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Hyper-Regulation Leaves No Place To Hide

BY BOB NORTON

When the "official" end of the recession was announced last year, the recovery seemed incomplete and shallow for many businesses, corporate leaders and individuals. From a corporate perspective, the economic fallout continues to reverberate into the new year, impacting everything from staffing and capital expenditures to increased tax regulation and reform.

Indeed, the need to address unsustainable global deficits is driving an unprecedented level of regulation and new legislation resulting in widespread implications for tax and finance departments.

Convergence of U.S. generally accepted accounting principles and International Financial Reporting Standards, more aggressive tax enforcement, federal, state and international tax reforms and increasing demands for transparency are making one thing certain in an environment of total uncertainty: workloads for corporate tax departments will increase notably in 2011 and for a number of years into the future.

At a time when operational budgets remain static, new workload levels will create tax and financial reporting risks — issues of major concern to chief financial officers, controllers and audit committees. The rapid pace and extent of these changes are already causing systemic reverberations in how corporations manage global tax risk and new practices will evolve as the future unfolds.

To manage them, finance and tax departments will continue to become progressively more integrated operationally. Increasingly, both departments are turning to process improvement and automation through enterprise solutions for needed transformation to better manage risk, and that will continue to set the trend for tax departments this year.

As if excessive workloads and the risk of material weaknesses weren't reason enough to improve corporate tax process efficiency and accuracy, companies now need to prepare for aggressive audit tactics and disruptive tax reforms by governments worldwide.

Unlike past economic periods when governments acted separately to enact reforms, these same governments are now working in tandem and taking joint action to address ever-widening budget shortfalls at national, state and local levels.

Transparency, Audit Sophistication And Cross-Border Collaboration

While the Internal Revenue Service has been pursuing an agenda of transparency in recent years, last year it reached a whole new level with the issuance of Schedule UTP (Uncertain Tax Position). Apparently, the agency

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An unprecedented level of regulation and new legislation are expected to have a major impact on tax and finance departments. Tax is transforming from a departmental, siloed process to an enterprise function, as tax and finance departments are increasingly integrating to improve productivity and manage tax risk and compliance.

determined that FIN 48 financial statement disclosures did not provide enough insight into a company's aggressive tax positions. As a result, taxpayers must now submit Schedule UTP with their Form 1120, disclosing all uncertain U.S. federal tax positions in the order of potential size of exposure.

While the IRS softened its position in response to industry outcries during the Schedule UTP comment period, it will still require increased attention in 2011 from companies with more than $100 million in assets. The issuance of Schedule UTP is a game-changing event in IRS policy and will likely be mimicked by states and foreign countries.

In another sea change in transparency practices, more than 80 countries have committed to "international cooperation in tax matters." According to the Organization for Economic Co-operation and Development (OECD), since 2008, the number of multilateral tax information exchange agreements between countries has grown from only 44 to more than 600.

With more than 60 double-tax treaties and more than 25 tax information exchange agreements in place, IRS Commissioner and sitting Chair of the OECD Forum on Tax Administration Douglas Shulman will continue pushing an agenda of cross-border joint audits.

In remarks last June to OECD members Shulman noted, "We are now working on developing a protocol for joint audits with other countries … it is a process where two or more countries join together to carry out a single audit of a company with cross-border business activities."

Similarly, on the other side of the pond, Dave Hartnett, secretary of HM Revenue and Customs in the United Kingdom, is also on board with joint audits. "I think moving forward, this will happen very quickly. We will see more joint audits between nations," Hartnett said in an interview last February with Ernst & Young.

"We will see the beginning of tax authorities saying to multinationals, 'Well, the U.S. is going to audit you in North America, the U.K. will audit you in Europe. Australia will audit you in the Pacific, and we'll use our treaty networks to join all that up,' " he added.

In September, at the sixth meeting of the Forum on Tax Administration sponsored by OECD, tax commissioners from more than 40 countries declared that they will be conducting joint audits between free-trade agreement (FTA)-participating countries. At the same time, many countries warn that they will aggressively pursue transfer-pricing abuses, and none more so than the U.S.

According to data compiled by *Bloomberg*, U.S. companies accumulated more than $1 trillion in foreign profits that were not taxed in the U.S. as of the end of 2009. Martin Sullivan, a tax economist who formerly worked for the Treasury Department, said that "a very significant part of this accumulation of profits offshore is the artificial shifting of profits using transfer pricing."

This issue is highly visible on Capitol Hill. Last July the House Ways and Means Committee held a hearing on transfer pricing issues. In his opening statement, Acting Chairman Sander Levin, a Michigan Democrat, noted that transfer pricing is a serious issue that poses a "challenge to the enforcement of United States tax laws," and cited reports of multinational corporations, "potentially gaming the current system" to shift assets and cash within foreign-based entities to avoid paying U.S. taxes.

Recently, prior to the November midterm elections, Levin advised that he expected to bring transfer pricing legislation to the House floor during the lame duck session of Congress in an attempt to prevent improper tax avoidance strategies employed by multinational companies.

The IRS recently reorganized its Large and Medium Sized Business (LMSB) division into the Large Business and International Division (LBI), dedicated to improving international compliance, especially transfer pricing. As part of this realignment, the IRS will add 875 employees, a transfer pricing director and a chief economist, all of whom will oversee IRS economic positions pertaining to transfer pricing.

Now armed with more than 600 multilateral tax information exchange agreements and formal coordination on cross-border joint audits, global tax administrators are more equipped to pursue tax underpayments in 2011 than at any other time in history. To catch offenders, they will be looking closely at Schedule UTP, mining e-file data submissions, cross-referencing data with XBRL-based financial disclosures and using powerful analytics to accurately determine the audit risk of companies so they can focus their audit resources on companies with the highest potential return.

To support these initiatives, companies can expect tax agencies to increase the level of data detail that they will want submitted with returns and through audits. All of this will create an additional workload for tax and finance departments, as well as necessitate a greater focus on tax data accuracy. The end result? Increased tax risk.

New Taxes and Accounting Standards

While the predictions noted above will expose tax department staffing shortages in 2011, a wave of new taxes and accounting standards on the horizon will also increase risk, decrease efficiency and continue to drive the integration of corporate tax and finance departments in search of productivity gains.

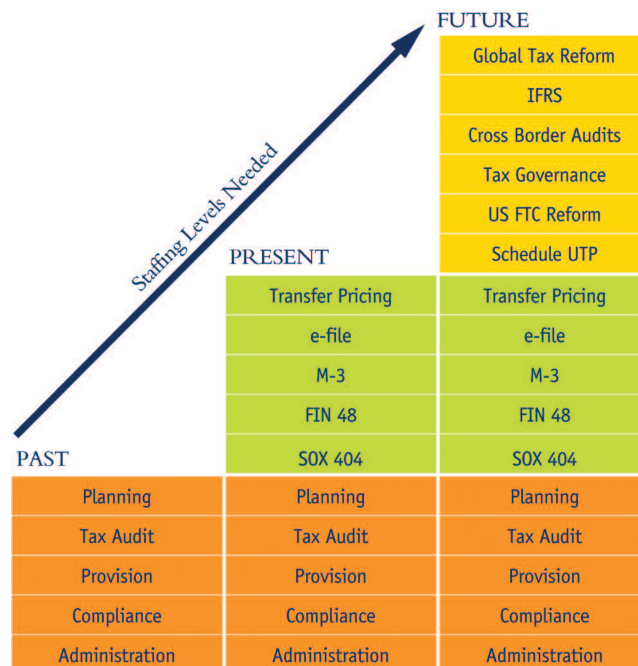
Throughout the recession, state budget deficits skyrocketed, driving governments to focus on increasing tax revenue by enacting thousands of tax changes where it was politically feasible. In the U.S., states raised 850 sales tax rates across 8,000 tax jurisdictions in 2009. In 2010, the average U.S. state tax rate was at its highest level in nearly 25 years.

Looking ahead, state income tax-

es are expected to increase even further as states try to balance budgets. Other countries are following suit. While global corporate income tax rates are trending lower, in many places, value-added tax (VAT) rates are on the rise and the tax base is broadening.

Brazil's recent transaction tax amendments number in the hundreds across its 5,500 taxing jurisdictions and the U.K. VAT rate has increased from the "stimulus" level of 15 percent in 2008 to 20 percent effective in 2011 in an effort to reduce deficits.

And the changes don't stop there. The Financial Accounting Standards Board and International Accounting Standards Board are churning out new exposure drafts of proposed accounting standards at an unprecedented rate — all in an effort to converge their accounting standards this year.



New accounting for revenue recognition, comprehensive income, financial statement presentations and financial instruments will all impact the starting point of most countries' taxable income. This is not welcome news for accounting staffs, many of whom are burned out after years of Sarbanes-Oxley remediation efforts, incessant regulatory changes and the global recession.

Nor is this good news for tax staff — those who will also be dealing with the tax aspects of the prospective U.S. adoption of International Financial Reporting Standards. IFRS is already creating potentially significant tax accounting risk for U.S.-based multinationals with significant non-U.S. operations, because adoption of IFRS for statutory reporting by the various foreign countries is inconsistent and at the election of each countries' government.

Additionally, IFRS continues to evolve and countries may or may not choose to convert statutory accounting methods to the latest IFRS as promulgated by the IASB.

Since many countries use statutory accounts as the starting point in determining the corporate income tax, with so many countries' statutory accounting and reactionary tax legislation in a state of flux, the ability to accurately calculate the tax provisions of multinational corporations has never been more difficult and risk-laden.

U.S. Tax Reform Uncertainty

The historic level of uncertainty around U.S. tax reform cannot be overlooked. While few U.S. federal tax law changes occurred last year, as of this writing it appears likely that the expired Bush-era tax cuts will get extended during the congressional lame duck session, if only for a few years.

And while the recommended plan of the President's National Fiscal Commission did not muster the needed 14 of 18 votes for congressional action, with the recent Euro zone debt and interest rate scares, it is likely a number of the deficit-reduction recommendations will find their way into the 2011 budget. On the other hand, the 2012 presidential election campaigning could cause gridlock over the next two years.

With continuing high unemployment levels, legislators must balance the short-term need for economic stimulus with the long-term need to reduce deficits. All together, the 2012 elections, a Democratic-controlled Senate and Republican-controlled House, the jobless recovery and unsustainable deficits, it's unknown know how things will shape up until the debates are held and new laws are enacted.

2011 Corporate Tax Implications

Corporate finance and tax departments are facing challenging and uncertain times. Workloads have increased and are expected to continue increasing. With no additional resources to address the workload, however, quality will likely suffer and that will raise risk potential, a concern for financial executives and audit committees. (See the chart "Increasing Tax Department Responsibilities" on page 43)

To survive this environment in 2011 and beyond, it will be crucial that corporations find ways to increase the efficiency of tax processes, particularly in the area of tax data management — the common foundation of the tax planning, tax provision, tax compliance and audit defense processes.

Independent studies have shown that collecting, validating and preparing data may consume upwards of 50 percent of a tax department's total time. Yet most companies continue to use a patchwork of custom-built approaches for these functions. In the end, tax data

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gets calculated to produce generally accurate provisions, tax return calculations and tax planning scenarios — but at what cost?

Without the ability to leverage the work done in the provision process to jump-start compliance and planning, tax professionals will continue to fall further behind and become more reactive and distracted, rather than proactive and focused on value-added activities.

In a hyper-regulatory environment, this is a high-risk situation. Complicating matters is the fact that the disparate tax technology solutions for provision, compliance, planning and audit defense (and their underlying databases) only serve to re-silo data, rather than create a single, integrated and reliable source of the tax truth. This reality is driving an evolution in corporate tax departments that will accelerate this year.

Meanwhile, barriers to process improvement exist both within firms and across the industry as a whole. These barriers must be addressed this year.

The sheer number and degree of pending changes mean that many national and multinational businesses will reach a point where they can't efficiently and cost-effectively manage their tax positions — or effectively manage tax risk around the world — using the tax tools currently at their disposal.

These include standalone, country-specific compliance systems and spreadsheets, both of which require too much manual data entry and constant maintenance. Today's disparate, standalone solutions have different features and functions, user interfaces and separate databases. They require different upgrade procedures, data import formats, report formats. Most require manual maintenance of rates, rules and logic changes.

To manage tax operations in 2011 and beyond, the only plausible answer is to find technology-enabled efficiency improvements.

While most vendors are communicating plans for a holistic solution to the entire tax life cycle — including tax planning, tax provision, tax compliance and audit defense processes — these are not currently ready for prime time.

This year, tax needs to learn from recent finance transformation efforts by taking an enterprise-wide approach to tax transformation that incorporates a tax data warehouse that can be synchronized with the company's financial systems and general ledgers. With this approach, all relevant book and tax data and the required level of detail would support "open" tax obligations through the entire tax life cycle.

Sharing this data and calculation logic across applications for tax planning, tax provision, tax compliance and audit management will allow the productivity gains needed to maintain present levels of tax risk management and expense minimization.

This enterprise approach to tax software should align with corporate information technology's focus on lowering IT costs by harmonizing business systems into a single global deployment. Methods to achieve harmonization can vary, including the use of on-site systems or a shared services center, or outsourcing of work or software (Software as a Service, for example).

The results of such harmonization, however, are universal: significant cost savings, increased process transparency and faster, easier process transformation.

The coming year promises to be a challenging one for corporate tax and finance departments. Unprecedented regulatory and accounting standard changes, stricter tax enforcement, governmental demands for transparency and global tax reforms on the horizon have produced an environment full of uncertainty and ripe for tax and financial reporting risk.

Having to do more with less, tax and finance professionals have one option if they are to continue to adequately manage risk and add value: increase productivity.

By taking a holistic approach to process improvement, tax and financial professionals can set the stage for implementing new enterprise-level technologies that together will yield efficiency dividends in 2011 and for a long time after that.

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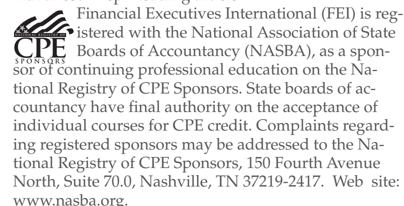

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