RISK MANAGEMENT
BUILDING A FRAMEWORK FOR SUCCESS

Jeremy McCallum of Macfarlanes LLP explains the importance to businesses of having a robust and effective risk management framework.

At the end of December 2020, as part of the UK's negotiated exit from the EU, the UK took the decision to disapply the majority of the hallmarks in Directive 2018/822/EU (DAC 6); thereby reducing the reporting burden on businesses in respect of cross-border tax arrangements (*see News brief "Tax reporting and DAC 6: UK moves from EU to international rules", www.practicallaw.com/w-029-3478*). This unexpected step was welcomed by the business community, and the UK business community in particular. However, proper identification and management of tax-related, and other, risks remains a priority and regime reporting may still be necessary.

These requirements together highlight the importance of having robust risk management procedures as a component of a business's wider risk management framework, both in the DAC 6 context and more widely (*see box "Developing a risk management framework"*).

An effective tax risk management framework comprises a combination of factors, including having:

- The right tone from the top.
- Robust policies and procedures.
- Strong internal functions.
- Regular and relevant training.
- Good awareness, effective engagement and use of advisers, a strong compliance culture, and demonstrably responsible behaviours.

This article looks at some of the reasons why a strong risk management framework is important, what this means in practice, and what a good framework might look like. The article also considers some of the ways in which good governance can be tested.

DIRECTION OF TRAVEL

The HM Revenue & Customs (HMRC) attitude to risk is changing and taxpayers are increasingly keen to be able to demonstrate and to promote good governance, controls and behaviours.

Failure to prevent tax evasion

Recent years have seen the introduction of the corporate criminal offence under the Criminal Finances Act 2017 (2017 Act), aimed at tackling the failure to prevent the facilitation of tax evasion (*see feature article "Facilitation of tax evasion: new offences of failure to prevent", www.practicallaw.com/w-010-4276*). The new offence comes with criminal sanctions and can apply to all businesses. An offence is committed where a relevant body fails to prevent a person associated with it from facilitating tax evasion, either UK or foreign. There is a statutory defence if it can be shown that the relevant body had implemented reasonable prevention procedures.

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DOTAS

The disclosure of tax avoidance schemes (DOTAS) regime, originally introduced in 2004, requires those that design, sell or implement tax avoidance schemes to provide HMRC with information about arrangements that are expected to have a UK tax advantage and meet a "hallmark". The aim is to provide HMRC with information to allow it to investigate and take action where appropriate.

DAC 6

The DAC 6 reporting regime is fresh in the mind and goes further than the DOTAS regime in light of its cross-border application (*see box "DAC 6 reporting"*).

Business risk reviews

With effect from October 2019, HMRC has also adopted the new business risk review system for larger businesses (*www.gov.uk/hmrc-internal-manuals/tax-compliance-risk-management/tcrm3340*). Under this process, HMRC evaluates a large business's tax compliance risk profile and categorises it as low, moderate, moderate-high or high. The review involves HMRC assessing a business against three factors for all relevant taxes: systems and delivery, internal governance and approach to tax compliance. Large businesses that are assessed as low risk can reasonably expect that they will not have their returns or declarations challenged by HMRC and that HMRC will not review the company's risk rating for three years. At the same time, HMRC will focus more resources on businesses that are not assessed as low risk and with those taxpayers HMRC may require more dialogue and conduct ongoing annual risk assessments. The methodology here is indicative of HMRC's wider approach to risk, and how HMRC resources are likely to be allocated.

Developing a risk management framework

Typical procedures and controls
Identify and document principal tax risks, appetite and controls.
Develop policies for the procurement of external advice, the use of sub-contractors and outsourcing.
Dovetail and refresh group policies across all functions.
Align approaches to risk across the business.
Develop a system for the review and sign-off of difficult or sensitive issues.
Establish the tone from the top and disseminate.
Develop a robust document management and retention system with audit trail.
Define the process for transaction follow-through and general health checking.
Set out a policy for the development and use of technology.
Ensure that teams stay current and are trained as necessary.
Conduct specific training, guidance and procedures for anti-money laundering, the corporate criminal offence and DAC 6 (Council Directive 2011/16/EU in relation to cross-border tax arrangements).

Other measures

Other recent measures addressing transparency and compliance include country-by-country reporting where, under the Taxes (Base Erosion and Profit Shifting) (Country-by-Country Reporting) Regulations 2016 (*SI 2016/237*), UK-headed multinational enterprises are required to file a confidential annual country-by-country report with HMRC (*see News brief "Country-by-country reporting for multinationals: EU transparency proposals", www.practicallaw.com/0-627-0585*).

There is also the common reporting standard, the general anti-avoidance rule and, for large businesses, the publication, and annual updating, of a tax strategy (*see News brief "Autumn Statement 2015: key issues for businesses", www.practicallaw.com/7-622-1756*). At the same time, recent consultations, such as those relating to the notification of uncertain tax treatments, align with this general direction of travel (*see News brief "Spring Budget 2020: good news in times of uncertainty", www.practicallaw.com/w-024-5854*).

Many of these developments are concerned as much with an organisation's conduct as with tax specifically. The sheer volume of change brought about by the various regimes creates the risk of tax fatigue. Businesses need to be alive to this risk.

MESSAGING, CULTURE AND RISK APPETITE

As tax is increasingly viewed as a boardroom issue, with the conduct of the board members playing a significant part, HMRC's expectation is that the right tone should be set and maintained from the top. The corporate governance principles for large private companies, the Wates Principles, were introduced to improve the UK's corporate

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governance framework and, although not tax-focused, are relevant in this area (*see News brief "Corporate governance for large private companies: a flexible framework", www.practicallaw.com/w-018-7078*).

For example, a board needs to be able to demonstrate that it has effective oversight of risk, a responsible attitude to it, and a good understanding of the policies and procedures that it needs to have in place in order to monitor and manage risk. The key messages need to be disseminated across the business and applied to the business's operations. As far as tax and tax risk is concerned, those functions in the business that have particular connection or interaction with the tax function should be underpinned by consistent and co-ordinated policies and procedures; a piecemeal policy approach is unlikely to encourage the behaviours that are expected, or to reflect well on governance overall.

Some organisations may want to test the board by undertaking an evaluation for general assurance as to good behaviour on the part of its members. Some may feel that the messaging may not resonate as intended if the board itself is not seen to have its own house in order.

It follows that the composition of the board, and its messaging around risk, are both fundamental in setting the right tone and embedding it within the business. As far as composition is concerned, the board is likely to include the chief risk officer, or equivalent, and perhaps the general counsel or the head of tax. But irrespective of the board's composition, there is an expectation that it should have a good understanding of risk and quite possibly a degree of tax expertise, and that the board will empower the risk and tax functions and engage with them. At the same time, any operational committees with risk responsibility of whatever nature should be constituted accordingly (*see Briefing "Risk committees: a solution for troubled times?", www.practicallaw.com/w-027-5122*).

DAC 6 reporting

Directive 2018/822/EU, also known as DAC 6, imposes mandatory reporting of certain cross-border arrangements. It is an EU reporting regime.

DAC 6 was introduced as part of the Organisation for Economic Co-operation and Development's anti-base erosion and profit shifting (BEPS) project (*see News brief "The OECD's action plan on BEPS: a taxing problem", www.practicallaw.com/0-538-9745*).

DAC 6 applies to cross-border arrangements that meet certain so-called "hallmarks". While the regime was designed to catch potentially aggressive tax planning, its application is wide, and its ambit can include transactions undertaken with no obvious tax motivation. It applies where the arrangements involve at least one EU member state or the UK. The reporting obligations fall on intermediaries or, in some circumstances, the taxpayer. The regime is complex and imposes a significant compliance burden (*see "DAC 6 policies" in the main text*).

In the EU, the full DAC 6 regime is now live and requires real-time 30-day reporting of any arrangement that triggers a hallmark (business-as-usual reporting). In addition, the regime required the reporting of certain historic arrangements where the first step in the implementation of the arrangement took place on or after 25 June 2018 (legacy reporting). Under DAC 6, the information reported is then exchanged between the states concerned.

STRATEGY AND CONDUCT

Some companies are required to publish a UK tax strategy and may also wish to adopt a general statement of business principles or a code of conduct. The tax strategy will address the organisation's management of tax risk, its attitude towards tax planning, communication with HMRC and, depending on the nature of the business, management of tax at the subsidiary or portfolio company level (*see feature article "Large business tax strategies: too big to fail?", www.practicallaw.com/w-014-8263*). HMRC may wish to test whether the organisation is abiding by its published tax strategy.

Some groups will develop a global approach based on their UK strategy and will refresh it regularly. Even for groups that are not within the scope of the UK regime, they may nevertheless wish to develop and publish a strategy. That strategy is likely to operate alongside and complement an organisation's risk register, in which it describes its principal risks as a business and sets out, risk-by-risk, the relevant controls and mitigating steps that it takes.

Where a business develops a code of conduct, this is likely to require compliance with both the letter and spirit of laws, regulations and contractual obligations, while also endorsing the importance of managing conflicts and respecting confidentiality. These principles are becoming increasingly important in an environment, social and governance (ESG) context (*see "ESG issues" below*).

These principles, together with any tax strategy, are likely to be rolled out across all group entities and some groups will expect that any such principles, and the tax strategy, should be provided to professional advisers and generally adhered to by those advisers in the advice that they give. Where a business has created a code of conduct, this should form a component in the employee induction programme and all employees should be expected to have read and understood it. It may be prudent to require employees to certify compliance with the code, perhaps annually, with sanctions applied for non-compliance or non-certification.

INTERNAL RISK FUNCTIONS

It is important that the board's messaging is disseminated clearly across the business and applied effectively to its day-to-day operations. This will raise a number of issues for a group's internal functions.

Remit

The remit of the function is key; that is, the scope of work for which the function takes responsibility. Taking the tax function as an example, responsibility for overseas tax, where relevant, should be addressed and the process for interaction with front office teams that have tax involvement, such as the transactions and structuring groups, should be clearly articulated. Deal teams need to understand the operating protocols where tax is involved in what they do.

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Some of the common issues that arise in this area include the need for the central tax team, or tax committee, to sign off on the transaction, and the process for continuing review and follow-up. For example, once a transaction has been executed, it may require ongoing review; for instance, to ensure that any recommended actions, or contractually agreed steps, are actually implemented as advised. This requires transparent operating procedures and a good level of positive interaction and communication between the various teams concerned. It also involves good document storage and retrieval facilities. Similar principles also apply to an organisation's overseas offices, that may or may not have their own internal tax resources and where formal reporting lines should be clearly delineated.

Structure

There are various structures that an internal function can take. The solution as to which to choose will inevitably involve a balance between internal resources and external advice, and of course all operating models will be different. For the tax function, the role of technology plays an increasingly important part in the compliance process and is likely to shape the structure of the function itself. It may require a blend of tax technical and tax technology expertise.

The development of technology, and increasing subject matter complexity, is one factor in the decision that some international businesses have taken to review their approach to outsourcing. Some have chosen to outsource not just the work, but in effect the function and its people too. The intention with these strategies is to create a leaner and more agile operating model, to reduce costs and to improve overall quality.

These initiatives have not been limited to tax. Other functions, such as finance and legal, have been largely outsourced as well. The perceived cost and efficiency benefits are generally readily apparent from the outsourcing business's perspective, although it will be important that lines of communication remain open to ensure that the service provider stays close to the business and its decision makers, and is fully aligned with its approach to risk and its culture. For the service provider recipient, the anticipated benefits involve a deeper working relationship and the expectation of recurring work over a significant period of time, but this will not be without risk in terms of cost, integration and culture. Where the service provider is an audit firm, auditor rotation may have an adverse impact on the operating model in the medium to long term, with associated challenges on both sides (*see News brief "Corporate reporting and audit: a new approach", www.practicallaw.com/w-030-7100*).

The simpler outsourcing structure will involve outsourcing the work alone. In other words, consideration has to be given to what work should be kept in-house, what should be undertaken by external advisers and what this means in terms of resourcing and ongoing training and support.

Procurement process

There is an increasing level of attention being paid to the outsourcing process from a risk perspective, especially in terms of procurement process and policy. The corporate criminal offence regime under the 2017 Act has encouraged businesses to focus on the risks in this area, and a business is likely to demand a level of assurance that the advisers it engages with will not create a tax evasion facilitation risk.

Having a panel of advisers is helpful here and will usually be underpinned by a robust process for ongoing review and monitoring of panel firms. This can go wider than the practice by which professional advisers are asked to confirm that they have understood the client's approach to risk. It can also involve an assessment by the client of the adviser's key policies and procedures for assurance that their respective approaches are broadly aligned. This may be underpinned by a formal right of audit in certain circumstances, particularly where the client's business is regulated (such as a bank).

Assuming that an organisation operates a panel of preferred suppliers, including its professional advisers, the process for engaging with those suppliers should be clearly documented, as should the process for selection and appointment of additional suppliers where that may be necessary. Appropriate terms and conditions are also required and, where a master set of terms has been negotiated, any engagements that are governed by them will need to be specifically scoped and priced. At the same time, the master terms should be kept under review and refreshed as necessary, and should be available in a readily accessible form. The business may also need guidance as to additional terms, or variations, that should be included from time to time, perhaps in respect of liability caps, confidentiality provisions or data protection language, and help with scoping.

Finally, any function will need a healthy level of interaction with management, with the business generally and with the other internal functions.

GROUP POLICIES AND PROCESSES

Particular internal functions are likely to operate their own policies and processes, but where there is a policy overlap, it is important to ensure that there is a general level of consistency between the functions. The policies concerned may be global, local or entity-based, depending on the circumstances, and some may have been introduced on a rather piecemeal basis. If so, the business should undertake a degree of dovetailing in order to eliminate areas of unnecessary overlap and to ensure consistency (*see below*).

In addition, the business should identify an "owner" for each policy and it should be clear from the policies themselves how frequently they are to be reviewed, by whom, and when the last review was undertaken. Reviews should take account of changes in business model, as well as changes in law or regulation. While this approach is especially important for regulated businesses, it will in any event demonstrate good risk management practice for all organisations.

In terms of dovetailing, for example, a corporate criminal offence-driven tax evasion policy will inevitably overlap with aspects of a business's anti-money laundering (AML) policy. So steps should be taken in order to ensure that the suspicious activity reporting (SAR) process under an organisation's AML policy aligns with the internal reporting process for the facilitation of tax evasion offence. Equally, guidance that is provided to employees in either case may identify particular red flags to watch for and these should be consistent.

Possible indicators, or red flags, for a risk of facilitation of tax evasion might include:

- A failure to follow normal decision-making processes.

- Pressure for early payment.

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- Unusual payment methods.
- Missing or inaccurate documents.
- Unusual invoice details.

A risk in this area could arise where any of these types of indicators are present and, in addition, a SAR may be required if the indicators in question raise the suspicion of tax evasion (as well as money laundering or terrorist financing).

A specific policy to address the risk of facilitation of tax evasion, if introduced, may well be based on findings and recommendations arising from a risk assessment in that area. Any such assessment should be refreshed regularly in order to ensure that any relevant changes in business model or operations are reflected in the analysis, and are addressed and managed. In doing so, a business will want to emphasise its top-level commitment to a zero-tolerance approach where financial crime is concerned.

As indicated above, procurement processes and policies are likely to have been updated or formalised in light of the regime under the 2017 Act, to seek to manage the facilitation risk for the business and to control any such risks arising from the supply chain (*see "Procurement process" above*). Wider risk management considerations will also arise in respect of advisers and other suppliers used.

DAC 6 policies

Notwithstanding the developments of December 2020 and the disapplication of the majority of the DAC 6 hallmarks in the UK, it remains important for businesses to introduce and operate a clear process for DAC 6 analysis and reporting, to be responsive to changes in relevant law and practice and to scope and price engagements where specific DAC 6 advice is required.

At the same time, some organisations are interested in deploying a software solution in order to track, in dashboard form, the DAC 6 reporting position across the affected jurisdictions in which they operate, recording the conclusions reached by the relevant advisers and flagging any anomalies. These types of software solutions can also provide a robust audit trail, while ensuring that all relevant supporting materials are secure and readily accessible.

Related information

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Most policies are likely to be the subject of new joiner induction training and, for the more significant policies, some level of ongoing training is likely to be required. Again, it may be prudent to require employees to provide regular certifications to demonstrate an understanding of, and compliance with, the policies. A consistent approach should be developed and implemented in this area. The same will apply for ongoing professional training, as necessary.

ESG ISSUES

ESG issues bring together what firms can do to improve their environmental footprint, create positive impact and potentially transform their businesses. A robust ESG strategy is becoming more important in protecting the value of a company's business and portfolio, and stakeholders are increasingly applying an ESG lens to what they see. The "G", good governance, is becoming especially important in this context.

In terms of tax governance, this can be tested. This testing is likely to involve an assessment of many of the matters raised above, including:

- Board oversight and approach to tax.
- Attitude to and disclosure of tax risk.
- The operation and remit of the tax function.
- Business risk reviews.
- Tax disputes.
- New business developments.
- Principal risks and controls.
- Engagement with stakeholders and industry bodies.

The author's experience is that businesses are interested in procedures that are designed to provide a snapshot of their ESG position with red, amber and green ratings for each measure, with suggestions for remediation as appropriate. The output here will help to identify what good practice should look like and, importantly, whether the standard has been met or exceeded.

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