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The Current Tax Risk Environment and Best Practices for Managing It

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In this article, the authors identify some key topical areas of tax risk that multinational groups are commonly encountering, and offer some best practices for addressing them.

This year began with a continuation of the major tax trends emerging in the post-COVID-19 era:

- More aggressive audits by tax authorities in search of additional revenue;
- Increased international cooperation between tax authorities;
- The end of transitional concessions to assist businesses through the pandemic; and
- A developing role for tax in shaping ESG policies and behaviors.

These trends have emerged in an increasingly complex technical tax environment characterized by an accumulation of new rules and the layering of international tax regimes (such as the Organisation for Economic Co-operation and Development's global minimum taxation rules) on top of domestic tax regimes. At the same time, regulators are demanding enhanced transparency, tax authorities are mining data with smarter and faster AI tools and governments are getting more efficient at sharing information across borders. Against this background, the management of modern tax risks has become a cornerstone of sound corporate responsibility.

Set out below are some key topical areas of tax risk that multinational groups are commonly encountering, and some best practices for addressing them.

INTERNAL TAX RISK MANAGEMENT: TAX STRATEGIES AND POLICIES

Establishing and maintaining robust internal procedures for identifying, comprehending and mitigating tax risks can lower compliance costs in the long term while allowing more nimble decision making and facilitating a positive relationship with taxing authorities. An effective framework requires involvement and collaboration at every level of an organization, from the board, to senior management, to the audit and risk committees, to the members of each department.

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Best practices include a clear and documented tax risk management strategy set by the board and audit committee, accountability protocols adopted by the tax, finance, human resources and legal departments, and ongoing review and monitoring by business, accounting and tax teams. Members of the tax and accounting teams should be in regular communication with each other and with business teams and should review all business decisions above a certain materiality threshold. Tax risks should be addressed in a consistent manner as other business risks. Achieving an effective system requires top-down engagement and transparency throughout.

The adoption of a formal (and public) tax strategy is a legal requirement for large companies in some countries. The UK, for example, requires large groups with UK members to publish an annual online strategy document covering the group's attitude to UK tax planning, the level of UK tax risk the business is prepared to accept and how the business works with the UK tax authorities. Large corporate groups might consider something similar even if not formally required.

TAX AUTHORITY RISK MANAGEMENT: COOPERATIVE COMPLIANCE

Cooperative compliance initiatives are being increasingly adopted by tax authorities around Europe. Originally these initiatives were available only to large companies, but many countries are now considering reducing the relevant thresholds (which are generally based on annual turnover), to expand their reach to mid-sized companies as well as to high-net-worth individuals.

The main goal of a cooperative compliance approach is to ensure tax compliance through an enhanced relationship with the taxpayer. The benefits to the taxpayer - in the form of reduced risk of tax authority challenge and assessments - can be material. Eligible taxpayers who have a history of compliance, who commit to exchange information with the tax authorities on an ongoing basis and who implement other controls to measure, manage and control tax risks can generally expect favorable administrative procedures, such as expedited access to tax authorities as well as enhanced engagement from tax authorities in formal and informal discussions on uncertain tax issues. Timely and comprehensive disclosures under a cooperation agreement can also result in reduced penalties if assessments nonetheless occur.

ORGANIZATIONAL TAX RISK MANAGEMENT: RISKS OF MODERN WORKING PRACTICES

The post-pandemic shift to mobile and remote working practices has exposed organizations to increased risks of establishing an unintended taxable presence in countries or states where they did not previously report or file returns. This can trigger unplanned corporate income taxes, sales taxes and value added taxes, as well as payroll reporting and withholding obligations. Tax authorities are becoming less accommodating on these matters.

From a corporate income tax perspective, companies generally become subject to tax and filing obligations in jurisdictions where they are considered to be tax resident or in which they are considered to maintain a permanent establishment (PE). Tax residence can often arise in a jurisdiction if management functions are exercised there - some jurisdictions look

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to the location of board level management and control, whereas others look more at the place of effective day to day management. A PE can arise (even if tax residence does not) if a company has a fixed place of business in a jurisdiction or if it has a dependent agent doing business there on its behalf. Tax residence typically entitles the jurisdiction of residence to impose taxation on the company's worldwide profits, whereas the presence of a PE generally entitles the relevant jurisdiction to impose tax on profits of the company attributable to the PE. Similar considerations are also relevant for other taxes (such as VAT and other trade taxes).

Many tax authorities relaxed their enforcement of rules for determining tax residence or the existence of PEs during the pandemic. However, under renewed pressure to increase tax revenues, and with the benefit of recent extensions to international treaty-based rules for when PEs are deemed to exist, those authorities are clamping back down. Consequences can be severe - in some European jurisdictions, for example, an undisclosed PE can result in significant penalties and potential criminal exposures.

Considering these risks, groups with internationally mobile directors, senior management and other employees, or personnel who work remotely in a different jurisdiction to their employing company, should ensure they have an accurate picture of the applicable rules that apply wherever the relevant individuals regularly perform their duties. Any remote working policies put in place during the pandemic should be revisited with additional safeguards being put in place, where necessary. The same is true for permissions that may have been given for directors to attend board meetings by telephone or video conference. Care should be taken to monitor who does what and from where, with contemporaneous evidence - like board meeting minutes, time sheets and travel records being obtained and retained. In some cases, it may be advisable to prohibit remote working practices or locations in the absence of a clear benefit to the business; in other cases it may make sense to embrace a taxable presence in a new place and to set up a local entity to house relevant individuals. Targeted solutions may be available for certain risks, like engaging local professional employer organizations (PEOs) to take on the legal, tax and compliance burdens associated with payroll obligations for remote workers.

TRANSACTIONAL TAX RISK MANAGEMENT: THE USE OF INSURANCE POLICIES

Transactional tax risks are traditionally managed either through contractual arrangements that allocate the risks between the parties (for example in the tax warranties or tax indemnity provisions of a share purchase agreement) or, if available, advance tax rulings issued by the competent tax authority. However, both approaches have limitations:

- Trying to manage tax risks through contractual arrangements remains subject to negotiation power and ultimately counterparty/solvency risk. Also, classic tax indemnities do not typically provide for a "clean break." Due to customary international tax audit cycles, tax risks often take some years to surface, so parties to a tax indemnity will often only know years after a transaction has closed whether a tax risk could materialize, and they could then remain entangled with

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each other for subsequent years based on applicable statutes of limitations and tax assessment and appeal processes.

- Tax rulings, if available, often take too long to be obtained to be a practical tool to address risks arising on deals. They also can trigger significant statutory administrative fees and/or the materialization of tax risks. Furthermore, tax rulings are in many jurisdictions limited to future, yet unimplemented fact patterns and so are not able to address scenarios relating to past transactions.

Many varieties of tax insurance policies have been (and are continuing to be) developed to provide solutions to these concerns:

- Warranty and indemnity (W&I) insurance policies regularly cover tax risks that have not been identified in tax due diligence. Typically, the buyer is required to take out a W&I policy, and the seller's liability under the purchase agreement is either excluded or limited to a symbolic one Euro/Dollar - all subject to satisfactory customary tax due diligence and customary exclusions (such as transfer pricing and fraud). In such cases, the W&I policy covers liability scenarios in which the seller would otherwise be liable under the purchase agreement's tax warranty and indemnity provisions.

- An evolving trend in tax W&I policies is for cover to not strictly be linked to the provisions of the purchase agreement: so-called synthetic/virtual insurance policies are, if available, able to cover fact patterns that are not covered under the indemnity provisions in a typical purchase agreement, including extending the statute of limitations beyond the survival provisions or "scraping" knowledge qualifiers in warranties.

- Tax insurance policies may also be available in relation to certain known tax risks identified in tax due diligence. This so-called special tax liability insurance is often promoted on the basis that it is obtainable faster than a tax ruling, it can cover known but not yet materialized tax risks resulting from past events, and it can bridge risk allocation gaps between the seller and the buyer.

Although tax insurance coverage can often provide solutions on M&A transactions, it can come with drawbacks too. Obtaining the insurance adds another work stream that will require a certain level of tax due diligence, the negotiation of the insurance policy and additional fees, premiums and potentially insurance premium taxes. Other than for the most standard W&I policy (and certainly not in the case of a special tax liability policy) insurance is not a one-size fits all solution and will require tailoring to each deal. In some cases, the timing and cost required to put insurance in place, or the exclusions and other burdensome terms of the policy may outweigh accepting the risk.

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