

Tax Risk Management

- Various Perspectives on Corporate TRM -
Australia, Hong Kong, China



Australia

Mr Gary Christie

1. Introduction

Tax Risk Management (TRM) has gained prominence in recent years as a number of global and local factors such as corporate governance requirements resulting from Sarbanes-Oxley legislation in the US, Corporate Law Economic Reform Package (CLERP 9) and an increased compliance focus by the revenue authorities have compelled companies to take TRM seriously.

One way a company can demonstrate to revenue authorities as well as to investors and shareholders that they are managing their tax risks appropriately is to adopt a TRM approach.

There has been quite a lot written globally on TRM in recent years, particularly on what is TRM and the processes used to identify and manage tax risks.¹

While this article will discuss the concept of TRM and some of the processes used to identify and manage tax risks, the focus of this article is on TRM from an Australian perspective. With this in mind, the article will look to examine what the Australian Taxation Office (ATO) is currently doing about TRM and what an Australian company can do to minimise its tax risk exposure.

2. The Current Environment in Australia

Pressures for improved corporate governance have come from a number of high profile investor crises. The agenda for improved corporate governance is aimed at empowering boards to achieve high levels of financial disclosure and protection of shareholder interests. Regulators are demanding greater transparency in taxation matters. As a consequence, organisations are being required to disclose much more information to the government and shareholders than ever before. Some important examples in the development of this trend are:

- Sarbanes-Oxley – The Sarbanes-Oxley Act 2002 has focused corporate attention on risk management including the management of tax risk associated with the financial reporting process. As a consequence, corporations have been required to develop appropriate TRM policies and controls to manage their tax risks and the reporting of such risks
- Corporate Law Economic Reform Package (CLERP 9) which effectively requires that a board of a listed entity be confident that financial reports present a true and fair view in all material respects of the organisations taxation responsibilities and that it has established policies on TRM
- Australian Stock Exchange (ASX) principles of good corporate governance - The ASX principles describe ten principles of good corporate governance, each of which is supported by best practice recommendations;² and

- increased and more sophisticated tax enforcement processes as the Australian Taxation Office (the ATO) improves its approach to identifying and understanding tax risks.

It is particularly important therefore, that in the current environment of increasing regulatory reporting and disclosure, an organisation has implemented appropriate processes around tax compliance, transparency and corporate governance and that corporate boards and directors are not only aware of these processes, but oversee such processes in order to minimise its risk exposure.

3. What is TRM?

TRM is designed to assist an organisation in the development of a framework around risk identification and risk management that:

- assists in identifying existing and potential tax risks across an organisation
- prioritises those risks so that appropriate attention and resources are focused on the most critical areas
- determines a treatment strategy or appropriate response for each priority risk area
- communicates the TRM process to key stakeholders within the organisation including senior management, the audit committee and the board of directors; and
- establishes procedures for evaluating future tax planning opportunities, based on the risk tolerance of the organisation.

Essentially therefore, TRM is about understanding where the tax risks arise and making a decision around how they are to be addressed. It is considered broadly, that the concept should address the following specific types of risks or uncertainties:

- Transactional risk – this relates to the risks and exposures associated with the application of tax laws, regulations and decisions to specific transactions undertaken by an organisation. An organisation needs to ensure that the particular transaction complies with appropriate tax laws and regulations
- Administrative/Procedural and Compliance risk – risks associated with meeting an organisations tax compliance obligations, for example, compliance with tax laws and regulations, filing of tax returns, compliance with withholding and indirect tax obligations and keeping up to date with changes in tax laws and the tax environment which can affect existing tax exposures
- Operational risk – this relates to the underlying risks of applying the tax laws, regulations and decisions to the day to day business operations of an organisation. Tax risks can arise where there is:
 - a lack of tax awareness within the organisation
 - a loss of knowledge and gaps in corporate memory due to staff movements
 - inadequate documentation of transactions and positions taken; and
 - inadequate controls around financial and tax reporting systems.

- Financial risk – From a tax perspective, financial risk can relate to:
 - inadequate tax provisioning in financial accounts
 - identified but not reasonably quantified tax exposures

- lack of a reasonable arguable position to support aggressive tax positions
- undetected tax exposures; and
- penalties and interest as a result of late payment of taxes or the lodgement of incorrect tax returns.

- Market and reputation risk caused by:
 - loss of shareholder or investor trust or support
 - adverse media or market perception; and
 - negative perceptions by other regulators and stakeholders.

4. How are organisations currently managing tax risk?

There is a growing realisation among organisations of the importance of TRM.

In 2001, 120 of Australia's largest companies were surveyed as to how they responded to the increasing complexity and changes in the tax law. Only 32% of respondents said they had a formal TRM framework in place.³ This figure increased to 52% in a similar survey undertaken in 2004.⁴

Interestingly, reliance on external advisors increased during this time from 29% to 60% leading to an increase in compliance costs.

To the best of my knowledge, there is no survey data available post 2004; however anecdotal evidence would suggest that the number of organisations which have in place an appropriate TRM framework has increased from the 52% reported in 2004.

5. What influences tax risk?

Many aspects influence the tax risk position of an organisation. Consider the following diagram:⁵



The challenge for an organisation is how best to manage the above risks.

TAX RISK MANAGEMENT

Arguably, the best way to manage tax risk is through the development of a framework that will:

- align tax function goals with the organisation's overall business objectives
- identify and assess risks
- develop and capture appropriate treatment strategies
- identify controls and policies that will manage risks and determine whether tax policy and controls are working
- evidence appropriate and reliable reporting and sign offs
- enable effective and efficient use of the organisation's resources; and
- monitor compliance with tax laws and regulations.

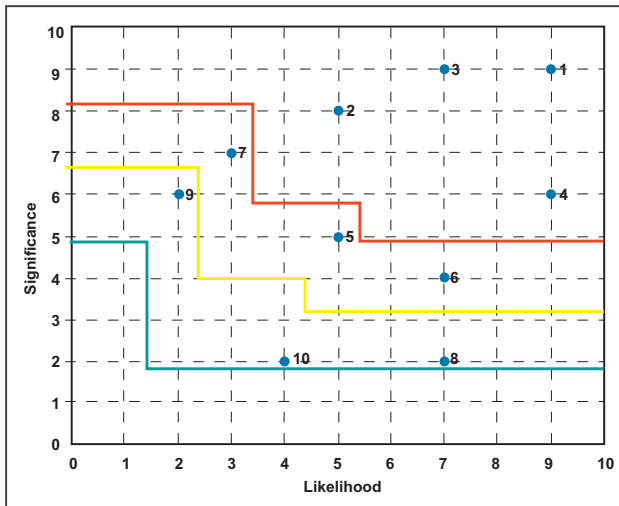
In order to achieve the tax risk objectives above, an organisation's tax function needs to:

- identify all events, both risks and opportunities, which potentially impact achievement of the organisation's objectives
- analyse risks, based on the likelihood of the risks arising and the consequences (impact) should the relevant risk arise to determine how risks should be managed
- determine the severity of the risk (range from low to high and where appropriate allocate potential monetary values to the level of risk)
- develop appropriate implementation actions, such as strategies to deal with risks based on the organisation's risk tolerance. Even if the decision is made to merely accept an existing tax risk with no further action, it is important for tax functions to communicate that decision to appropriate individuals in the organisation
- implement procedures and policies that help ensure risk responses are effectively carried out
- implement systems that support risk mitigation processes
- establish processes for information to flow across all levels of the organisation enabling people to carry out their responsibilities

regularly review and monitor strategies to ensure they remain current and appropriate in order to minimise risk.

The following models are useful in developing an appropriate TRM process to be used by organisations:⁶

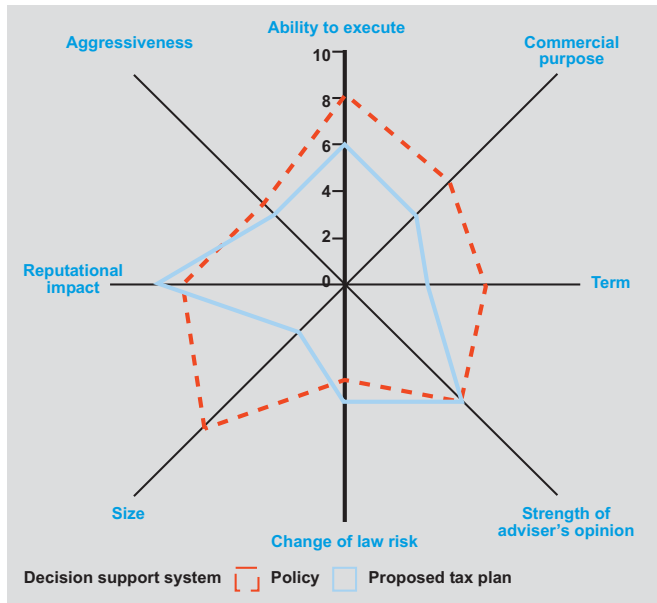
Tax Risk Map



Number	Risk Area	Likelihood	Significance
1	Outstanding disputes or audit enquiries with the ATO <i>Are there any disputes against assessment or outstanding audit enquiries with the ATO that could result in additional costs to the organisation?</i>	9	9
2	Timing issues <i>Tax costs resulting from a failure to meet compliance obligations or inadequate tax reporting systems and procedures</i>	5	8
3	History of losses <i>Does the organisation have history of continuous losses or low effective tax rates compared with business performance</i>	7	9
4	Transfer Pricing issues <i>Has the organisation appropriate transfer pricing methodologies and supplementary documentation to justify transfer prices for international dealings with related parties?</i>	9	6
5	Significant Transactions <i>What potential acquisitions, disposals or other/unusual transactions have been initiated or are on the horizon that could lead tax costs?</i>	5	5
6	Market Valuations <i>Are there distortions and inconsistencies between market valuations?</i>	7	4
7	Goods and Services Tax <i>Are there significant differences between financial statements and reported GST amounts?</i>	3	7
8	Legislative Changes <i>Has the business considered tax costs arising from variations in accounting policy or new tax legislation?</i>	7	2
9	International Group Structure <i>Has the business considered tax sensitivity issues such as debt/equity ratios that could be caught by thin capitalisation rules?</i>	2	6
10	Controlled Foreign Companies <i>Are there potential CFC issues, undisclosed branch income or residence issues resulting from international transactions?</i>	4	2

Importantly, the 'Tax Risk Map' enables an organisation to analyse its tax risks across each part of its business.

Decision support graph



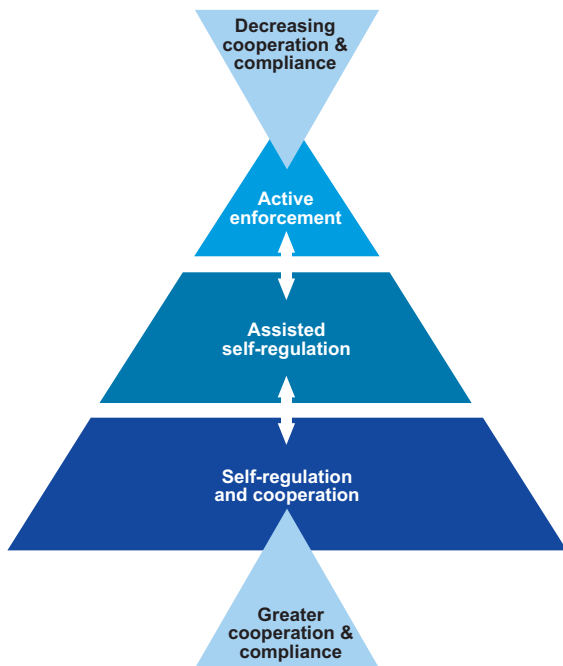
The 'decision support graph' helps a company assess specific transactions from a tax risk perspective. It analyses the factors that influence a tax decision and plots a given proposal against these and the organisation's risk profile. This transparency is critical, because it allows those not familiar with detailed tax policy issues to participate in tax risk assessment and decision making.

Using the tools such as those described above within the broader context of the TRM framework, organisation's can actively manage their tax risk profile and assess operating improvements throughout the organisation.⁷

6. Tax Risk Management- The Australian Taxation Office (ATO) perspective

The ATO applies what is known as the Co-operative Compliance Model (the Model) in its administration of tax risk.

The following diagram demonstrates how the Model is intended to operate:⁸



The diagram shows how co-operative compliance allows for movement both up and down the pyramid, from active enforcement measures at the top down to self-regulation and co-operation at the base.

The base of the pyramid, characterised by a co-operative, self regulatory approach, is the most desirable area of operation for the ATO and for business.

The ATO uses a wide range of possible compliance methods to manage corporate compliance depending upon where in the compliance pyramid hierarchy they consider an organisation's overall risk level resides.

The Model determines the type of compliance response or action to be taken by the ATO depending on the level of co-operation and tax compliance of the organisation.

The compliance options available to the ATO largely fall within three main categories:

Active enforcement:

Where there is a decreasing level of co-operation and compliance, the ATO uses a range of enforcement options including the use of various audit products and the potential use of sanctions and prosecution action. Importantly, non-compliance carries risks to an organisation's financial position as a result of the additional costs of having to deal with an audit or potential litigation.

Assisted self regulation:

Products such as Advance Pricing Arrangements are used to assist organisations in understanding their future tax obligations. Often ATO officers are assigned to a large

corporation to provide a direct link in order to help resolve administrative issues and assist them in complying with their taxation obligations.

Self-regulation and co-operation

A technical advice program exists to clarify and communicate the law and provide guidance to corporates. Products such as Public and Private Rulings assist in enabling corporates to self regulate. Private rulings relate to particular circumstances raised by an entity and which relate to that entity. Public rulings impact on a wider group of businesses in the community. Consultative forums between the ATO and large corporates complement an environment of self regulation and cooperation.

The Model emphasises that the business community and the ATO can work together to identify weaknesses in the tax system (both for and against), and develop streamlined cost-effective solutions that increase certainty and overall community confidence.

However whilst the Model is aimed at building a positive professional relationship, it does not preclude a business organisation from disagreeing with the ATO or taking a different view of the law as it applies to a particular transaction.

7. How does the ATO look to apply the Model?

The Model is applied by bringing together the following five processes:

- understanding business and the law
- assessing the risks
- planning strategies
- implementing strategies; and
- reviewing and improving.

The Model is designed to have application regardless of whether the risk relates to a single transaction, a specific entity or group, or whether it relates to a whole of market/industry or the wider community.

Understanding business and the law

The ATO recognises that large business operates within a constantly changing social, political and economic environment that influences decisions and behaviours. To understand what drives business behaviour, the ATO uses the 'BISEPS' system which reflects the fact that compliance decisions and behaviour are effected by a wide range of factors that are often related. These factors are (B) Business, (I) Industry, (S) Sociology, (E) Economy, (P) Psychology and (S) Systems of compliance.

TAX RISK MANAGEMENT

The following table illustrates some examples of the BISEP factors:⁹

B	Business	The extent and nature of the group's business activities and transactions The structure of the entity or group Financial performance and ratios
I	Industry	Industry norms around financial performance and other ratios Industry profit margins and cost structures Conditions affecting the industry such as region, size and participants
S	Sociology	Culture of the organisation and management (i.e. whether risk adverse, aggressive) How the entity or group deals with paying taxes and its financial arrangements Standard of record keeping and lodgement timeliness
E	Economy	Domestic, international environment and trade conditions Government policies – interest rates, inflation, tax system and economic and tax reforms
P	Psychology	Approach to managing risk and drivers of the risk strategies Attitude and relationship with the ATO Management objectives
S	Systems of Compliance	Compliance history Tax analysis of issues Quality assurance standards and corporate governance processes Decision making systems, processes and organisational structure The degree and ease in accessing information

Assessing the risk

It is important for an organisation to understand how the ATO operates in terms of its compliance activities. Such activities are generally undertaken on the basis of assessing identified risks. Risks are analysed and assessed according to the level of risk in order to arrive at an overall risk profile for an organisation and the tax risks that need to be

addressed. This risk management approach allows the ATO to tailor its strategies that appropriately addresses identified risks.

As a general rule, the ATO considers the following criteria when assessing risks:

- business structure and transactions
- compliance obligations and systems to measure
- compliance
- application of the law
- materiality levels
- international activity
- attitude; and
- perceptions of stakeholders.

An overall risk ranking that ranges from Severe to Trivial, based on the likelihood and consequence of the risk occurring, is made for each criterion, with an overall risk rating made of the organisation after considering all relevant risk criteria.

A sample risk matrix is contained hereunder:

Criteria	Severe	High	Medium	Low	Trivial
Business structure and transactions	<ul style="list-style-type: none"> ● Complex business structure and transactions ● Volatile industry and business activity ● Significant internal restructures and/or acquisitions or sell offs 				<ul style="list-style-type: none"> ● Simple business group structure ● Minimal change in group structure ● Straightforward business transactions
Compliance obligations and systems	<ul style="list-style-type: none"> ● Poor compliance history ● No effective quality assurance processes ● Minimal corporate governance ● Lack of compliance processes ● Minimal supporting documentation 				<ul style="list-style-type: none"> ● Excellent compliance history ● Quality assurance, corporate governance and tax risk management in place and working ● Accurate and supporting documentation of transactions
Application of the law	<ul style="list-style-type: none"> ● Novel applications of the law ● Aggressive tax positions ● Tax outcomes that are inconsistent with the policy of tax reform 				<ul style="list-style-type: none"> ● No novel applications of law ● Technical position supported by law or ruling
Materiality	<ul style="list-style-type: none"> ● Very significant impact on revenue 				<ul style="list-style-type: none"> ● Minimal risk to revenue
International activity	<ul style="list-style-type: none"> ● Significant cross border and or tax haven activity ● International aggressive tax planning activities 				<ul style="list-style-type: none"> ● No cross border dealings
Attitude	<ul style="list-style-type: none"> ● Little commitment to compliance ● Uncooperative or confrontational approach ● No use of self regulatory approaches such as private rulings 				<ul style="list-style-type: none"> ● Highly cooperative approach ● Strong commitment to compliance ● Use of self regulatory approaches such as rulings, forward compliance arrangements
Perceptions of stakeholders	<ul style="list-style-type: none"> ● Potential for serious damage to tax system integrity ● Significant impact on community confidence 				<ul style="list-style-type: none"> ● No impact on community confidence

The risk assessment process enables the ATO to make sense of any information gained either before or during the course of any preliminary review of an organisation's tax affairs. Given that the ATO looks to focus on the most relevant material tax issues, this review process helps to

identify and verify whether such risks represent a material tax issue that requires further action. The nature and scope of any further action typically depends on the scope and extent of the risks verified during the course of the overall risk assessment process.

Planning and implementing strategies

The Model draws on the notion of movement between a range of compliance activities, shifting from cooperation and self regulation to active enforcement as required. Just what compliance strategy to use, is determined as a result of the ATO's understanding of the business gained through the risk assessment process described above.

The range of compliance products available to the ATO is extensive with different products developed to suit where in the compliance pyramid an organisation is considered to operate. Some examples of the different types of products available are as follows:

Enforcement options	
Full Audit	Comprehensive examination of a group or business. Generally limited to those businesses that pose the greatest risk.
Specific issues audit	An examination of a limited number of issues of a business or business group.

Assisted self-regulation	
Advance Pricing Arrangement	An agreement with the ATO on the future application of the arm's length principle in respect of international dealings that a business has with related parties.
Test Case	Litigation that is undertaken by the ATO where the interpretation of the law can be tested and clarified by the courts for the benefit of business in the wider taxation system.
New legislation/ ruling review	A review to determine the level of understanding and compliance with new legislation and rulings.

Self-regulation	
Public/Private rulings	Technical advice program to clarify and communicate the law. Private rulings relate to circumstances raised by an organisation. Public rulings impact on a wider group of business in the community. Rulings may be given on questions of law, fact and on administrative issues.
Technical Fact sheets	Guidance issued by the ATO as to how a particular provision of the law operates.

Reviewing and improving

It is essential that the impact of compliance strategies are monitored and effectively measured. What the ATO learns will provide a foundation to build better compliance processes and strategies, and adapt the Model to meet changes in business and the wider environment. Effective monitoring will reveal deficiencies in the system that need to be addressed and may provide insights into areas such as where the law is too complex or onerous and requires amendment to improve the overall level of compliance.

8. What can an organisation do to minimise compliance tax risks?

Tax has always been a significant factor in the overall risk profile of a business. It can eat into the revenue, swell the expense base and erode profitability, thereby requiring organisations to keep it under control.¹⁰ However, in the past there has been a tendency for tax to be viewed as a complex area which was left to the tax professionals. Tax was not commonly subject to oversight by boards, although legislation such as the Sarbanes-Oxley Act 2002 has changed this perspective.

In recent years this perception has changed. In an ATO media release in June 2003, the then Taxation Commissioner, Michael Carmody, encouraged board members, senior executives and tax advisers to take another look at their tax responsibilities as part of good corporate governance. The Commissioner commented that "judgments about tax compliance need to be part of the corporate governance processes of every company and board".¹¹

In its examination of large business governance processes, the ATO had noted that management reporting to the board was often done only on an exception basis. Unless a major event occurred, in many cases a board was not sufficiently informed about material aspects of the business, including potentially major taxation risks. In fact, many organisations had delegated the responsibility of tax risk management to the in-house tax manager or outsourced compliance obligations to a professional firm.

In January 2004,¹² the Commissioner wrote a letter to corporate boards encouraging them to identify and manage major corporate risks. The letter was aimed at improving corporate governance processes from a tax perspective through boards providing leadership in managing tax compliance risks.

In writing to board chairs, the Commissioner was not suggesting that directors needed to be tax experts, rather he was writing to them in the context of the accepted responsibility of board's to identify and manage major corporate risks.¹³

Essentially, the Commissioner was saying to boards that TRM requires leadership in ensuring that an organisation has given appropriate attention to having the necessary systems and controls in place in order to meet its ongoing tax obligations. It also requires leadership in seeking advice and understanding the tax risk associated with major corporate transactions that by their nature come to the board for attention. Without sound TRM, financial disclosures and shareholder interests may be compromised.

TAX RISK MANAGEMENT

The Commissioner's letter provided a list of questions (contained hereunder), the answers to which will assist boards in appropriately identifying taxation risks, the extent to which they are prepared to accept those risks and the processes for managing any of the accepted risks.

1. What level of confidence do you have in the correctness of your advice?

Consider whether advice is provided with a high degree of confidence (almost certain) compared to advice provided on the basis that it is reasonably arguable (is about as likely to be correct as not) or some lesser basis. Consider also the questions you asked to obtain this advice.

2. How likely is it that the ATO will take a different view of the application of the law and assess the company accordingly?

Consider whether the advice prepared addresses appropriate law, relevant tax cases and rulings or other ATO technical products.

3. If the ATO takes a different view and the matter proceeds to litigation, what is the risk of the Federal Court or the High Court deciding the matter in favour of the ATO?

Consider the merits of the case, matters of evidence and supporting case law.

4. What is the potential downside if the company is unsuccessful in litigation with the ATO?

Consider the downside if unsuccessful, the cost of litigation, penalties and interest.

5. If there is a dispute with the ATO, what is the likelihood of it being prepared to settle the dispute and, if so, on what terms?

The Tax Office has published guidelines on settlement. Where the issue is of precedential importance, the ATO may not settle. However if the issue is a question of quantum, the ATO may be prepared to settle.

6. How likely is it that the ATO will identify the tax issues which arise from the proposed course of action? Allied to that, to what extent will embarking on the proposed course of action increase the tax risk profile of the company and increase the possibility of audit scrutiny?

Given the ATO has fairly sophisticated risk assessment techniques; it is unlikely that a major transaction and/or major tax issues would go undetected.

7. In light of the potential risk, would it be desirable to approach the ATO for guidance in the form of a private binding ruling?

Creates certainty. Consider how likely it would be to get a positive ruling response. If unlikely to get positive response, is the risk worth taking? If there are time pressures, it may be possible to fast-track the ruling process.

8. Where a position has been taken on a tax issue, would it be desirable, in the interests of appropriately managing any risk, to be upfront with the ATO identifying the issues before or when lodging the tax return and endeavouring to handle constructively any disagreements which may ensue?

Could minimise any penalties that may otherwise arise.

9. Is the advice based on the actual transaction or on an expectation of how the transaction will be implemented?

If based on the expected implementation, any material change in the transaction that is ultimately implemented may impact the validity of the original advice.

10. Are you satisfied that the factual basis of your opinion to the board has been properly checked?

Were the facts independently verified?

The tax function of an organisation can no longer afford to be isolated from the rest of the business organisation. The board of an organisation needs a clear understanding of the work the tax function is doing and its effect on overall risk. It is considered therefore that the board should ensure through its discussions with the tax function of the organisation that they:

- have agreed reporting procedures to the board
- have an appropriate strategic tax risk policy and appropriate tax risk tolerance boundaries. Tax risk management policies should be reviewed regularly to take account of changes in the organisation and external developments
- seek the board's direction, and authority where necessary; and
- have a tax risk framework that effectively manages tax planning and compliance. In this regard, as mentioned earlier in the paper, such a framework should enable the organisation to:
 - identify and assess risks
 - develop appropriate implementation strategies
 - deploy appropriate resources and obtain external advice as required
 - implement robust reporting procedures around tax risk management; and
 - identify controls and policies to manage tax risks.

9. An organisation needs to be able to explain the following:

The ATO considers that the following factors will assist organisation's to determine whether there are any potential taxation problems in the group that are likely to attract their attention, and if so, whether they can be explained by the organisation :

- financial or tax performance that varies substantially from industry averages and pattern
- significant variations in the amounts and patterns of tax payments compared to past performance and relevant economic indicators and industry performance
- unexplained variations between economic performance, productivity and tax performance
- continuous or unexplained losses, low effective tax rates, and cases where all or part of the group consistently pay little or low amounts of tax
- a history of aggressive tax planning by the corporation, group, board members, key executives or advisers
- significant cross border and/or tax haven dealings
- distortions and inconsistencies in market valuations

- complex arrangements that generate GST benefits
- weaknesses in the group's structure, processes and approach to tax compliance; and
- tax outcomes that are inconsistent with the policy intent of the law.

10. Managing an organisation's internal relationship between its tax function and the board

As part of its tax risk management policy, it is critical that the internal tax function of an organisation have agreed reporting procedures to the board. In developing such procedures an organisation should consider the following:

- the nature and form of reports for each meeting
- the organisation's tax risk appetite; and
- the materiality level of what should be reported to the board.

Information that an organisation may look to provide to a board each time it convenes could include whether:

- the organisation has a tax exposure. If so, information should be provided as to what processes or controls have been put in place to minimise such exposure and strategies to reduce future exposures and what penalties have been or will be applied
- the organisation is under audit or has been notified that it will be subject to an audit. If so, information should be provided detailing the scope of the audit, processes that have been or are to be put in place to manage the conduct of the audit, what disclosures are required or have been made including the cost of such disclosures, and any penalties including any interest component that may be applicable
- there is a current dispute with the ATO and the likelihood of settlement of the dispute, whether there is a reasonably arguable position and the potential exposure to primary tax and penalties
- there are any outstanding objections or audit requests, and the progress of any current tax litigation
- the organisation is considering or in the process of making a private binding ruling and/or class ruling request
- there are any outstanding lodgement of tax returns or other outstanding compliance obligations around indirect tax obligations
- there have been any key tax developments
- there are significant transactions the organisation has entered into or is proposing to enter, the level of risk associated, whether appropriate advice has been received or is to be received, what is the implementation strategy and to what extent it will increase the tax risk profile of the organisation
- the organisation has made any losses and if applicable whether there is an explanation for those losses that is likely to satisfy any ATO enquiries; and
- the organisation's financial performance or tax performance varies substantially from past years, and if so, reasons for the variation.

11. Some ways an organisation can look to obtain tax certainty

Provision of written advice

The written advice regime is designed to provide taxpayers with certainty around arrangements or schemes they are seriously contemplating or have entered into. Written advice

provided by the Tax Office comes in many forms. Examples include:

- Public rulings
- Class rulings
- Product rulings
- Private Binding rulings
- Administratively binding advice; and
- Written general advice.

Under the regime, a ruling may deal with anything involved in the application of a tax law or provision. This includes issues relating to liability, administration, procedure, collection and ultimate conclusions of fact.

The level of protection varies from product to product. For example, public rulings provide taxpayers who act in accordance with them, protection from additional primary tax, penalties and interest.

In addition, the ATO has recently introduced a priority rulings process that seeks to provide taxpayer certainty around transactions that are prospective, time sensitive, where the tax outcome is a critical element of the transaction and where the transaction has major commercial significance requiring consideration at the board level.

Advance Pricing Arrangement

Advance Pricing Arrangements (APA) can provide significant benefits to a wide range of businesses because they have the capacity to deal with real time business issues, including highly integrated operations and novel situations.

An APA may cover many different types of international dealings with related parties, including transfers of tangible or intangible property, services, cost sharing, global trading and global manufacturing.

As a general rule, an agreement usually covers a period of three to five years and may be reviewed if the trading circumstances of the business materially change.

An APA is a prospective arrangement, negotiated in a cooperative environment. Some of the benefits that may result from the APA process include:

- providing certainty on an appropriate transfer price methodology for the business and therefore enhancing the predictability of tax treatment around international transactions
- ensuring the correct application of the arm's length principle in related party international dealings
- a possible solution to situations where there is no realistic alternative way of both avoiding double taxation and of ensuring that all profits are correctly attributed and taxed
- limiting the prospect of potentially costly and time consuming examination of major transfer pricing issues which would arise in the event of a transfer pricing audit, lessening the possibility of protracted and expensive litigation

TAX RISK MANAGEMENT

- placing the business in a better position to predict costs and expenses, including tax liabilities; and
- reducing the record keeping burden as the business will know in advance which records they are required to keep to substantiate the agreed transfer pricing methodology.

GST Cooperative Compliance Advance Agreements

A GST Advance Agreement is a written agreement that formally acknowledges self-regulation. Businesses are required to satisfy certain requirements before the ATO will agree to enter into a GST Advance Agreement. These requirements are that they have:

- demonstrated a high level of self compliance with the GST law
- performed a rigorous self-examination of processes and system controls
- demonstrated a high level of commitment toward cooperative compliance; and
- agreed to allow Tax Office staff to have full and free access to systems, training and system manuals and relevant personnel.

Forward Compliance Arrangements

The concept of Forward Compliance Arrangements (FCA) is a new and innovative approach to the management of tax risk across all taxes that is currently being piloted. An FCA is seen as providing an alternative to traditional compliance approaches.

It is a voluntary arrangement between a large business and the ATO which sets up an agreed way of working together on a forward basis.

Entry into such an arrangement will enable a corporate to minimise tax risk and plan from a position of greater certainty. However, it is recognised that entry will require a significant investment by a corporate in their tax risk management processes (including their systems) together with a commitment to transparency and continuance disclosure, therefore it may not suit everyone.

A key element of the process is a due diligence verification of the corporate which includes a health of the systems review across all taxes to examine the adequacy of the systems, governance framework and controls in place to effectively manage tax risk.

12. Conclusion

Every organisation needs to manage its tax risk. The benefit of an organisation having a tax risk management framework in place is that:

- tax risk exposure is minimised
- tax risks are able to be detected early and assessed as to their relevance and materiality
- audit risk is reduced and relationships with the ATO can be enhanced

- compliance costs are reduced and it facilitates a more appropriate allocation of resources
- there are fewer surprises
- there is likely to be a much greater alignment of the organisations tax strategy to its business objectives
- compliance with regulations and tax laws is likely to be improved; and
- there is a greater awareness and understanding of what transactions may present tax issues and which risks are acceptable and which are not.

As a final point, whatever tax risk model is implemented, there needs to be an appropriate control framework in place. It is important that any control framework include identifying indicators or warning lights to signal that a risk is arising, so that it can be addressed before it manifests into a real problem.

The views in this document are those of the author and do not represent the views of Deloitte Touche Tohmatsu or any of its related practice entities (Deloitte). This document is provided as general information only and does not consider any one's specific objectives, situation or needs. You should not rely on the information in this document. Neither the author nor Deloitte accept any duty of care or liability to anyone regarding this document or any loss suffered in connection with the use of this document or any of its content.

© Gary Christie, June, 2006. All rights reserved.

Australian Stock Exchange (ASX) Principles of Good Corporate Governance

Principle 1:
Establishing the roles of management and the board.

Principle 2:
A balance of skills, experience and independence on the board appropriate to the nature and extent of company operations.

Principle 3:
Integrity among those who can influence a company's strategy and financial performance, together with responsible and ethical decision-making.

Principle 4:
Presenting a company's financial and non-financial position requires processes that safeguard, both internally and externally, the integrity of company reporting.

Principle 5:
Provide a timely and balanced picture of all material matters.

Principle 6:
The rights of company owners, that is shareholders, need to be clearly recognised and upheld.

Principle 7:
Every business decision has an element of uncertainty and carries a risk that can be managed through effective oversight and internal control.

Principle 8:
Formal mechanisms that encourage enhanced board and management effectiveness.

Principle 9:
Rewards are needed to attract the skills required to achieve the performance expected by shareholders.

Principle 10:
Good corporate governance recognises the legitimate interests of all stakeholders.

FOOTNOTES

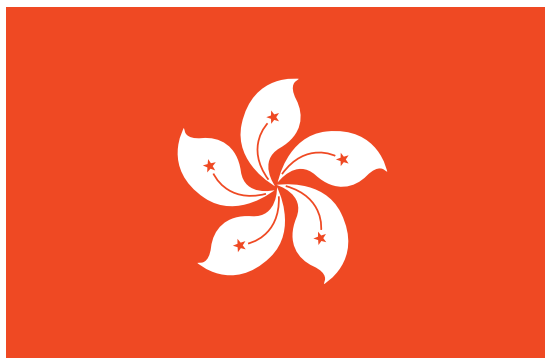
1. See, for example, Michael D'Ascenzo, "Making choices: Risk management in action" (2004) 19 Australian Tax Forum 525; Andrew Mills, "Tax risk management: You might be an aristocrat but are you fireproof?", paper presented at Tax Institute of Australia New South Wales Annual Intensive Retreat, 5 November, 2004; Frank O'Loughlin, "Tax risk management: Rulings – real protection or a false sense of protection?", paper presented at Tax Institute of Australia 20th National Convention, 17 March, 2005; "Tax risk management: a routemap to compliance" – Deloitte, 2005; "Forward thinking tax risk management: Deloitte Tax LLP's point of view" – Deloitte, 2005; John A Stacey "Managing tax risk" – Deloitte & Touche LLP, 2005.
2. As this paper focuses on tax, these principles are reproduced at Annexure 1 to this paper
3. Survey conducted by Ernst & Young – "Maximising value in the Australian corporate tax function", see E&Y Press Release (7 February 2002) at <> (accessed 29 June 2006).
4. Gilbert + Tobin (2004) "Tax as a corporate governance issue – emerging trends in corporate Australia"
5. Stephen Green, "Managing tax risk in an international tax group", paper presented at 2005 Taxation Institute of Australia Financial Services Taxation Conference.
6. Deloitte, "Overcome hurdles – Tax risk management: a route map to compliance" (2005) available at <http://www.deloitte.com/dtt/cda/doc/content/dtt_ie_
7. IAASA_overcomehurdles_0505.pdf> (accessed 29 June 2006).
7. Deloitte, "Forward thinking – Tax Risk Management – Deloitte Tax LLP's point of view"–(2005), available at <http://www.deloitte.com/dtt/cda/doc/content/us_tax_trm_point-of-view_061605.pdf> (accessed 29 June 2006).
8. Australian Tax Office, "Cooperative compliance – Working with large business in the tax system" (2004), available at <<http://www.ato.gov.au/content/downloads/compliance.pdf>> (accessed 29 June 2006).
9. BISEPS factors and examples taken from ATO Cooperative Compliance Model
10. KPMG, "Tax risk management in the financial services industry – An international KPMG survey" (2004) available at <<http://www.kpmg.com.au/Portals/0/FSTaxRiskManagement.pdf>> (accessed 29 June 2006).
11. ATO media release Nat 03/54 (10 June 2003).
12. Letter to chairpersons of listed public companies on the role of boards of directors and good governance in managing tax risks sent on 29 January 2004.
13. ATO Commissioner Carmody's speech to country CFO forum (4 May 2004) available at <<http://www.ato.gov.au/corporate/content.asp?doc=/content/sp200402.htm>> (accessed 29 June 2006).
14. ATO, "International transfer pricing – Advance Pricing Arrangements" available at <http://www.ato.gov.au/content/downloads/LBI_35286_Advanced_pricing_arrangements.pdf> (accessed 29 June 2006).

Author's Profile

Mr Gary Christie is a tax partner in the Melbourne office of Deloitte Touche Tohmatsu and the head of National Tax in Australia.

Acknowledgement

We thank the International Bureau of Fiscal Documentation and the respective authors for their consent to reprint the above series of articles on Tax Risk Management and acknowledge that they were originally published in the "Asia-Pacific Tax Bulletin" Volume 12, No.5 2006.



Hong Kong

**Mr Luis Coronado, Mr Philip Wong
and Mr Anthony Lo**

1. Introduction

The Hong Kong Special Administrative Region is well known for its relatively simple tax system. For a company carrying on business in Hong Kong, the only tax on income is a 17.5% profits tax levied on profits arising in or derived from Hong Kong from the business carried on in Hong Kong; there is no indirect taxation in Hong Kong. In terms of profits tax compliance, companies operating in Hong Kong are only required to file a simple annual profits tax return, supported by an audited accounts and tax computation showing adjustments from accounting profits

to assessable profits based on the Hong Kong Inland Revenue Ordinances (IRO).

With a relatively low profit tax rate and not complicated profits tax compliance requirements, most companies in Hong Kong generally do not see the need to allocate too much effort to tax risk management. Another major reason for the lack of emphasis on internal tax risk management is the lack of local legislation imposing internal tax risk management requirements on companies listed on the Hong Kong Stock Exchange.

While the Hong Kong Inland Revenue Department (IRD) has always been diligently going after companies suspected of under-reporting their income, in the last few years it became apparent that the IRD has also increased scrutiny of tax avoidance and evasion cases focusing on (i) the use of offshore vehicles closely linked to Hong Kong operating companies and (ii) tax planning arrangements without genuine commercial motives. In cases where the IRD can successfully challenge the offshore transaction or a tax planning arrangement as nothing more than a simple siphoning from Hong Kong of profits, which should have been subject to profits tax, the IRD may invoke the penalty sections in the IRO in addition to a recovery of the underpaid tax. It follows that management of Hong Kong companies should not underestimate the importance of tax risk management as part of corporate governance. Indeed, where the circumstances so warrant, the management should act decisively to deploy adequate resources to manage tax risks, rather than to take a "wait and see" attitude. Following are some of the tax risk management areas that should warrant special attention and resources.

2. Transfer Pricing

The IRO does not contain specific provisions outlining the transfer pricing methodology acceptable to the tax authority. However, there is a provision requiring an arm length's return for a Hong Kong company when dealing with a closely connected non-resident person, which may ultimately affect the liability of the non-resident person. Under such provision, the IRD is empowered to tax the non-resident person who conducts business with a resident person using a transfer pricing arrangement where such arrangement brings no or less than the ordinary profits to the resident person.

Although transfer pricing audits are not the current main priority for the IRD, the IRD would nevertheless attack transfer pricing arrangements between group companies during field audit, especially if a tax haven group company involved in the transaction were shown to earn an "unreasonably high" profit. Moreover, it is seen that transfer pricing enforcement is being taken more and more seriously by other tax authorities in Asia and other countries. Tax authorities in many different countries are gradually introducing new and detailed local transfer pricing rules and compliance requirements. It may not be long before the IRD increases their focus in that area and starts auditing transfer pricing arrangements with Hong Kong based groups involving transactions between resident and non-resident affiliates.

Furthermore, transfer pricing could be seen as a key element of tax risk management for Hong Kong based multinationals with outbound investments in countries with onerous transfer pricing rules already in force. This may

stem from the fact that Hong Kong based multinationals are more accustomed to the simple tax system in Hong Kong and may be less familiar with the need to undertake transfer pricing studies to support their pricing methodologies for inter-company transactions.

3. Offshore Income Planning

Unlike some other jurisdictions that impose income tax on their resident companies on a worldwide basis, the IRO adopts a territorial concept to profits tax. Only profits that arise in or are derived from Hong Kong from a business carried on in Hong Kong are liable to profits tax.

With this concept in mind, an increasing number of Hong Kong based groups attempt to structure their businesses in such a way that part of the group income is treated as offshore income and therefore exempt from Hong Kong profits tax. These structures mainly involve setting up group companies in tax haven locations (e.g. British Virgin Islands, Mauritius, etc.) with the objective of taking a part of the group operations offshore, i.e. profits related to those operations are captured offshore and should not be subject to tax in Hong Kong.

The IRD has always been skeptical about the use of tax haven companies to derive tax savings without sufficient and adequate business and/or commercial substance and motives. In recent years, the IRD has increased scrutiny of taxpayers having transactions with related tax haven companies. The IRD has included a specific section in the Hong Kong Profits Tax Return requesting taxpayers to declare whether they have any transactions with a closely connected non-resident person and if so, the IRD may issue future enquires. Recent court cases have also indicated that the IRD has not only become very stringent when examining and acceding to offshore claims, but also routinely challenges offshore claim positions. If the IRD is successful in challenging a tax planning scheme and establishing that the scheme is tax avoidance in nature, the IRD may invoke penalty sections in the IRO (which include a maximum penalty at 300% of tax underpaid) in addition to recovering any underpaid tax. Hence, Hong Kong based groups that utilize tax haven vehicles and claim offshore income should adequately manage the tax risk e.g. by maintaining sufficient documentation that can justify and support their offshore claim position.

In Hong Kong, the IRD will allow for apportionment of profits (i.e. 50% offshore and 50% onshore) derived from sales of goods manufactured in the People's Republic of China (PRC) under certain type of processing or assembly arrangements with local PRC entities. However some taxpayers are not exactly clear on what type of processing arrangement is entitled to this apportionment treatment and this may result in significant tax risk if an improper 50:50 offshore claim is made.

There are two common types of processing and assembly arrangement in the PRC generally described as the contract processing arrangement and the import processing arrangement. In contract processing arrangement, a Hong Kong company will provide equipment, technical know-how, design, and supervision to a PRC entity which will carry out the processing manufacturing in the PRC. The PRC entity in a contract processing arrangement is responsible for providing factory premises and local labor to render processing to the raw materials consigned from the Hong Kong companies. The finished goods are then exported to Hong Kong company. In an import processing arrangement, a PRC entity will purchase raw materials from a Hong Kong company for manufacturing the goods on its own, and sell the finished products to the Hong Kong company that has supplied the raw materials.

The IRD in recognition of the involvement of the Hong Kong company in a contract processing arrangement in the PRC, will accept that profits on the sale of goods derived by the Hong Kong company can be apportioned on a 50:50 basis such that only 50% of the profits will be subject to tax in Hong Kong. Import processing arrangement however is regarded by the IRD as a simple sale of goods by the PRC entity to Hong Kong company, with the PRC entity undertaking the manufacturing of the goods in the PRC on its own basis. Hence IRD will regard the Hong Kong company under an import processing arrangement as carrying on trading business so that the profits derived from sales of goods will not be entitled to the 50:50 apportionment.

While contract processing arrangement is very common in Southern China in 1990's, in the recent years Hong Kong based groups have gradually established their own legal entities in the PRC and converted their contract processing arrangements into import processing arrangements. Despite the conversion, the relevant Hong Kong companies may continue to make the 50:50 offshore claims by arguing that the contract processing and the import processing arrangements are only different in form and not in substance. On the other hand, the IRD has increased scrutiny of such offshore claim and disallow claims which are based on import processing arrangement. Hence, Hong Kong based groups should review their processing arrangement to ensure any 50:50 offshore claim is supported by the correct form of subcontract processing. If IRD is successful in challenging the validity of the offshore claim, the IRD may invoke penalties as earlier described.

4. Permanent Establishment Exposures in the PRC or Other Countries

Many Hong Kong based groups have extended their operations beyond Hong Kong to overseas territories and

most commonly to the Mainland of China. Most foreign tax systems use the concept of permanent establishment (PE), defined in the local tax laws or double taxation agreements (DTAs). In general, a non-resident company can be considered having a taxable base in a foreign country when the non-resident company's activities undertaken in the foreign country reach a certain level. When such taxable base in a foreign country is established, it is considered to be a PE, which gives the country the right to tax profits of that PE.

In terms of PE definition in DTAs, Hong Kong recently signed a DTA with the Mainland of China on August 21, 2006 which will become effective with respect to Hong Kong taxes from the year of assessment beginning on or after April 1, 2007 and with respect to Mainland taxes for the taxable year beginning on or after January 1, 2007. Besides, Hong Kong has entered DTAs with Belgium and Thailand. All of the above Arrangement and DTAs contain definitions of PE. Apart from the above three countries, other non-DTA countries would apply their own definitions of PE under their respective domestic tax laws to Hong Kong companies having activities in such foreign jurisdictions.

It is not uncommon that a Hong Kong company lodges an offshore claim to the IRD on the basis that all of its activities are undertaken in Mainland China. According to the newly signed DTA between Mainland China and Hong Kong, a lodgment of an offshore notice may provoke mutual exchange of information between the IRD and Mainland China's tax authority, i.e. a Hong Kong company would essentially be volunteering to provide information on the existence of a PE in Mainland China to the IRD. The failure or inability of a Hong Kong based group to manage its PE exposure can trigger tax audits or tax disputes in Mainland China and other foreign jurisdictions. Without an in-house team that focuses on tax risk management, this type of tax exposures can hardly be identified and managed by the ordinary accounting or finance functions.

5. Summary

Despite the simple tax system in Hong Kong and in the absence of local laws imposing compulsory internal tax risk management, it is still important for Hong Kong companies to self-impose certain effective tax risk management strategies and system to identify and manage tax risk exposure, especially in the specific areas described earlier in this article.

It should also be noted that while companies may engage external tax advisors to assist in designing tax risk management process and provide advice on the implementation process, the ultimate successful running of an effective risk management process would still rely

on the company's willingness to allocate resources and prioritize this matter in the overall corporate governance model. Companies who take a more serious view on tax risk management tend to have in-house core tax or finance team, including dedicated tax personnel, to monitor, identify, and assess potential tax exposures and provide proper preventative measures to manage and/or resolve the

situation. On the other hand, companies that do not see tax risk management as an important matter may question the need for allocating resources on tax risk management. However, when there is a major tax audit or a significant unexpected tax assessment, the past oversight in tax risk management will be unveiled.

Author's Profile

Mr Luis Coronado is a tax partner in Deloitte's Shanghai office and the leader of the transfer pricing team in China. **Mr Philip Wong** is a tax partner and **Mr Anthony Lo** is a senior manager in Deloitte's Hong Kong office.



China

**Mr Luis Coronado, Ms Vicky Wang
and Mr Hong Ye**

1. Introduction

Tax risk management is not a new concept in the People's Republic of China (PRC). The business communities and academia have published many articles on tax risk management but formal regulation of this subject has been lagging behind. It is not until very recently that the Chinese government published regulations dealing with internal controls of Chinese listed companies, which also indirectly cover tax risk internal controls. For many foreign-invested enterprises owned by a multinational corporation and not listed on the Chinese stock exchange, there are still no mandatory official risk management procedures to follow under the Chinese regulations, although many of those enterprises are following internal tax risk management guidelines set forth by the parent company in accordance with a foreign legislative requirement, such as the United States Sarbanes-Oxley Section 404 requirements.

Unmonitored tax risks may result in government sanctions (which may be of monetary or even criminal nature) and reputation losses. Tax risks may arise as a result of not appropriately applying tax laws to the company's operations or transactions or not complying with the relevant reporting requirements. If not properly disclosed in the financial statements, material tax risks may also distort the financial information of a company, misleading investors. A company's

management thus has fiduciary obligations to properly monitor tax risks to minimize a potential damage to the shareholder value.

2. Contributory Risk Factors in China

Tax risks often arise from both intentional and unintentional actions. Similar to many countries, the management integrity, mentality on risk tolerance, internal control systems, and the regulatory environment, may all contribute to the risk factors.

In China, since the tax system is still in a developing stage, the regulatory environment often becomes a relatively higher-weighting contributory risk factor, in addition to the commonly seen risk factors in countries with more developed tax systems.

Specifically, the following elements are commonly seen in the Chinese tax system:

Incomplete tax law

As China modernized its tax code only in the early 1990's, and taking into account the fact that China has so far maintained two tax systems, i.e. one for domestically owned enterprises and one for foreign-invested enterprises, the tax law is often incomplete and unable to cover all types of transactions and taxpayers. In addition, case law is essentially nonexistent in China, thus resulting in even more limited citable sources in this area. Due to the incompleteness of the tax law and in the absence of specific regulations, many taxpayers tend to take advantage of various loopholes.

This approach increases tax risk, as some of the positions may subsequently be considered by the tax authorities as being in violation of the spirit of the fundamental law principle.

Non-transparency of the tax law

It is not uncommon for the local tax authorities to stipulate local regulations or administrative measures, which are intended to supplement the national law. However, some of these regulations or measures are not well communicated to the general public but rather remain as internal enforcement guidelines. Such non-transparency of the tax law further increases non-compliance risks for the taxpayers.

Inconsistent interpretations of the law

Given the developing stage of the Chinese tax legislation, many terms in the tax law are not yet fully defined in the published tax circulars. Interpretation of the published law by local tax authorities often becomes the determining factor in concluding a particular tax position. Some interpretations may be to the advantage of a taxpayer, while some to the disadvantage. If a taxpayer has operations in multiple locations in China, the interpretations from different localities may be inconsistent, thus again causing compliance difficulties. In addition, some interpretations by the local tax authorities may not be viewed as being in line with the national policy upon a subsequent review by the national tax authority, taxpayers may therefore be exposed to the potential of being subsequently challenged by the national tax authority with adverse consequences if a locally approved practice is revoked and retroactive action is taken.

Inconsistent enforcement of the law

There are occasions where the tax law is published but not actively enforced in practice due to macroeconomic control needs. For example, the land value appreciation tax was published in late 1993 with the intention to curb land speculation at the time. However, in practice, this particular tax was not collected for a long time, due to the subsequent real estate market trends and economic control needs. Situations like this pose a financial statement disclosure challenge and require companies to assess the risk in view of the overall regulatory environment and likelihood of the risk.

Lack of a regular ruling system

The private ruling system is not well established in China (except in the case of transfer pricing where the Advanced Pricing Arrangement (APA) regulations have been in place since September 2004). For most of the transactions, taxpayers may only find out the exact tax treatment after a transaction has taken place, which increases the risk and potential cost of a transaction.

That said, the management integrity and risk tolerance levels continue to be the most important factors contributing to tax risks, which often determine the level of the effectiveness of an internal control system and related measures.

Based on our experience, tax risks for a Chinese taxpayer often arise from the following areas:

- Transfer pricing, both domestic and cross border transactions;
- Indirect tax and customs duty, especially related to complicated processing models;
- Withholding tax, especially on service fees attributable to both onshore and offshore services;
- Permanent establishment of a foreign principal;
- Corporate income tax incentive entitlement; and
- Individual income tax reporting and withholding of expatriate employees.

3. Tax Risk Management

For many companies in China, tax risk management means:

- ensuring that tax accounting (i.e. financial statement presentation) is properly done;
- ensuring that tax personnel are knowledgeable about Chinese tax laws and practices;
- maintaining proper documentation and invoicing;
- knowing how to respond to a tax audit; and
- reducing the tax burden effectively and legitimately so that the tax position taken can sustain any future challenges.

Tax risk management is embedded in the company's culture and is often driven by the top management's attitude toward this subject. A more risk-averse management team (often of a public company) would tend to impose stricter internal control to ensure regular compliance and approval procedures for aggressive tax positions. In China, as perhaps in any other country, an ideal "perfect compliance" with the tax law may prove to be extremely costly. This is especially true when doing business in China, considering its currently imperfect tax system. Therefore, understanding and controlling tax risks at acceptable levels is a more realistic approach than trying to completely eliminate tax risks.

Facing the fast-changing Chinese tax regulatory environment, companies are advised to consider consulting external tax professionals for assistance with better understanding of the tax risks involved in a complicated situation or transaction. This will also allow the company to make an informed decision dealing with the tax risks. Companies should also consider using internal control specialists to help implement and monitor effective internal control systems if the existing internal resources are not sufficient to meet the needs. This is particularly the case in view of recently published regulations, as discussed below.

4. Recent Development on Internal Control

China's relatively short history of public listing of companies began in the early 1990's. Although the corporate law has adopted the basic principles and concepts of Western countries, it still lacks detail in the areas of explanation and implementation. Enron's demise and the enacting of the Sarbanes-Oxley Act in the United States generated much debate on corporate governance and management's responsibility in China. But it was not until the late 2005, that China released the rule that called for management's responsibility for internal controls for publicly listed companies in China. In October 2005, the State Council issued an opinion prepared by the China Securities Regulatory Commission (CSRC) aimed at improving the quality of the corporate governance in public companies (the Opinion). Guofa (2005) 34. In the Opinion, the CSRC called for establishment of an internal control system by public companies. The Opinion requires that public companies periodically engage external auditors to conduct audits on its internal control systems and conduct self-reviews and assessment of the effectiveness of its internal control systems via internal reviews. The relevant

information is then required to be disclosed to the public.

Following the issue of the Opinion, the Shanghai Securities Exchange issued Guidelines on Internal Control by the Companies Listed on the Shanghai Securities Exchange (the Guidelines). The Guidelines were issued on 5 June 2006, and became effective on 1 July 2006. They require that all companies listed on the Exchange prepare annual internal control self-assessment reports and have them audited by Chinese Certified Public Accounting (CPA) firms. The Guidelines further stipulate that the internal controls should cover all aspects of the business operations, including, but not limited to, areas such as revenue recognition and transfer pricing policies and documentation of related party transactions, which are closely related to tax risk management.

It appears the overall regulatory environment in China has been increasingly calling for a tighter control system for risk management purposes, similar to those in many western countries. Now, as public companies are called upon to set up internal control systems, tax risk management is poised to become a hot topic and an increasing focus in China.

Author's Profile

Mr Luis Coronado is a tax partner in Deloitte's Shanghai office and the leader of the transfer pricing team in China/HK.

Ms Vicky Wang is a tax partner and **Mr Hong Ye** is manager in Deloitte's Shanghai office.

UPDATE:

China's SAT Announces Signing of First Bilateral APA with U.S.

Mr Luis Coronado, National Transfer Pricing Leader, Deloitte China/HK

On 11 January China's State Administration of Taxation (SAT) announced the conclusion of the first bilateral Advanced Pricing Agreement (APA) entered into by China and the United States. This is a milestone announcement and reflects China's footprint in the field of mutual agreement procedures in the context of APAs. It is the second bilateral agreement concluded by China following the APA with Japan 2005.

SAT Commissioner Mr. Xuren Xie signed the bilateral APA during his visit to Washington, D.C., after two rounds of negotiations that started in June 2006 and concluded on 22 December.

Wal-Mart is the taxpayer that obtained the APA, according to the official announcement by the SAT.

This case will certainly provide taxpayers assurance on making use of treaty provisions in negotiating for prospective, as well as renewing, bilateral APAs, thus

minimizing any potential double taxation that can occur from carrying out business globally.

The SAT issued China's formal APA rules in September 2004 and has recently indicated that during its case selection process it will focus on technical aspects of transfer pricing, as well as cutting-edge topics such as intangibles and cost sharing.

An APA is an agreement concluded between the relevant tax authority and a taxpayer that allows transfer pricing issues related to transactions between associated enterprises, such as pricing policies and calculation methods and other relevant important assumptions, to be determined for a given period in the future, generally four years. Under the SAT APA rules, the agreed APA terms can be rolled back to the year in which the APA application was submitted although rollback to earlier years is negotiable and not guaranteed.