Revenue in low tax jurisdictions. There are a number of means by which this may be attempted.

A relatively unsophisticated approach to profit shifting in respect of goods is simply for one member of a Multinational Enterprise in a low tax jurisdiction to sell its goods to a member in a high tax jurisdiction at above an arm's length or market price.

An alternate to this approach is to charge the correct amount for goods but then to add either excessive charges for marketing intangibles or services to reduce profit in the high tax jurisdiction. Such an approach may be used during the earlier stages of a Multinational Enterprise's presence in a particular high tax jurisdiction and argued as "market penetration" expenditure. Legitimate market penetration expenses may result in early losses but are not expected to continue beyond a reasonable period of time.

A more sophisticated approach is to interpose a service entity in a low tax jurisdiction between the manufacturing member of a Multinational Enterprise and the distribution entity. This is done with a view to charging in excess of an arm's length price for the services provided with a view to reducing taxes in the other two jurisdictions thus reducing taxes overall.

There are many different ways open to the aggressive taxpayer to attempt to shift profits, but the resultant primary tax adjustments, penalties and penalty interest adjustments together with loss of reputation

and increased tax risk ratings are inevitably present should the aggressive taxpayer be unsuccessful. It is unquestionably a matter of choice to pursue such practices.

7.6 Addressing the Ethical Tax Questions

It has been estimated that the aggressive tax avoidance industry organises and executes international transfer pricing arrangements avoiding taxes in the order of US$1,000 billion *every year*. As such, Lawmakers are severely challenged as to how to address the vast loss of revenue to improper, if not illegal, international tax practices.

The introduction of ethical tax regimes or an ethical tax regime specifically relating to the transfer pricing question is advocated as a prime objective of the Pentology. If the Lawmakers can encourage ethical tax practices through economic means, there will be far greater certainty in terms of the tax base, reduced costs of monitoring by Revenue Authorities as a result of less tax being "in play" and likely an improved quality of Government service through increased revenue. All these outcomes are laudable objectives for any Lawmaker in any jurisdiction.

An alternative approach may simply be for the international community, perhaps through the OECD, to set a series of "safe harbour" transfer pricing rules in respect of the full spectrum of international related

party transactions. This would essentially mean that all international related party transactions would be subject to a specific range of returns based on an internationally determined and agreed set of factors. Anything falling outside the range would, of necessity, be the subject of extensive Revenue Authority investigation.

A further approach that would assist with the problem of the imposition of double taxation on the same transaction through the inconsistent treatment by Revenue Authorities in different countries would be the establishment of an International Court of Transfer Pricing Matters. Such a Court would be given the full authority to make binding decisions in respect of transfer pricing disputes between Governments. This would be a clear advantage to international commerce to ensure that large amounts of capital (or alternately large tax provisions) are not tied up for years through disagreement between Revenue Authorities. The second advantage would be the establishment of a specialised team of jurists well versed in resolving transfer pricing disputes. One of the challenges faced by virtually all jurisdictions is the general inexperience of the judiciary in transfer pricing matters that can result in inconsistent and therefore unproductive decision making on transfer disputes. Such issues would be eliminated through the establishment of the Court.

Finally, although more radical, would be for all Governments to simply cede their transfer pricing law making powers to one global authority with the mandate of governing all international related party transactions. While no doubt difficult to establish, this would eliminate the transfer pricing challenge entirely.

Chapter 8

Case Study 2 in Ethical Tax Behaviours - Offshore Planning

8.1 Introduction

In recent years, the concept of transferring functions to a jurisdiction with lower employment or production costs seems from an observational viewpoint to become the panacea for under-performing companies, poor performing companies or companies struggling to come up with an effective corporate strategy, rather than companies with outstanding records who have connected well with their home jurisdictions. The basic premise appears to be that a corporation, by shifting a number of functions to a low cost jurisdiction, will reduce operating costs for the company and then the company will be in a position to pay a bigger dividend to shareholders.

Many of these businesses tend to be motivated by short-term perceptions of positive management action, but there are many potential, generally unforseen, commercial and societal risks and problems with businesses moving *parts* of their business offshore. Further, there is the *tax risk* question of foreign Governments changing their tax laws at a future point in time presenting very real tax

challenges that are only occasionally fully discussed in the advice of the international firms.

Identifying the full range of risks together with appropriate risk management strategies for these identified risks is critical to allow for the proper evaluation by senior executives and Boards of any offshoring business case

The purpose of this Chapter from a case study perspective is to examine these risk questions at a more general level but also from an ethical tax viewpoint.

8.2 The Great Temptation of "Going Offshore"

As discussed above, the primary advantage from "going offshore" is cost reduction for the business not just in terms of lower salaries and on costs such as employment taxes but also in respect of all other associated costs of those functions placed "offshore" in the foreign jurisdiction. Such associated costs typically include office space, IT equipment, software development and the full range of office support services.

These projects should be distinguished from "outsourcing" projects, that is, the placement of usually specialised services outside the organisation such as legal or actuarial services. It is also possible to "outsource offshore" as is sometimes colloquially

known, that is, the placement of specialised services to a lower cost foreign jurisdiction.

Apart from cost reduction, it should be recognised that there are a number other advantages to offshoring including the capacity to service potential customer enquiries and customer service requests "around the clock" in the twenty four business cycle potentially generating additional revenue for the business but at a reduced cost to the local function.

Depending on the nature of he business, there may also be the potential for the opening up of new markets in the offshore jurisdiction by establishing commercial contacts through the *offshoring* process although this could equally be achieved by *outsourcing* to the foreign jurisdiction as well.

From the viewpoint of attracting quality staff or retaining staff at the head office level, the possibility of improved opportunities for *international* placements may also prove to be attractive as part of the overall human resources strategy of an organisation.

From a *tax* viewpoint, it should be also noted that a number of *emerging* economies offer various forms of tax concessions and tax incentives to establish a business presence within that foreign jurisdiction. These may be lucrative in the short to medium term, but the potential tax risks relating to these

concessions and incentives requires consideration from a longer-term viewpoint, which is discussed below in Section 8.4.

8.3 Commercial Risks

One of the biggest risks of offshoring is that companies tend to *over-estimate* the benefits in their business cases and *under-estimate* the rapid economic development in those foreign jurisdictions. Typically, the business environment of any potential “offshoring” foreign economy is developing far faster as a result of the “incentivised ”economic circumstances in that economy than the Western economies that seek to place functions within them.

While initial financial outcome may look very good based on *current* assumptions, the financial outcome in five to ten years may look radically different. The combination of professional salaries in those emerging economies moving closer to global norms, particularly for IT professionals and the increasing strength of the currencies for similar reasons will potentially mean that the cost advantages originally sought may completely disappear and possibly reverse in time.

Changes in Government in the emerging economies or tough economic times locally or globally may cause changes in economic policy also resulting in increases in costs to the business. Once established in a foreign jurisdiction, political influence for the migrating business tends to be dramatically reduced in both the foreign and home jurisdictions. The costs of returning to the home jurisdiction may also be prohibitive in terms of cost and extremely disruptive to the wider organisation and customer base rendering this option impossible.

Apart from potential unexpected costs, establishing the functions in the foreign jurisdiction may prove more difficult than originally anticipated. The inability to adequately test potential business partners through the normal due diligence processes and controls may result in a real deterioration in the quality of services, temporary or permanent.

Reputation risk for migrating businesses should also not be underestimated. Repeated headlines referring to local business icons moving functions to foreign jurisdictions with local losses of jobs tend to be seen very poorly by both customer and Government alike. Competitors who have not migrated their functions offshore to a foreign jurisdiction will also find soft targets in the businesses that have resulting in likely further damage to the migrating business.

Potential loss of *intellectual property* through employees moving to competitors in foreign jurisdictions should also be recognised as a real risk. Many jurisdictions do not have the same legal protections in place as Western Economies and there may be little sympathy from local authorities for foreign companies complaining about "successful" local start up businesses.

Inefficiencies due to different time zones or differences in work or local culture may also prove costly. Further, the risk of local industrial action over work practices and remuneration should not be underestimated. Foreign jurisdictions may not have the same industrial law protections in place such as compulsory arbitration to encourage settlement of work place disputes.

Overall, any move offshore must be carefully considered from a risk perspective. The above risks are but a few of the many that may be encountered in practice turning a "brilliant cost cutting move" in to a commercial poisoned chalice for the organisation.

8.4 Tax Risks

The tax risks associated with offshoring, outsourcing and indeed offshore outsourcing should also be carefully considered by any organisation contemplating such a path.

While *current tax risks* may be considered and managed with reasonable certainty, the impact of *future tax risks* is extremely difficult to predict and manage both in terms of the direction of the foreign jurisdiction's emerging tax policy and unforseen additional tax costs related to the migrated functions. Such potential future risks rarely form the basis of detailed advice due to the extreme difficulties in predicting such tax outcomes with most advisers staying closer to announced changes to the tax law perhaps the findings or recommendations of tax reviews being conducted in that foreign jurisdiction.

Some jurisdictions may treat the migrated functions as a sale *of part* of the business for tax purposes resulting in a potentially large capital gains tax liability arising for the organisation. While this may be managed for an initial *outbound* move offshore by an organisation, the emergence of such legislation in the foreign jurisdiction may effectively prevent a return of the migrated functions back to the home jurisdiction, a point generally over-looked in business cases presented to senior executives and Boards.

Further, other jurisdictions may under their interpretation of the transfer rules use under the *comparable uncontrolled price* method (the open market price) the service charges charged by third party service providers in the *home* jurisdiction, rather than the more usual *cost plus method* approach (a small mark up on fully absorbed cost) of the

jurisdiction providing the service in the foreign jurisdiction.

Another possible tax risk is that the foreign jurisdiction will increase the withholding taxes, local VAT or GST on such migrated services sourced in that country and such taxes may not be creditable or allowed to be used in the home jurisdiction.

Each of the above changes to the taxation law in the foreign jurisdiction will have a substantial impact on the financial outcome of the outsourcing business case and therefore should be financially factored in to the proposal.

8.5 Addressing the Ethical Tax Questions

From an ethical tax viewpoint, there are substantial issues for Lawmakers in allowing offshoring practices to flourish within their jurisdiction without any properly structured and considered policy evaluation. It is not a strong argument to suggest that free market forces should govern the offshoring question for a number of reasons.

Firstly, by permitting functions to be moved offshore the Lawmakers are allowing a valuable part of the business to be moved out of the jurisdiction without any consideration of potential taxing points. Many countries under their taxation laws deem taxing points and impose taxation liabilities on exiting

entities from the jurisdiction. Such tax treatment therefore requires appropriate consideration.

Secondly, allowing functions to be moved offshore will result in the loss of local jobs and generally erode local employment conditions. Many perceived “low value” jobs from the big end of town’s viewpoint are in reality the “starter” jobs for many loftier careers. Learning to accept direction in employment, working with customers and being part of a focussed work team are invaluable skills to be gained as part of the transition from the education system to the workplace. It is a far better for any economy to engage the youth in more junior roles to fully understand what the workplace is about and keep them focussed than have a highly educated but unemployed youth disgruntled about their “work entitlements”.

Thirdly, losses of local jobs through migrating functions will put pressures on national budgets through the payment of long term or even temporary unemployment benefits. Retraining of more mature staff including lengthy formal education following redundancy will add to these costs. Further with more mature workers nearing retirement, the prospects of re-employment even with retraining programs may not be high resulting in an additional financial burden to the retirement system and also the health system. It should also be recognised that these more senior workers in our community would

have not chosen to retire but instead were "retired" without any personal choice in the matter.

Fourthly, any reduction in local staff by a major corporate will immediately trigger the "specialist expertise" of human resources teams with the objective of keeping redundancy payments to a minimum. Some companies contrary to workplace laws will, ahead of any restructuring, seek to de-motivate or harass staff from their employment to reduce such redundancy costs. Such practices are clearly not ethical or indeed legal in most countries, particularly for otherwise loyal and high performing staff. From a corporate risk viewpoint, such actions are generally perceived to be covered by confidentially agreements even if signed under duress. Depending on the circumstances, this may not prove to be correct.
Fifthly, any loss of jobs by allowing businesses to migrate offshore will also erode the tax base simply by way of a reduction in employment taxes levied on the former employees of the company. This will then generally reduce the capacity of the local economy to fund its tax-funded programs generally.

The above issues are all substantial matters for detailed examination by the Lawmakers of any Government, if not a full formal Government enquiry.
It is entirely reasonable for any Government to find that large companies should be directly levied or charged for the costs borne by them as part of the

company’s partial exit of the jurisdiction. This should properly include the repayment of historical expenses in providing Government incentives to support those businesses. Further, it is also important that proper workplace practices be followed in such “restructures” to ensure full compliance with employment laws with appropriate sanctions for senior executives and Directors for breaches of such laws to prevent such practices.

Chapter 9

Case Study 3 in Ethical Tax Behaviours - Acquisitions, Divestments and Associated Transactions

9.1 Introduction

Modern business is extremely dynamic and challenging with most of the world's major companies being subject to what has become a world of *"dog eat dog"* transactions. Quite legitimately, in today's financial world shareholders ask of the companies that they have an interest in whether additional *shareholder value* can be extracted by acquiring a rival business or indeed by being the subject of a friendly or possibly a hostile takeover.

With the influx of high liquidity and historically low interest rates, superior performance is no longer a safeguard against being taken over and broken up by a competitor in the pursuit of "adding value". Modern Chief Executive Officers must actively consider such transactions with their Boards as part of normal business strategy. Indeed, potential acquisitions and divestments and the financing arrangements that support them will form a major part of every company's cyclical plans whether those plans be annual, three or five yearly.

This cauldron of activity has become a rich sources of fees for the aggressive tax advisors, particularly where companies are quickly sold in one jurisdiction with profits are extracted rapidly offshore to tax haven or a jurisdiction where a cooperative tax agreement does not exist, thus avoiding domestic taxing points.

This Chapter explores some of the ethical tax issues around the acquisitions and divestments question and potential ways forward for the Lawmaker to address societal imbalance.

9.2 Funding Arrangements for Acquisitions

In medieval times, there were only *two legal* ways of funding the acquisition of an asset. Either the money or money equivalent was available to purchase an asset in which case it was a purchase *by way of equity* or the money was borrowed from a money-lender in which case it was a purchase *by way of debt.*

In the 17th and 18th centuries, the various forms of ownership emerged such as companies, partnerships and trusts, but nevertheless the basic distinction between debt and equity remained. As the various tax systems around the world emerged, interest was treated as a straightforward tax-deductible item against taxable income. This dichotomy also presented certainty for the taxpayer and resulted in a no risk tax position.

In the 1960's and onwards, there was a considerable increase in general liquidity for the banks through the increasing wealth of the middle classes and the introduction of effective retirement saving plans that increased deposits dramatically. By the 1980's and 1990's, this general liquidity matched with the opening up of finance systems across the globe including "floating" or trading of currencies resulted in the emergence of a plethora of investment banks and a multitude of "tax based financial products".

Given the generally much higher interest rates being incurred at that time, there was considerable pressure on the treasuries of the major corporates to examine and implement such financial products to reduce financing costs. Unfortunately, this created a "hot bed" of financial exposures for the major corporate for a number of reasons.

Firstly, the investment banks themselves used generally very aggressive sales tactics quoting restated "after tax" funding costs as if these restated figures were virtually a certain outcome. Further and despite their financially flimsy appearance, the structures were allowed to be proceed relying heavily on the reputation of the wider organisation in respect of more conventional and "safe" funding arrangements.

Secondly, some of the major accounting firms were prepared to accept engagements from the investment banks to prepare what amounted to no more than "advocacy" advice stating the tax arguments in support of the particular transaction, which was then presented to the client as legitimate tax advice from a major firm *fully backin*g the major investment bank in the arrangement. The downside tax risks were never the subject of real examination either being played down or not mentioned at all.

Thirdly, the concept of independently assessing risk, let alone tax risk management, was yet to meaningfully develop within the major corporates. As such, considerable reliance was placed by the major corporates on the perceived reputation of the investment bank and the tax advisory firms to correctly advise the optimal "tax efficient" financing structures.

Fourthly, the relevant Revenue Authority or the Lawmakers were never consulted on their views as to the efficacy or otherwise of the arrangement. The response by the relevant Revenue Authority and the Lawmakers tended to be swift with either specific loophole legislation being introduced or challenges being made through the Court System.

Fifthly, follow up action in the event of a Revenue Authority investigation was never really contemplated and the major corporates were often

left holding the responsibility for fighting the case, while the investment bank and the tax advisory firm pointed the finger at each other as to who was at fault.

In today's environment, under either an conventional or an ethical approach, such an outcome would be far less likely to arise due to stronger risk management practices generally that would require a closer working relationship with the banks and the tax advisory firm discussing all risk issue. Further, such risks issues would now be followed by full disclosures to the Regulator and the relevant Revenue Authorities to determine their views by way of discussions *and* written proposals or by way of a formal view.

Nevertheless, today's financing structures still place challenge on the treasury teams of major corporates. One such structure is the so-called hybrid structure that carries elements of both debt and equity depending on the individual definitions of those terms in the relevant jurisdictions.

The issue from an ethical viewpoint arises where money is forwarded from a parent company to another jurisdiction and interest is claimed by way a tax deduction under the laws of that other country where it is treated as a loan arrangement but is returned to the first country as an exempt dividend and is not assessable in that country. The reason for this is that it is considered an injection of equity under the law in that country This arbitrage

"opportunity" essentially arises as a result of a mismatch in characterising the same arrangement as "debt" in one country and "equity" in the other.

The net benefit from the arrangement is a lowering (perhaps only temporarily) of the cost of funding. However, it is an arrangement that was not intended to occur by the Lawmakers of *both* jurisdictions and *possibly neither*. While the mismatch remains, there will be a clear distortion towards the arrangement thus creating an *opportunity* for the *aggressive* taxpayer but a *dilemma* for the *ethical* taxpayer.

Potential approaches for Lawmakers to address this problem from an ethical viewpoint are discussed in Section 9.5.

9.3 Taxes on Transfer of Assets

Most jurisdictions around the world charge some form of taxation or duty on the transfer of assets following an acquisition. Such transfer taxes will arise whether an acquisition is hostile or friendly, whether it is an acquisition of a company by way of share purchase or a business by way of asset purchases or whether the acquisition is funded by way of debt or equity.

Typically, the objective for the acquiring entity from a transfer taxes viewpoint is to keep the payment of such taxes to a minimum. From the viewpoint of tax

planning, it is not uncommon for the transfer taxes to determine the overall structure of the transaction.

In some jurisdictions, a purchase of shares may result in a lower transfer taxes charge than a purchase of the assets and in other jurisdictions the reverse may be true. In most jurisdictions, there will be a natural transfer taxes charge whether an acquiring company chooses an acquisition by way shares or by way of purchase of business assets.

Generally, it should also be recognised that the transfer taxes law internationally tends not to be as robust as its income tax equivalent in terms of anti-avoidance provisions. In such jurisdictions where the anti-avoidance provisions are not strong, the aggressive taxpayer will seek to exploit the position by attempting characterisations of assets to force the lowest possible initial tax result and then run the risk of detection, but in the belief that the argument will be successful.

Notwithstanding, a tax risk will remain for the aggressive taxpayer that the relevant Revenue Authority will audit the transaction and raise an adjustment and penalties against the taxpayer that should ne appropriately advised to the Board.

The question then arises as to what is the correct approach for the ethical taxpayer in such circumstances. As stated many times throughout this

volume of the Pentology, the ethical taxpayer will follow the basic principles of the ethical tax approach by working within the taxation law and if there is uncertainty in respect of the taxation law to then clarify the legal position with the relevant Revenue Authority to eliminate all taxation risk.

In such circumstances, the same advice may well be received from the external adviser as the aggressive taxpayer. However, if the Revenue Authority agrees following full disclosure from the ethical taxpayer that the approach is acceptable from a legal viewpoint, then no further action is required apart from confirmation in writing. However, unlike the aggressive taxpayer all tax risk has been removed and this again should be the subject of reporting to the Board.

9.4 Acquisitions and Divestments Structuring

From the perspective of transfer duties there is a natural outcome on acquisitions and divestments based on the arm's length valuation of the assets being transferred.

The approach from the aggressive tax avoider is to attempt to circumvent the arm's length valuations, if they exist under local taxation local law, by replacing them with their own purported arm's length valuations or alternately in the absence of such arm's

length valuation requirements simply stating the most advantageous valuations to produce the lowest possible taxation outcome. There are two aspects to this.

Firstly, taxes on transfer of assets, which has already been discussed above in 9.3.

Secondly, valuations that provides the best outcome for income tax purposes. From time to time, virtually all jurisdictions have one favourable tax concession or another on the purchase of capital assets. This may range from the more humble depreciation on the purchase of plant and equipment to the more exotic purchase of technology for the purposes of research and development by the acquirer. At one time, a major tax jurisdiction allowed a 150% deduction on the purchase of an entire company if purchased for research and development purposes. Given the tax rate at the time was 49%, this allowed 74% of the company to be paid for through the tax system whereas previously there was no tax deduction available. While this position did not last long, it was nevertheless entirely legal and indeed ethical from a tax viewpoint to make the claim.

Generally, any positions on tax concessions taken and valuations made for tax purposes should be the subject of confirmation by the ethical taxpayer with the relevant Revenue Authority or Revenue Authorities. Again, aggressive taxpayers will typically

dismiss this action introducing tax risk for the major corporate or organisation.

9.5 Addressing the Ethical Tax Questions

The most important question from the Lawmaker's viewpoint is how to ensure the integrity of the acquisition and divestment process including financing arrangements under the various heads of taxation and the wider regulatory requirements of Government.

The aggressive major corporates and investment banks are particularly adept at finding weaknesses in any Government system and exploiting such weaknesses whether it is by way of lowering their tax payable below what is legally due through aggressive taxation practices, finding a way to take the proceeds of a divestment out of a jurisdiction past taxing points and avoiding tax completely or finding a way around other regulatory hurdles and requirements to the financial benefit of the major corporate.

As recent commercial history has shown, such outcomes do occur far too frequently for comfort from a taxation and regulatory viewpoint and raises the question why does this occur?

One of the greatest weaknesses with virtually every Government around the world is that there is no single body that controls the acquisition and

divestment process from end to end. As such, this then becomes fair game for the major corporates and investment banks to divide and conquer between the no doubt many Government bodies and instrumentalities typically involved only in narrow aspects of the process.

By consolidating all approvals, payment of taxation due and agreed with the relevant Revenue Authorities, the release of funds net of appropriate tax paid to the sellers of the asset and other more general approvals into a single statutory "super authority" body charged with overall responsibility for such transactions should substantially reduce the opportunity for avoidance of taxation and regulatory exploitation.

This "one stop" shop concept for taxation and regulatory matters could be used in other situations of regulatory significance such as the transfer pricing and offshoring situations outlined in Chapters 7 and 8 above to pre-approve such transactions from both a taxation and regulatory viewpoint.

There is little doubt that the companies pursuing an ethical corporate approach generally would accept the simplicity and certainty of a one-stop shop.

Chapter 10

Emerging Issues Influencing the Taxation Law

10.1 Introduction

The taxation law and its various supporting mechanisms are evolving continually to adapt to an increasingly complex world.

Just 25 year ago, the notion of shopping by way of a computer in one's own living room was barely considered *in fantasy* let alone *in reality*. Now it is the curse of every father with a keyboard savvy daughter ordering a constant stream of deliveries to the front door.

Unlike the befuddled father, the Lawmakers and the relevant Revenue Authority must develop laws and strategies to ensure that new commercial arrangements are appropriately taxed and that the Revenue Authority captures that tax through its compliance measures.

While it is envisaged that the Lawmakers and the relevant Revenue Authority would consider the promotion of such behaviours as one of their top priorities, there is the interesting question regarding what measures can be taken to either improve the existing rules or to develop brand new set of rules for such a purpose.

The purpose of this Chapter is to consider a range of potential measures that could achieve this purpose.

10.2 Rating System for Analysts and Investors

As noted earlier in 2.7, regulators and other stakeholders will likely favourably consider a company that takes an ethical stand on any matter including taxation whether this is part of a required taxation transparency regime or merely a voluntary disclosure.

If a company is publicly listed, the advantage should be a likely positive impact on the share price due to the recognition that there are no downside tax liabilities, that there will *likely* be lesser statutory penalties of any kind compared to more aggressive competitors and there will *likely* be a quality management team prepared to examine complex issues and appropriately handle them.

The question then arises as to whether this very real and tangible benefit can be meaningfully quantified for rating purposes by stock market analysts and investors. This may require a change of disclosure requirements to allow such analysis to occur but would provide for a number of advantages.

Firstly, the market could directly value the introduction of an ethical tax regime.

Secondly, taxation should be considered a lead indicator of financial management and a quantifiable rating will assist this analysis.

Thirdly, it would be possible to establish a dedicated ethical tax fund for investors. If one is correct in the assumption that ethical corporate tax behaviour is an indication of strong financial discipline and strong financial discipline is an indication of market outperformance then it is likely that such a fund will be attractive to investors. Such a fund would also be assisted by the introduction of potential tax incentives under an ethical tax regime such as a lowering of the corporate tax rate that would increase returns to investors (see 10.3 below).

Finally, it should be noted that analysts are innovative in using new disclosures and measures to analyse the market. The question will arise within the analysts' cohort as to how this measure could be used either individually or in combination with other factors to examine potential out-performance against the overall index. Only time will tell!

10.3 Tax Incentives for Ethical Taxpayers

The concept of a tax holiday is well known in developing jurisdictions whereby qualifying taxpayers receive an exemption from tax or a reduced rate of tax for a period of time with the objective of

establishing and building businesses within that particular jurisdiction.

In advanced jurisdictions, various tax concessions or elections are available to encourage certain types of behaviour usually with the objective of promoting economic activity.
Again on the assumption that Lawmakers would like to promote ethical behaviours with respect to taxation, the question arises whether taxpayers should be directly rewarded for such ethical tax behaviour.

One such approach may be for Lawmakers to define what is considered to be ethical behaviour for corporates and then to allow a reduced tax rate for qualifying taxpayers as part of an ethical tax regime. As such, it would be mandatory for taxpayers to make an election whether to be part of the ethical tax regime or not.

The extent of the reduction in the tax rate will be determined on its own merits by the Lawmakers in conjunction with advice from the relevant Revenue Authority in terms of likely practical effectiveness.

While such an approach has not been used before in this context, there are sound reasons for its introduction.

Firstly, it would encourage corporate taxpayers to be ethical from a tax perspective by providing a direct tangible financial reward.

Secondly, as noted in 10.2, a quantifiable benefit would likely lead to a positive impact on a publicly listed vehicle's share price. Further to the example in the opening comments about Volkswagen, it should be noted that the share price of Volkswagen following the disclosure of its unethical behaviour dropped by as much as one third wiping some 17 billion Euros off the total value of the company. The resignation of the CEO and the "reinstatement" of ethical behaviours had an immediate positive effect on the share price.

Thirdly, the cost of the reduced rate for ethical taxpayers would be funded at least partially by an increase in the corporate tax rate for corporate taxpayers who opt out of the ethical tax regime and also reduced requirements and resources for the relevant Revenue Authority in monitoring the qualifying company or organisation.

While a novel approach no doubt and one that has never been tested in practice, an ethical tax regime that offers a corporate tax rate discount is entirely consistent with other tax incentives that have been highly effective globally in encouraging other commercial behaviours such as Research & Development Tax Concessions and Film Incentives.

10.4 Increasing Regulatory Penalties

The corollary to offering a tax incentive for ethical tax behaviours is to increase tax penalties for aggressive tax behaviours where there is such a profoundly clear disincentive associated with the tax risk that the behaviour is simply eliminated.

In addition to the current regime of penalty tax and penalty interest, one alternate approach may be to introduce a further penalty tax regime along the lines of the “three strikes law” of some 24 US States. Under these laws, the Judges hearing such criminal cases are required to impose much harsher sentences on third time offenders with the objective of causing the crime “wave” to stop completely as a result of very long prison sentences.

In respect of taxation matters, where aggressive tax behaviours resulting in large tax adjustments against the taxpayer occur on multiple occasions within a defined period of time the outcome would be a rapidly escalating scale of penalty with a “knock out” penalty on the third occasion such as a permanent increase in the corporate tax rate.

All relevant terms would of course be defined by the relevant jurisdiction, but again such a punitive measure would be likely to, if not certain to, reduce the incidence of aggressive tax behaviours.

The link between the taxation law and the desired behavioural outcome is discussed further in Chapter 11.

10.5 Strengthening the role of the Statutory Taxation Officer within Corporations

In most jurisdictions, there will be a primary statutory officer who asserts that the tax information in respect of a particular company or organisation is true and correct.

Usually, the relevant officer will base this assertion on proper enquiry including testing of controls across the various tax processes supporting the relevant tax filing.

In recent years, there has been an international trend to increase both the obligations and the penalties relating to taxation filings. Given this emphasis by the Lawmakers and Revenue Authorities, consideration should be given by companies and organisations to ensuring that the reporting line from the Statutory Taxation Officer to the Board is sufficiently close to allow for direct access and candid discussions regarding tax risks.

There are several reasons for this.

Firstly, it should be remembered that the total tax impost on companies might well exceed 50% of net

revenue before tax when all taxes paid including direct, indirect and employment taxes are taken into account. As such, the Board in allowing direct access should give appropriate recognition to the quantum of tax payable and the importance that it is calculated correctly.

Secondly, the Statutory Taxation Officer (usually the Chief Taxation Officer) will likely be the *most knowledgeable* officer in the company regarding the technical merits of taxation matters and its impact on the company.

Thirdly, the Statutory Taxation Officer (as discussed before) has *personal legal responsibility* for the carriage of such matters and as such should lead any discussions on tax matters.

Fourthly, the Statutory Taxation Officer is required to *independently consider* taxation matters and initiate action based on these views.

Finally, it should it should be recognised that the Statutory Taxation Officer cannot be improperly influenced or coerced in his decision-making. This is discussed further in 10.6 below.

10.6 Coercion of Statutory Officers

As noted in 10.5, the Statutory Taxation Officer is required to independently consider taxation matters and initiate appropriate action based on these views.

The question arises as to how Lawmakers and indeed the individual Statutory Taxation Officer should respond to acts of coercion or similar behaviour from a person or persons *internal* to the organisation or by a person or persons from an *external* party.

Coercion can take many forms but the essential element is that the Statutory Taxation Officer is placed in a situation where an independent decision cannot be made as a result of comments or actions including threatening comments or actions.

This should be distinguished from the normal Board processes where the Board would openly discuss a tax matter with the Statutory Taxation Officer and seek to resolve differences of opinion. After discussions, if the Statutory Taxation Officer cannot resolve the differences, although unusual, the Statutory Taxation Officer would normally tender his resignation to the Board due to “loss of confidence” issues by the Board.

A prime example of coercion is where an officer in the reporting line between the Statutory Taxation Officer and the Board takes the Statutory Taxation Officer aside for a “private discussion” and makes verbal threats or demands for the Statutory Taxation Officer

to act in a certain way in his decision-making. Apart from the fact that the Statutory Taxation Officer is not then in a position to make an independent decision, the Statutory Taxation Officer is further put at risk as a result of the coercive officer being able to deny the verbal threats made during that "private discussion".

When such coercive action occurs *within the organisation,* the Statutory Taxation Officer should stand down at least temporarily, draft a detailed report of the coercive action and immediately submit the report to the Board. If the Board does not take appropriate action, it may also be necessary for the Statutory Taxation Officer to report the matter to the Relevant Regulator (if the company is licensed) and also the relevant Revenue. Authority. Otherwise, the Statutory Taxation Officer will risk prosecution for potentially breaching a statutory duty.

When such coercive action occurs from a party *outside the organisation*, it is no doubt less sensitive politically at least from an internal viewpoint, but a similar process of standing down, preparing a report to the Board and advising the Relevant Regulators and the relevant Revenue Authorities should be immediately undertaken.

The next question is how should Lawmakers address the coercive actions of the internal officer or an external third party in such circumstances from a legal viewpoint.

There is little doubt that both actions may result in a tax fraud being committed, however, conspiracy to defraud a Revenue Authority may be considered a little obtuse or simply too difficult from a legal viewpoint to address such matters.

The better view is that such coercive or similar behaviour is closer in law to the crime of perverting the course of justice where a legal decision-maker such as a jury member or officer of the court is swayed from their legal duty through the actions of an external party.

While perverting the course of a statutory officer in the performance of a statutory duty may be a crime in some jurisdictions, it is strongly recommended that Lawmakers in all jurisdictions add such a crime to the law books as an integrity measure to allow the tax process to operate as it was intended.

10.7 Availability of Choice in International Advisors

As discussed in Chapter 6, one of the basic principles of ethical or no risk tax behaviour is to ensure that independent and accurate tax advice is available to support tax positions taken.

This is relatively easy to satisfy where a company or organisation is based in one jurisdiction only. For a

Multinational Enterprise, consistency of advice across all the jurisdictions in which it operates is essential.

As Multinational Enterprises have generally become much larger through acquisitions and mergers, so have the major accounting firms at one time the “Big 10” but now just the “Big 4”. Additionally, the growth in service options available within such firms has also grown considerably raising conflict issues.

The difficulty is that if a Multinational Enterprise decides to change its accounting firm for any reason and there is a conflict with another firm, then the Multinational Enterprise will be limited to a choice of just two firms. If there is a conflict issue with two firms, then the Multinational Enterprise will be limited to a choice of just one!

From a competition and regulatory viewpoint, this position appears absurd. With so few choices, the risk of market power or cartel behaviour should be a concern to regulators.

The question arises as to what can be done to address this issue. It would seem unlikely that the Big 4 would of their own accord move to split and recreate a “Big 8” due the costs and business disruption involved. Therefore, the solution would seem to fall to the regulators as to whether they can find a solution by way of break up through a complete split, a regional split or perhaps a functional split.

As alluded to in Chapter 6, the alternative to "splitting up" a firm is to introduce much tighter regulation on the "Big 4" firms by introducing a new Global regulator who would enforce high practice standards or force the firms to publicly list and subject themselves to stock exchange listing rules in a competent jurisdiction or both.

It may be observed that the reduction from a "Big 5" to a "Big 4" by way of the collapse of Arthur Andersen & Co some years ago may well have created more problems globally than the intended sanctions. Of itself, this may provide valuable lessons for Lawmakers.

10.8 Demonstrating Ethical Behaviour

The concept of an ethical tax regime was mooted in 10.3. This raises the question for Lawmakers as to how to ensure that if an ethical tax regime offering a discount or other tax concessions is introduced, how should it be monitored to ensure demonstrably ethical tax behaviours.

Unfortunately, the current set up virtually all tax practices, accounting, legal or otherwise means that an immediate conflict would likely arise due to independence considerations.

This would essentially mean the foundation of a new advisory discipline with appropriate education, training, accreditation and continuing education.

From a tertiary education viewpoint, accounting, business law and law would require only a modest change given the generally ethical positions taken.

From a Regulatory and Revenue viewpoint, very little change at all would be required given it is their responsibility to act properly.

These matters are further discussed in Chapter 13.

Chapter 11

The Mathematics of Tax Certainty

11.1 Introduction

As mentioned in the opening Chapter (1.8), an interesting question arises as to the relationship between ethical tax behaviours and the resultant financial outcome of this strategy. As such, it is the premise of the Pentology that ethical tax behaviours will (or should) produce a profitable outcome over time and over a level playing field.

This is a particularly important issue for Lawmakers charged with the responsibility of ensuring compliance with the taxation law.

Clearly, if the taxation Lawmakers do not build in sufficient sanctions in the taxation law to *discourage* aggressive or non-compliant tax behaviour then Lawmakers will in effect be *encouraging* aggressive or non-compliant tax behaviour. It will not matter what the lawmaker or a politician states publicly or indeed what the preamble to the legislation advises if the outcome is to produce a positive advantage to proceed down the aggressive path.

While many companies and organisations will still operate ethically by choice, a competitive tax disadvantage will challenge some companies or

organisations. For example, those companies or organisations that are in a marginal financial, position, that are the only ethical player in an industry, that are simply aggressive by nature or that are in a generally less regulated industry *may* lean to the aggressive side in the absence of appropriate sanctions.

A strong statement condemning avoidance behaviour by politicians requires equally strong laws to support those assertions. While politicians do have other considerations including international competitiveness which they must take into account in developing tax policy, the Lawmakers would be derelict in their duties in passing tax anti-avoidance legislation with inadequate sanctions – the so called "toothless tigers".

It should not be forgotten that any resources saved by both the private sector and Government on aggressive tax behaviour can be reapplied for more appropriate and beneficial uses.

Nevertheless, each path chosen by either the private sector or Government in relation to taxation has a reasonably predictable outcome and must be carefully considered to eliminate inappropriate behaviours.

It is the objective of this Chapter to explore some of these issues and to encourage others perhaps better

qualified in the mathematical field to further this work and build a better overall outcome for society.

11.2 Testing the Baseline Assumption

Under the principles of statistical prudence, all taxpayers will commence with the same first step on the way to the doors of choice between ethical taxation behaviours and taxation aggression.

That logical first step is to consider the ”low hanging fruit” of the taxation system, the “intended” tax benefits. As noted earlier, the intended tax benefits cover much more than the headline taxation concessions such as investment allowances or the research and development concessions but also include the many elections available under the various heads of the taxation law.

A complete analysis of all such provisions and elections under the taxation law and related legislation to determine the optimal outcome requires considerable discipline, a detailed knowledge of the taxation law and much time.

Nevertheless, this process will identify a very detailed list of further opportunities for a corporate taxpayer to claim tax deductions.

For the sake of this discussion, it is at this point that the ethical and aggressive taxpayers will take different paths with the assumption that both will be on even footing from a tax viewpoint.

Nevertheless, it is well arguable that the ethical taxpayer will be both highly considered and measured in identifying specific opportunities because of the no risk position adopted in the Board Tax Mandate. The aggressive taxpayer will likely miss potential opportunities through lack of discipline and taking risks at the management and executive levels to deliver the perceived tax gains with a view to impressing a Board.

This raises extremely interesting questions about risk taking behaviour in commercial situations generally and the outcomes of such behaviours. Clearly, these behaviours lack objectivity and are driven in the taxation industry by subjective feelings of being "smart" and "way ahead of the competitors", the well known sales techniques pushed by the sales gurus of the tax avoidance industry.

It should be stressed that the engineering profession necessarily built the Burj Khalifa in Dubai (the world's tallest building) and the Akashi Kaikyo (the world's longest single span suspension bridge) by extremely rigorous fail-safe procedures. If one compares the number of major structural collapses against the number of financial collapses of major

companies, it is not surprising that so many engineers rise to the Chief Executive Officer position of global companies. This is a rich and fascinating vein for researchers interested in how to select senior executives with the skills necessary to avoid such risk taking behaviour.

I certainly encourage research in this area to develop recruitment strategies to potentially avoid risk-taking behaviour by individual senior executives that may well assist to reduce the risk of destabilising financial crashes such as the Global Financial Crisis.

11.3 The Path of the Conservative Taxpayer

Once the baseline assumption has been set and the detailed list of further opportunities to claim tax deductions has been developed, the conservative taxpayer will then work with the regulator on uncertain positions or promote changes to the taxation law which only means a potential upside tax position. This should be explained in a little more detail.

At the point in time when the ethical taxpayer is uncertain as to the tax implications of a particular fact situation, a tax deduction *will not be taken*. For example, this may occur where a taxpayer introduces a new high-speed “state of the art” production facility costing $500 million, but is uncertain as to whether certain elements costing $100 million in developing

the facility will qualify for a further tax benefit under the relevant research and development tax incentive legislation. Let us assume a tax rate of 30% and that the research and development incentive allows for an additional 100% immediate write off on qualifying expenses. Therefore, the potential additional tax benefit is some $30 million.

The ethical taxpayer under the Board mandate will either seek external advice to confirm the position or seek to clarify the law with the relevant regulator.
If the path of external advice is taken and the doubt *cannot* be removed by way of discussion or referral to the regulator then a lobbying case should be considered for *potential* submission to the Lawmakers. The decision to submit will be dependent on the ethical taxpayer's assessment of the strength of the case and the views of the regulator. Clearly, there is little point going to a Lawmaker with a weak case, as it will potentially negatively affect the reputation of the ethical taxpayer and prejudice stronger submissions.

The outcome for the ethical taxpayer is that any change in the baseline position will be *to the upside*. In this way, management will *never* disappoint the Board by way of adverse tax decisions.

By providing certainty to the Board in relation to taxation matters, the Board also will also (or should)

have confidence in management's ability to handle such matters.

While not a financial benefit, this is nevertheless a key tangible benefit within the wider Governance process.

11.4 The Path of the Aggressive Taxpayer

The aggressive taxpayer will likely fully pursue all legal avenues, but will risk only downside positions in the event of a loss that includes penalties, penalty interest and loss of reputation. Again, this should be explained in a little more detail by way of the same high-speed production facility example referred to in 11.3.

At the point in time when the aggressive taxpayer is uncertain as to the tax implications of a particular fact situation, a tax deduction of $100 million *will be taken* and justified internally. So in this case, the tax benefit under the research and development tax concessions will be claimed by way of an internal opinion perhaps supported by external advisers *without referral to a regulator*.

The outcome for the aggressive taxpayer is that any change in the baseline position will be *to the downside.* There is little doubt that any competent Board will not be pleased with a potential string of adverse tax decisions. While the Board may initially support management in pursuing tax matters through

the legal system, loss of confidence in management's ability will eventually follow particularly if the Board is forced to make disclosures under listing requirements.

As with the tax avoiders of old described in the opening Chapter, the aggressive taxpayer will initially have the illusion of success that may represent an opportunity for short-term internal political gain, but the final outcome will potentially be the complete reverse.

11.5 Comparing Outcomes Under the Ethical and Aggressive Tax Paths

Large negative primary tax adjustments, penalties, penalty interest and loss of reputation through aggressive tax behaviours *never occur* where a taxpayer has chosen the ethical tax path and hence represent a permanent difference between the two choices. Again, this should be explained in a little more detail by way of the same high-speed production facility example referred to in 11.3 and 11.4.

As noted in 11.3, the ethical taxpayer cannot have a potential tax adjustment as the tax position taken will have been confirmed with either the Regulator or the

Lawmakers so there is *no possibility* of penalties, penalty interest, loss of reputation or other adverse outcomes including heavy legal expenses. In our example, the cost to the ethical taxpayer of an adverse decision of the Regulator will be zero dollars.

The path of the aggressive taxpayer is somewhat different. In our example, the aggressive taxpayer has claimed his $30 million research and development incentive but left his tax risk position open and is exposed despite his internal documentation. The next stage for the aggressive taxpayer will be an audit by the Regulator usually some two to four years after the initial claim was made.

The tax risk here is that the Regulator may simply disagree with the internal view of the company irrespective of the belief of the strength of the argument by the company or the external adviser.
Once a large tax claim is made and an adverse decision arises, the legal expenses relating to pursuing a matter through the Court system appear relatively modest. Nevertheless, penalty interest will in many jurisdictions continue to accrue and should be taken in to account.

In this case, given the quantum involved the aggressive taxpayer probably has little choice but to fight the Regulator's initial decision through the lower Court and the various Courts of Appeal. Normally, this will take some years to achieve. In our case, let us

assume that audit was undertaken some three years after the initial claim and that the aggressive taxpayer was ultimately unsuccessful, which was the same result as for the ethical taxpayer. The total tax adjustment for the aggressive taxpayer as compared with the ethical taxpayer will be as follows:

	Aggressive Taxpayer	**Ethical Taxpayer**
Primary Tax	$30 m	$30 m
Penalty @ 50%	$15 m	0
Penalty Interest @ 15% per annum	$31.5 m	0
Legal Expenses	$2 m	0
TOTAL	$78.5 M	$30 m

There are some further points that should be noted.

Firstly, the ethical taxpayer does not have a primary tax adjustment of $30 million. This is to recognise the fact that the ethical taxpayer did not claim the deduction in the first place and to ensure the comparison of like for like.

Secondly, the aggressive taxpayer's senior management will need to advise their Board of the $78.5 million total adjustment and, if publicly listed, the relevant stock exchange by way of announcement.

Thirdly, the aggressive taxpayer will likely suffer an increased tax risk rating by the relevant Regulator, an immediate decrease in stock price, if publicly listed, to reflect the financial loss incurred by the company and a general loss of reputation.

The above example is designed to illustrate the differences between potential outcomes under the ethical and aggressive tax approaches and how very large permanent differences can arise through aggressive tax behaviours. In practice, it should be recognised that such situations do arise on an all too frequent basis and, if tempted to pursue aggressive tax behaviours, major corporates will more times than not end up with a highly negative financial result, which could easily have been avoided through ethical tax practices.

11.6 The Variables Determined by Law

In the above example, certain assumptions were made in respect of penalties and penalty interest. As noted in the introduction to this Chapter, if the taxation Lawmakers do not build in sufficient sanctions in the taxation law to *discourage* aggressive or non-compliant tax behaviour then Lawmakers will in effect be *encouraging* aggressive or non-compliant tax behaviour.

Ethical tax behaviour is the product of a decision. If a decision is made by a major corporates *not* to act ethically in terms of their overall handling of the taxation function, then it is the absolute duty of the Lawmaker to step in and ensure that ethical tax practices are pursued to reflect community values and expectations of Government..

Clearly, no sanctions at all would open the floodgates to aggressive tax behaviours. At the other end of the scale, it is the view of the Pentology that high taxation penalties for aggressive tax behaviours including criminal sanctions should be considered absolutely acceptable if they promote ethical behaviours. This is both an important moral and legal question for the Lawmakers, but is also a question for the wider society who elected them. The preferred option is specific ethical tax legislation with incentives to encourage such behaviours.

Chapter 12

A Message for Our Times

Every person born to this earth has the capacity to make individual choices during what is a limited lifespan. Each choice will have an outcome. Some choices result in the expansion of human knowledge and result in great benefits to mankind. Other choices are far more self-serving and seek to benefit only the individual decision-maker.

Aggressive taxation behaviours may be viewed by some as little more than a game of chance in the casino of life. Such behaviours only seek to financially benefit the individuals who seek to play "the game" to the detriment of the wider society.

If an engineer were to deliberately substitute sub-standard materials to cut costs and a major bridge collapsed as a result, would society seek to reward the engineer for his deception? If a senior executive in a bank were to defraud that company of tens of millions of dollars, would that executive receive his full bonus at the end of the year? If a specialist doctor were to avoid necessary surgical training to go skiing and a patient is disfigured as a result, would his medical board enquire as to whether the snow was good? In all these cases, the answer would be a resounding "no". Yet, against all moral sense the aggressive tax behaviours continue to

seemingly thrive pushed by the players in the aggressive tax industry.
But tax is *not a game*!! It is the action of the Lawmakers to responsibly raise the funds from society and to morally allocate those funds back to society.

In order to do this and meet their wider duties in a democratic system, the Lawmakers must have *a deep understanding* of *both* the *responsible raising* and the *moral allocation* under the taxation process.

Balance is extremely important in this regard. Lawmakers pending time *only* with "the important people" of society will never deliver this deep understanding as the rich, the aspirational rich and those that serve them *tend* to be driven by their own interests. Lawmakers should ensure that they also directly talk to and *deeply feel* the circumstances of those less fortunate than themselves. They should look into the eyes of the mother who can no longer afford the necessary medicine to ease her child's pain from an incurable disease because a billionaire needed a tax break on a casino. Or perhaps sit down and share a sandwich with a homeless person, find out how he or she got there and consider the funding of a program to assist their return to mainstream society, rather than funding an exemption for a $20 million gain on the sale of a principal residence of a property developer.

The individual people who are the voters of our democratic nations scattered across our global society may also pause and take a deep breath and consider how aggressive tax practices affect the those around them. Again, there is a simple choice between voting for Lawmakers who will act on aggressive tax behaviours and those who will pander to “the top end of town” only.

While ultimately the voters will decide on whom to grant the next legislative mandate at the end of a Government’s term by way of the election process, the immediate legislative agenda is still very much the choice of the present elected Lawmakers.

In a casino, the house controls the odds to ensure a profitable outcome. In any jurisdiction, the Lawmakers similarly control the inter-election outcome of aggressive tax behaviours.

Measures that specifically encourage ethical tax behaviours by way of, for example, the discounting of corporate tax rates (and perhaps a premium for those taxpayers electing not to be ethical) should be carefully considered in a form appropriate to that jurisdiction and enacted. It does not matter whether that jurisdiction is generally “high tax” or “low tax” as the outcome against aggressive tax behaviours will be the same.

Lawmakers who purport to be against aggressive tax practices must ensure that the outcome of their actions is consistent with their stated policies. Aggressive tax practices should not be seen to be "smart" nor "worth the risk" to an organisation pursuing such practices.

Personally, I am very looking forward to the first politician who stands up in his or her House of Government and proclaims the necessity for an ethical tax regime and successfully steers it through their legislature to become law.

The Pentology has set down the processes for major corporates and Multinational Enterprises to employ ethical taxation practices, the way forward for Lawmakers to encourage such ethical tax practices by passing ethical tax laws and perhaps shed some light for international firms to return more closely to the original purpose of their professions, which is to *ethically* serve their clients and not themselves.

The challenge is now for the major corporates, the Lawmakers and the international firms to take the lead, look at those who are far less fortunate around them and move positively and cohesively on the ethical tax front to ensure ethical tax practices become the norm to create a better global society.

In honour of my father's brilliant research work and personal philosophy, the Pentology is also dedicated to the productive expansion of human knowledge.

Chapter 13
Prologue to the Pentology

13.1 Present and Proposed Work on the Ethical Tax Question

The Pentology is the first ever comprehensive and objective examination of the concept of corporate tax ethics in the modern world and unashamedly targets the global audience.

Each of the five works explores or will explore different aspects of ethical tax behaviour as it relates to the world today. This first volume is the foundation work exploring the general theme of what should be considered ethical tax behaviours and arguing for the introduction of ethical tax regimes by Lawmakers around the world as part of responsible Government.

The next two Volumes of the Pentology to be published will explore more specific aspects of ethical tax behaviour.

The second volume of the Pentology "Global Transfer Pricing Made Easy" will address the ethical tax questions around the internal cross-border transactions of multinationals and how multinationals should address such issues to be produce a zero tax risk outcome. This Volume will in part be based on my earlier two books on transfer pricing but will also address contemporary issues that have emerged since that time.

As has been previously stated, transfer pricing arrangements, ethical or not, make up greater than 50% of global commerce and are a rich source for aggressive tax practices and fees for international firms. Further, it is an area that has been the subject of considerable review by the OECD, which I firmly believe has been over-played and misdirected.

The transfer pricing question will not be solved by making the transfer pricing rules even more complex, it will be solved by making the rules simpler within a strong system of internationally supported "safe harbour" arrangements that are easily able to be audited by the relevant Revenue Authorities. In 30 years of advising a "statistically robust sample" of multinationals, I have never had a transfer pricing arrangement fail before a Revenue Authority. In my

view, the present path of the OECD will almost certainly *not achieve* what it is setting out to do due to an overly prescriptive set of rules that will likely result in an expansion of opportunities for aggressive tax practices, rather than a restriction or an elimination of such behaviours. As stated earlier in this work, legal complexity is the friend of the aggressive taxpayer.

The third volume of the Pentology “Big 4, Big Myth” explores how the major conventional international accounting firms are currently structured and operate and the weaknesses inherent in the their systems of operation in terms of ensuring ethical tax behaviours. This work will be partly based on the confidential comments of hundreds of present and former Partners of Big 4 firms who have expressed deep reservations about the ethical positions taken and the directions of the leadership of the firms. However, such comments must be considered objectively to gain insight in to possible future directions of such accounting behemoths.

Notwithstanding the view of any particular individual, the sheer penetration by the “Big 4” as conventional tax advisors and auditors to the overwhelming majority of multinationals and therefore the direction of world commerce demands analysis and strongly suggests greater accountability is appropriate for their operations. Such an analysis should include their organisational behaviours, sufficient controls to

ensure appropriate ethical *and ethical tax* behaviours and appropriate disclosures in line with community expectations.

If one lesson has emerged from the scandals surrounding international organisations in relation to poor governance behaviours such as the ongoing FIFA saga, no single major global body or organisation including the United Nations and the OECD should be in a position of acting without any form of effective and appropriate framework of accountability or regulatory supervision so why let a mere accounting firm with the objective of profit do so? Similarly no single organisation can realistically purport to “know it all” and be trusted to act as if it does – such would normally be the delusions only of the psychopath!

The next two Volumes of the Pentology to be published will likely be co-authored and released progressively over time as carefully crafted works for two very important groups of individuals for our future society.

The fourth volume of the Pentology “A Politicians Guide to Ethical Tax Behaviours” will explore the ethical tax question in relation to the conduct of Lawmakers, the elected representatives of our democratic system.

Unfortunately, every nation around the world has been rocked by at least one political scandal, if not a

thousand. While society imposes and expects high standards of behaviour on surgeons, judges, civil engineers and the lead bureaucrats, it would seem to be satisfied with no real base standards for politicians other than the dual Courts of Public Opinion and the Internet.

Politicians and Lawmakers themselves must look deep in to their souls and ask if this is the legacy by which they want to be remembered or do they want to be remembered instead for their ethical and moral actions when it was their turn in power. It is their choice as the legal guardians of those less fortunate in society to decide their own fate.

It is hoped that this work will be compulsory reading for all aspiring politicians in understanding and creating the appropriate environment for ethical tax laws and behaviours. I propose to co-author this volume with two senior retired politicians from opposite sides of the political divide to ensure both insight and balance in the arguments.

The fifth volume of the Pentology “Ethical Tax Behaviours: A Judge’s Companion” will provide commentary on ethical tax behaviours for the judiciary, the guardians of our legal system, on how to approach the ethical tax question in relation to tax matters before them. The Court System is the last effective “control” of society with the ability to not only interpret the law but to strike down

inappropriate laws under a robust constitution. I propose to work with an international panel of jurists to develop an approach in resolving this very complex question.

All four of these specialised works are important for different reasons in resolving the ethical tax questions of society, but it was decided to address what were perceived as the more immediate questions first that I could attend to personally.

Further by releasing all five volumes of the Pentology as E-books, this will allow all five works to be "living works" with what is hoped will be improvements to these works as understanding of the various issues deepens. Updated works will be provided at no additional cost to registered subscribers.

The next section discusses the structure for a proposed global model for addressing the ethical tax question and ensuring integrity within that process.

13.2 Global Ethical Tax Structure

From my perspective, there are three key structures for developing, rolling out and ensuring appropriate integrity of a global ethical tax platform.
These are:

1. Research and Knowledge Centre on Ethical Taxation Behaviours (13.2.1);

2. Accreditation Body for Ethical Taxation Practitioners (13.2.2); and

3. Practising Ethical Taxation Firm (13.2.3).

13.2.1 Research and Knowledge Centre on Ethical Taxation Behaviours

In 1991, my father Professor George Rozvany Senior founded the International Society for Structural and Multidisciplinary Optimization (the ISSMO). This was the commencement of an engineering school that was dedicated (in my words) to pursuing the most efficient engineering solution in a wide range of applications including aerospace, automotive, construction and heavy engineering. In this way, the engineering outcome was said to be "optimized". My father's school, his continuing role as Founder-President and the associated journal "Structural and Multidisciplinary Optimization" has resulted in a first rate forum for consolidating knowledge and exploring the key issues within this important discipline. As a result, there have been substantial gains in this area of human knowledge. Accordingly, the elements of the ISSMO that have made it so successful should be viewed *with considerable interest* in establishing *any school* of thought leadership.

The first observation is that the ISSMO re-caste what was a disparate group of researchers without any

clear global direction and only connected loosely by various "international" conferences in to a single highly efficient and effective research unit with outstanding internal communication and an extremely focussed and powerful technical journal.

The second observation is that typically in the academic world schools of thought operate
as "a royal club" that are dominated by a connected "gang" at the top, but ISSMO is unique in that it
has a democratic structure with the Executive Committee directly elected by its general membership. Technically, my father could have been voted off the Executive Committee but as "Founder President" he would have been immediately restored to the Executive as "top dog" under the constitution of ISSMO to ensure his vision of cultural integrity. The members of ISSMO uniquely bestowed this honour on my father in recognition of his contribution to human knowledge. Fortunately, he remained mentally sharp and productive in the cause that he loved to the end.

The third observation is that each member of ISSMO is considered equal. For example, during meetings each member is allowed no more than one presentation. There are no keynote speakers and no "VIP" guest speakers. This should be compared with the typical hierarchical structure of organisations where "the boss is always right". The reality is that the boss is *not always right* and unless staff members are encouraged to speak up about potential risks or

concerns then mistakes *will occur* with unplanned negative outcomes.

Notwithstanding, standards in respect of publication by an aspiring or established academic in the ISSMO Journal *Structural and Multidisciplinary Optimization* are extraordinarily high. Prospective research articles have to get through five levels of review made up of the sixty five or so lead Professors in the world in this discipline reducing many articles submitted to an elite few for publication in the Journal.

The fourth observation is that in terms of honouring researchers with prizes of superior performance, the only ISSMO prize was in relation to the promotion of research by "young researchers" under the age of 35 years of age. This was done to encourage young researchers to aim early and high to achieve lofty goals.

The fifth observation is that my father's leadership style and vision was one of placing selfless service as an example to the organisation. In the journey of optimization of structures, there is no end-point. Something can always be improved. It was the endless puzzle that my father was drawn to like a moth to a flame for over 60 years. There is little doubt that his passion inspired others to make the impossible become possible in the engineering world.

Given the prolific success of ISSMO, a similar structure will be adopted for "*The International Society for the Promotion of Ethical Taxation Behaviours (ISPETB)*" as the head body has been provisionally named.

Although the ISSMO and the ISPETB will be structured along similar lines, the respective areas of knowledge and research centred on engineering solutions and ethical questions respectively requires some consideration of potential additional requirements for the ISPETB.

In recognition that one of the objectives of ethical taxation behaviour is to ensure appropriate distribution of Revenue collected to *those less fortunate in society*, it has been decided that 10% of the *gross proceeds* of the Research Centre will be dedicated to various charity works to encourage a deeper understanding of the operation of these charities for members.

13.2.2 Accreditation Board for Ethical Taxation Practitioners

The prime purpose of an Accreditation Board for Ethical Taxation Practitioners would be to ensure that appropriate standards are maintained within the Ethical Tax Profession.

A Board elected by the general membership of the proposed ISPETB will determine professional standards for Ethical Taxation Practitioners. Members of the Executive Committee of the ISPETB cannot be also elected to the Accreditation Board to allow for sufficient independence between the two bodies, but the Chair of the Accreditation Board will sit on the Executive of the ISPETB in an *ex officio* capacity.

Due to the considerable skill set required in terms of legal analysis, reputation with the Government and the Revenue Authorities, extensive international experience, extensive commercial experience and the requirement to communicate effectively with Boards on a wide range of matter, standards of entry in to the profession will be at the elite level both in terms of ethical taxation behaviours and taxation experience.

It is anticipated that no more than 200 Ethical Taxation Professionals globally will ultimately be accredited to maintain the expected high standards required.

13.2.3 One Ethical Taxation Firm

Unlike the international taxation and accounting firms, the elite group of Accredited Ethical Taxation Specialists will operate through a company structure with the entire shareholding owned by the ISPETB.

The reason for this is to remove the "greed motive" that ties individual Partner incomes in all international firms to the fees generated by them often by overly aggressive sales and marketing techniques and fee extraction methodologies including excessive use of staff.

Accordingly, under the ethical taxation model the importance of the sales and marketing function in terms of the engagement process is totally eliminated from the functions of the advisory team.

It is a requirement of the engagement process that clients fully agree to accept the ethical taxation approach and also accept that an appropriately qualified ethical tax professional will be appointed to them to attend to their tax function. The approach is highly strategic and the ethical tax professional will be used to working with Boards and the senior executives of major companies.

It should be recognised that the ethical tax advisory team will be only made up of elite tax professionals with a continuing involvement in original research and publications work that will have also advised in various jurisdictions the Government and the relevant Revenue Authorities. In this way, the ethical tax professional will be far more likely to secure a no risk tax outcome through its stated policy of working with Revenue Authorities and/or Government on

major transactions and general reputation for delivering agreed tax outcomes for the client.

There are a number of reasons why the ethical taxation practice will be able to operate at a substantially reduced cost structure to the major international firms.

Firstly, the no risk tax approach is supported by extensive risk management practices. Accordingly, it is expected that insurance costs will be nominal compared with the major international firms.

Secondly, there will be no junior or middle level staff to build unnecessary fee bases from "leveraging". Approved specialist support firms under a strict mandate `will be used to provide specific technical support where required.

Thirdly, there will be no work "palaces" with expensive midnight lighting of firm names emblazoning the major cities of the world. Each ethical tax firm office will be as "green" as locally possible.

Fourthly, there will be no entertainment expenditure allowed for client facing staff beyond "coffee and sandwiches". While private friendships will be encouraged with clients as trust develops, it is important to recognise that client relationships are not there to be "bought", they are there to be earned

by performance. This philosophy also underlines the removal of the sales and marketing functions referred to above.

Fifthly, there will be a strict behavioural code imposed within the firm that will eliminate expensive sexual harassment, bullying and other lawsuits involving company staff.

Finally, it is emphasised that the ethical tax firm concept is one of *not for profit* whereby all profits of the firm will be used either for research in to the promotion of ethical tax behaviours or for charitable pursuits. Overall, the lower cost structures of such a firm will mean that the select group of ethical tax practitioners will be well commercially rewarded but highly focussed in achieving the agreed mutual objectives of the client base of the firm.

There are a number of proposed special risk management features of the ethical tax firm that are currently present in no other international firm.

Firstly, the ethical tax firm will be the first and only true global tax practice independently owned and without an economic motive connected by the common purpose of delivering superior ethical tax solutions that recognise the interests of the entire community.

Secondly, as the culture is one based on a democracy of elite ethical tax professionals, communication within the firm on any matter of concern will not just be a right, but an obligation. Along with the right to vote for the executive of the firm, there will be no other rights bestowed on the advisory team. As such, the guffawing “Partner” will not exist in this organisation, merely ethical tax professionals.

Thirdly, the risk management processes of the firm will require a triple peer review and sign off on all advice provided. If the client expresses concern, the advice will then be passed to a second panel of three advisers for review. The findings of the second review will then be distributed to the entire firm for comment.

Fourthly, the advisory approach is top down within the organisation of the client with advisers starting with the Board Mandate and then agreeing and working with senior executives to introduce ethical and tax risk management processes within the organisation.

Finally, the remuneration structures will be largely flat across the organisation with the elected executive *not* being additionally rewarded.

The above structure for the ethical tax practice is radically different from any proposed in the history of commerce. It is designed to attract the elite tax

advisor with a role that involves all the best aspects of professional life without compromising one's moral position.

In the pursuit of ethical tax practices, it is sincerely hoped that I will have a few good folk in the world agree with me on this point and will be brave enough to follow this model.