

# TAX RISK MANAGEMENT: A FRAMEWORK FOR IMPLEMENTATION

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Submitted in partial fulfilment of the requirements for the degree

Magister Commercii in Taxation

in the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

at the

UNIVERSITY OF PRETORIA

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Date of submission:

**2012-08-31**

## **ABSTRACT**

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This study attempted to establish a tax risk framework (TRF) with guidelines to equip parties concerned in a business environment with the necessary tax risk management (TRM) skills and knowledge. Countries obtain a significant part of their financing from taxes. Regardless of normal risks within a business environment, there are also payable taxes to be dealt with. Existing procedures in businesses do not have a TRM-function. Control Environments in businesses do not necessarily have a TRM component. As tax is the single main contributing expense on the income statement bottom-line, it is imperative that it should be included in the risk assessments.

TRM is the process of understanding, interpreting and implementing tax laws in order to mitigate tax risks. The basic definition of TRM is to apply tax laws to such an extent that the minimum amount of tax is paid, whilst adhering to the law. A TRM-framework must comply with international reporting standards and governance.

Existing frameworks, guidelines and policies available on risk management do not cover the specific area of tax, which complicate the establishment of a single framework. SARS is changing its auditing approach and joining hands with taxpayers, trying to determine their ways in managing tax risks. Grey areas in legislation cause loopholes and misinterpretations – leading to incorrect calculations, risks and incorrect amounts of taxes being paid.

More companies in South Africa expand their business activities to Africa from which export/import tax issues arise. A proper TRM framework will enable persons to estimate risks the moment they make a new deal. This will save a great deal of time and money.

Keywords:

*Tax risk framework*  
*Tax risk management*  
*Tax management*  
*Tax function*

## OPSOMMING

### **BELASTINGRISIKOBESTUUR : 'n RAAMWERK VIR IMPLEMENTERING**

deur

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Die doel van hierdie voorlegging is om 'n raamwerk vir belastingrisiko met riglyne aan betrokke partye in besighede voor te stel. Dit sal hulle toerus met die nodige vaardighede om belastingrisiko's te identifiseer en te hanteer. Lande se enkele grootste bron van finansiering is vanuit belasting. Afgesien van normale risiko's in 'n besigheid is daar ook die kwessie van betaalbare belasting wat bestuur moet word waarvoor huidige besigheidstelsels nie voorsiening maak nie. Vanweë die feit dat belasting die enkele grootste uitgawe op die inkomstestaat is, is dit van kardinale belang dat dit deel vorm van die risiko assesserings proses in besigheid.

Belastingrisikobestuur behels die begrip, interpretasie en implementering van belastingwette om risiko's te verminder. Die minimum belasting moet betaal word, maar belastingwetgewing moet steeds nagekom word. Hierdie raamwerk vir belastingrisikobestuur moet egter steeds aan internasionale verslagdoening standarde voldoen ten einde finansiële inligting aan te meld en te reguleer deur middel van goeie korporatiewe beheer.

Bestaande raamwerke, riglyne en beleide rakende risikobestuur maak nie spesifiek vir belastingrisiko's voorsiening nie wat die daarstel van 'n afsonderlike belastingraamwerk bemoeilik. Die Suid-Afrikaanse Inkomste Diens is besig om die benadering van audits te hersien en 'n nouer verwantskap met belastingbetalers te sluit ten einde hul bestuur van belastingrisiko's te bepaal. Grys areas in wetgewing veroorsaak skuiwergate en verkeerde interpretasie met foutiewe berekenings, risiko's en betalings.

Al hoe meer besighede in Suid-Afrika brei hul sakebelange na Afrikalande uit, waaruit invoer-/uitvoerkwessies rakende belasting ontstaan. 'n Deeglike risikobestuurplan wat belastingkwessies aanspreek, sal die rolspelers instaatstel om risiko's onmiddellik te bepaal sodra 'n transaksie gesluit word. Sodoende kan tyd en geld bespaar word.

Sleutelwoorde:

*Belastingrisiko raamwerk*

*Belastingrisikobestuur , Belastingbestuur, Belastingfunksie*

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The abbreviations used in this document can be summarised as follows:

**Table 1: Abbreviations used in this document**

<b>Abbreviation</b>	<b>Meaning</b>
ATAF	Africa Tax Administration Forum
ATO	Australian Tax Authority
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CEO	Chief Executive Officer
CFO	Chief Financial Officer
EPS	Earnings per share
ETR	Effective tax rate
FASB	Financial Accounting Standards Board
FIN	Financial Interpretation Note
GAAP	General Accepted Accounting Principles
IASB	International Accounting Standards Board
IAD	Internal audit department
IFC	Internal Financial Control
IFRS	International Financial Reporting Standards
ITA	Income Tax Act no 58 of 1962
KING	Report on Good Corporate Governance by Mervin King and committee
KPI	Key performance indicator
OECD	Organisation for Economic Co-operation and Development
PAYE	Pay as you earn
SA	South Africa
Sarbanes-Oxley	A non-negotiable compliance Act in the United States of America by two main architects of the Act namely Senator Paul Sarbanes and Representative Michael Oxley
SARS	South African Revenue Service
TCF	Tax Control Framework
TRC	Tax Risk Committee
TRF	Tax Risk Framework
TRM	Tax Risk Management
TRMF	Tax Risk Management Framework

# CHAPTER 1

## WHERE DO TAX RISK MANAGEMENT COME FROM?

### 1.1 BACKGROUND

Tax risk management is a process of stepping from reactive tax monitoring and structuring to a more pro-active approach. The South African Revenue Service (SARS) is changing its auditing approach and also starting to engage with taxpayers to identify the manner in which they manage their tax risk and if evidence of a framework can be found. Tax risk can be defined as the uncertainty of how well interpretation of the tax laws is done, or it is the uncertainty of how well systems are implemented to mitigate those tax risks.

With increased governance and best practice as stipulated by various guidelines like KING II and now KING III in South Africa, and with Sarbanes-Oxley as a legal requirement in America, the board members' responsibilities to their shareholders to minimize risk have dramatically increased with scandals like Enron and Parmalat (Elgood, Paroissien, & Quimby, 2004; 2)<sup>1</sup>.

These Governance systems were already described by the first United Kingdom Companies Act of 1844 where the Anglo Saxon model was used. The Anglo Saxon model is the combination of the best of governance models from the United Kingdom and United States of America, compiled by the Organisation for Economic Co-operation and Development (OECD) (Wixley, & Everingham, 2010:3-4). The current governance structure, revised during 2009, in South Africa is the King Report. It was compiled by the King Committee, where a report on governance was issued, namely the King Report on Governance for South Africa – 2009 (the “Report”) and the King Code of Governance Principles – 2009 (the “Code”), together referred to as “King III” on 1 September 2009 (PWC, 2010:1).

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<sup>1</sup> This reference is the first of two major research works used in this study.



As risk management traditionally focuses on business risks, it is imperative that tax which is the single biggest contributing expense on the income statement bottom-line, should also be regarded as a risk.

Risk committees as suggested by KING III are to have this type of committee because of the increasing sophistication of risk management techniques (Wixley & Everingham, 2010; 77)

The importance of tax risk management can further be highlighted with the increased focus at SARS of developing toolsets to identify risk areas regarding taxes within a company. These toolsets are to identify underpayment or no payment at all of taxes. The OECD, Centre for Tax Policy and Administration, released a report on Tax Administration dated 28 January 2009, prepared by the Forum on Tax Administration under the leadership of Pravin Gordhan (Erasmus, 2010). This report indicates the workable solutions for countries to share information regarding tax administration about taxpayers within different jurisdictions. The paper written by Erasmus is broadening the scope of Global Tax Risk as part of a Tax Risk Framework.

The traditional tax reporting concerns cannot be looked at in isolation and must be read together with other requirements, as in the case of reporting of large businesses which falls within the reporting requirements of International Financial Reporting Standards (IFRS). The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) concluded further standards and interpretations regarding the responsibilities of the board to disclose uncertain tax risks, the interpretation note 48 of the FASB (FIN 48) refer to how taxes should be handled in financial statements. The same requirements for identification of risk according to IFRS 7 are touching on risk management as a whole (Erasmus, 2010). The interpretation note FIN 48 refers to the accounting standards codification of ASC 740 which is the standard for the accounting treatment of Income Taxes of the United States Generally Accepted Accounting Principles (US GAAP).

SARS, together with the OECD, is actively involved in developing new methods of identifying risks of revenue losses and increasingly reforming the environment to mitigate the risk of tax revenue losses.

As a great deal of companies is starting to expand into Africa and international markets, unknown risks and high cost structures can be encountered. As from own experience the study field on graduate level for tax, does not fill the gap of knowledge required for international tax exposure. South African tax managers are not groomed to have international tax exposure within their field of study, with the exception of specialisation in certain post graduate studies; the body of knowledge can be inefficient as this is a very highly specialised area.

To implement a framework of tax risk management in a business is easier said than done, as the focus on risk management does not identify tax as a separate component. The KING III report does not identify this directly in the report.

Tax is also considered at a very late stage when business has been conducted as this is regarded as the Tax and Financial Managers' responsibility and not of the person that made the deal. The gap exists within this area where the person that made the deal does not keep tax in mind. If a framework is drawn for the decisions to do business, this can assist the dealmaker with the transaction and minimize taxes within the different legislative areas.

## **1.2 PROBLEM STATEMENT**

Tax Risk management is done in certain companies by a Tax Manager or team. Some companies even have the tax risks documented in a policy. The problem is that a great deal of tax risks are carried around in people's heads and if these people leave the organisation then the information leaves with them (Elgood *et al.*, 2004:10).

As organisations can have large deferred tax assets or liabilities, the question arises whether these future tax implications are correctly calculated. The embedded risk within these estimates or assumptions made within accounting does not always equal the tax

eventually due. Even though the calculated tax to be paid is calculated in accordance with legislation, interpretation and system risks can have an impact on the accuracy and interpretation of the calculated tax payable when done by SARS.

As the focus with these structures is to manage business risks, no attention is given to specific risks which are inherent in every transaction in every jurisdiction. Tax risk management as part of the corporate governance is becoming part of investor concerns as the risk of unforeseen taxes can result in the liquidation of a company. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) called for a study to develop a framework for internal control in the early 1990s. This framework became the standard for an integrated framework of internal control. This framework was developed to assist in proper procedures for internal controls and the environment within which entities should do business in. The model was not adapted to comply with risk management from a tax perspective. This model can however be adapted to assist in managing tax risks within an organisation (Elgood *et al.*, 2004:20).

A Tax accountant has the risk of not seeing the problems or risks within the figures in the trial balance which can cause tax risks. To identify these risks the need to establish a proper mechanism is becoming imperative for the tax function of a company.

The board of a company needs to establish a mechanism on how tax risks must be managed within the business. This study will attempt to provide guidelines on such framework of implementation together with the other material already written on this topic.

As the tax strategy should be the main driver of tax risk management, the question arises where the risk management of tax falls. If the management of tax risks are part of the bigger risk management process, the “how to manage tax risk” from the tax function needs to be put into a framework. This study will attempt to assist in developing a framework on how to structure a “good practice framework” to be implemented by the tax function. The objectives set out below will assist in defining this.

### **1.3 RESEARCH QUESTION**

The manner in which SARS is aggressively rolling out new strategies of which can be seen in most of the major newspapers for handling tax affairs, the benchmarking of SARS towards the OECD and other countries to establish a proper collective system for taxes is in its own way an indication of the questions raised below:

1. Why is it important to implement a Tax Risk Management Framework (TRMF) in a business?
2. What are the basic outlines of a generic TRMF?
3. How can a TRMF be implemented within a company?
4. How will the implementation of the TRMF look after the acceptance by the board?

The research question to answer is “How to achieve a well-balanced manner in which a proper proposed structure can be followed to implement a risk management approach specifically around taxes within a business?”

### **1.4 RESEARCH OBJECTIVES**

The objectives are:

- To establish the reasons why a TRMF would be important to a company.
- To identify methods of implementing a Tax Risk Management Framework within a company.
- To design a generic TRMF for Income Tax purposes that can be used by an organization.

## 1.5 DEFINITION OF KEY TERMS

The key concepts in this study are based on *tax risk, the framework and management* thereof. The key terms can be defined as follows:

### **Framework**

A framework is described as a set of broad ideas and principles taken from relevant fields and used to structure a subsequent presentation. A framework has potential usefulness as a tool to support research and, should be intended as a starting point for reflection about the research and its context. The framework is a research tool intended to assist in developing awareness and understanding of the situation under scrutiny and to communicate this (Smyth, 2004)

In this study the framework is a way in which a process can be formalised to mitigate the risks involved in taxes.

### **Management**

When using the term “management” with tax it can be seen as the way how the uncertainty in the tax can be mitigated to what is a suitable risk to the entity.

The definition of management can be defined as follows:

- The process of dealing with or controlling things or people; or
- The responsibility for and control of a company or similar organisation; or
- The people in charge of running the company (Oxforddictionaries.com. Not dated.)

### **Tax Risk**

Acknowledgement is given by Arlinghaus (in Wunder, 2009:16) that no universal definition of the term tax risk exists. He offers the following definition of the term:

- the likelihood that tax outcome differs from what is expected, due to a variety of reasons, for example, the judicial process, changes in the law, changes in business

assumptions, an increased intensity of audits, and uncertainty in the interpretation of the law; and any action emanating from the tax function that subjects the company to adverse publicity.

The term tax risk has a different meaning for different people and it is necessary to have a common understanding of what it is talked about. Only then can we address how tax risk can be managed (Elgood *et al.*, 2004:3).

Elgood *et al.* (2004:4) identifies seven areas of tax risk, adopting the common practice of defining business risk in terms of uncertainties accompanying decisions, activities, and operations undertaken by an organisation:

Specific risk areas:

- Transactional risk (e.g., acquisitions, mergers);
- Operational risk (e.g., new business ventures, new operating models, new operating structure);
- Compliance risk (e.g., weak records and controls, data integrity issues, legislative changes); and
- Financial accounting risk (e.g., changes in systems and policies).

Generic risk areas:

- Portfolio risk (e.g., combination of any of the risks);
- Management risk (e.g., changes in personnel, new/inexperienced resources); and
- Reputational risk (e.g., revenue authority investigation, press comment, legal actions).

Within many definitions of risk it is defined as an outcome of which there is uncertainty. This means that tax uncertainty is in itself a risk.

## **1.6 DELIMITATIONS AND ASSUMPTIONS**

### **1.6.1 DELIMITATIONS**

The study will focus on the processes of risk management in a tax environment and to keep in mind all the relevant factors implicating risks in a controlled environment. The identification of risks and the process of how to manage these risks within an organisation can sometimes be flawed. The boundaries of this study will be based on current research and documentation regarding the tax functions of companies as well as the exposure of auditing firms to tax risk management. As TRM is a fairly new area explored on the back of KING III it is at this stage theory that can be tested on a next level or research study. This study is limited only to minimal own experience and theory on this topic.

### **1.6.2 ASSUMPTIONS**

Assumptions are made in this study that the reader is familiar with the term risk management as well as the basic principles of internal controls. The environment discussed in this study will focus on the assumption that the control environment is applicable to all areas of business. It is furthermore assumed that the importance of KING III and its principles is accepted by companies, their boards and personnel and governance is a key component within a company and already implemented or accepted by the role-players to be implemented within a company. It is also assumed that the company will balance the cost of implementing the TRF with the inherent risk of not implementing a proper process of TRM to have a proper balanced approach towards risk.

## **1.7 IMPORTANCE OF THE STUDY**

The importance of Corporate Governance is highlighted in South Africa with the rework of KING II with the new improved KING III and the newly promulgated Companies Amendment Act No. 3 of 2011. The focus of KING II / III is mainly on the best practice principles and to streamline the process of governance. As governance is synonym to control it is important to have a transparent view to all stakeholders of an entity or

organisation (PWC, 2009:1). A great deal of data is available on risk management, for example: COSO and KING II / III. (PWC, 2010:1).

As the area of tax risk is not one which is given attention to by Board members or even the Chief Executive Officer (CEO) of a company it is sometimes neglected and seems to be the job of the finance team or auditor. In larger companies this is mainly the concern of the tax manager. The framework to implement the tax risk management process is not tailored specifically by COSO. There is not much literature available regarding risk management within a single line item on the face of the income statement namely: Tax. As tax is as old as trading with goods, this is an area that needs detailed analyses and technical skills to review and manage. If tax is not managed, it can result in a huge loss of money by the business. On the other side of the coin is that Revenue Authorities do not monitor the risk of loss of income as a result of unlawful schemes. Loss of revenue income for the authorities has the risk that the necessary fiscal expenditure cannot be met in countries to keep economies running.

This study is also meant to assist the tax manager in a “how to” approach of implementing a proper TRF within his / her organisation with proper buy-in from the Executives. Further motivation for the study is that opportunities lie within normal business activities / transactions and can be structured within the Income Tax or Revenue Acts of countries as allowed by the country’s specific revenue authorities. Having said this it can also result in huge risks in transactions as dealmakers do not normally keep tax consequences in mind when structuring deals. For both cases a formal process needs to be developed on how to mitigate the risk for loss of opportunity as well as the risk of a huge tax assessment

As Directors can be held responsible towards mismanagement of their companies it should also be kept in mind that the attitude of SARS is that if you do not comply within the governance principles of tax legislation, you are not necessarily a good corporate citizen. This can result in the view that the country will be better off without those companies.



## **1.8 STRUCTURE OF THE CHAPTERS**

The Chapters will be structured to handle the processes of TRM and building a framework from there. Chapter 2 will identify the need to manage tax risk in an organisation with Chapter 3 explaining how such layout of a Framework should look like. Chapter 4 will discuss the manner which can be followed to establish such a framework within an organisation. Chapter 5 will summarise the process of implementation and how the framework can be used.

## **1.9 SUMMARY**

Proper TRM can assist companies in optimising their tax affairs within the boundaries of tax legislation. This can result in optimised processes which were tailored by the Government to assist businesses by incentivising them. The process can result in legal tax cash reduction on the payment of taxes, but also paying no more than what is necessary.

The following chapters will discuss the process of setting up a TRF and an effective TRM. The KING III principles are driven hard to assist in having a proper process of compliance towards tax legislation in a country. With small adaption's to the proposed TRF in the later chapters it can be used by various tax managers over the world as it is suggested to be a homogenous framework on assistance in managing tax risks.

The Framework will include a well-known model namely the COSO model together with the requirements of KING III.

## CHAPTER 2

# A LITERATURE REVIEW OF TAX RISK

### 2.1 INTRODUCTION

Tax risks can be traced back to the early days of time, back to the Bible as mentioned in Genesis 47: 26, "Then Joseph made a law which is in force to this day, that Pharaoh was to have the fifth part...." (Biblos, 2011) As centuries have gone by taxes were mentioned often, and with this the risks are within the behaviour of country leaders, countries and governments for what they need the monies collected.

From the known quotation of Benjamin Franklin "In this world, nothing can be said to be certain, except death and taxes." <sup>2</sup>it is evident that taxes can be a risky business. Taxes should not be taken light-heartedly as it is the foundation on which countries are building their economies and self-sustainability. As for this, tax is influencing the behaviour of people (Glees & Kielstra, 2010:8). Taxes are also not seen as a positive manner in which countries build their economies and protect the interest of its people (e.g. in the form of import duties or withholding taxes on non-residents). Glees and Kielstra (2010:11) referred to how taxes are shaping the world and its economies and it can be clearly seen in the American (1773) and French (1780) revolutions.

The American Revolution was started during 1765, as King George III needed money to recoup its war costs. A series of actions including the Stamp Act (1765), the Townsend Acts (1767) and the Boston Massacre (1770) agitated the colonists, straining relations with the mother country. But it was the Crown's attempt to tax tea that spurred the colonists to action and laid the groundwork for the American Revolution ("The Boston Tea Party, 1773," EyeWitness to History, [www.eyewitnesstohistory.com](http://www.eyewitnesstohistory.com) (2002)).

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<sup>2</sup> Mark Twain has popularized this phrase in the 19<sup>th</sup> century, but it originates from a letter Benjamin Franklin sent on November 13, 1789 to Jean-Baptiste Leroy; it states, "Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes."

The French revolution started when King Louis XVI needed money. His financial crisis forced the French monarch to reluctantly convene the Estates General in order to levy a new land tax that would hopefully solve his monetary woes. It had been 175 years since the last meeting of this deliberative body that included representatives of three Estates: the First comprised the clergy, the Second comprised the nobility and the Third comprised the middle and lower classes ("The Beginning of the French Revolution, 1789," EyeWitness to History, [www.eyewitnesstohistory.com](http://www.eyewitnesstohistory.com) (2007)).

A list of various tax policy and unexpected outcomes are given by Glees and Kielstra (2010:10-11) of the change in how governments can impact their respective economies. An example is when the Roman Emperor Nero instituted a tax on collection of urine, Ivan the Terrible had taxes on "gun duty" and "nitrate duty", and Emperor Joseph II based taxes on roof areas and in the 19<sup>th</sup> century France, England, the Netherlands and Spain levied taxes on the number of windows in people's houses. (Glees & Kielstra, 2010:11).

The above summary of instance where taxes have majorly impacted people, it started some of the most radical changes to the society which we live in as it ended in war in some cases. This in itself can be seen as how tax can be risky business for the government of the day.

Gabriel Calcagno, the Head of Tax at an Argentinian subsidiary of Monsanto (in Amaral, 2010:35) says: "We have lots of grey areas here and sometimes things depend on the interpretation by the tax authorities at a particular moment". As taxes can be changed by governments it can also be interpreted by them in various ways out of which tax risk can arise for the entities or individuals concerned. People are only human and they do make mistakes when entering transactions within accounting systems. This can result in incorrect interpretation by the persons responsible for the companies' tax affairs. It also can be because of the complexity of the changes of world economics and the manner in which countries are interpreting their tax legislation. Because of the changing requirements of governments to fund projects or their societal network's needs, their citizens can have an impact and change on the taxes collected. When new governing bodies are elected, this tends to complicate the environment of collecting money through a new tax system.

As the risk of tax increase in the way societies and governments change the manner in which they collect money from the people, it is important to be up to date with those countries' legislation with which business is done.

It can be summarised that tax risk is the risk of doing business in any part of the world where the manner in which transactions are captured differs from one country to another. Furthermore, the risk of the complexity and incorrect interpretation of tax laws and regulations can be strenuous. This increased the risk of incorrect calculation of the tax liability and will result in governments to be more rigorous on tax laws.

## **2.2 THE RISK OF ARRANGEMENT OF TAX**

With the robustness of the taxpayers when transactions are planned to avoid paying taxes; this gave rise to new legislation and even more robust enforcement by governments. The reasoning of governments is that the economical drivers of each country should be fuelled by some or other means of tax (e.g. land taxes). This did not change since the very early days of enforcers and societies as mentioned in the previous paragraphs.

Within this environment a taxpayer can arrange its affairs to achieve a result of reduced taxes, this can within itself hold the risk that it can be seen as a scheme of arrangement. Within the South African perspective, based to some extent on English law, OECD and the Australian tax models, transactions should be planned within the legal frameworks of the South African Income Tax Act no 58 of 1962 (ITA).

As the South Africa government have replaced section 103(1) of the ITA with sections 80A to 80L, effective for transactions on or after 2 November 2006, this gives rise to an even more complexity of how transactions and planning thereof can be seen as illegal or impermissible.

When South Africa companies are looking to expand globally the risk of the current ITA can be severe to the company because the transactions can be deemed illegal or impermissible tax avoidance agreements.

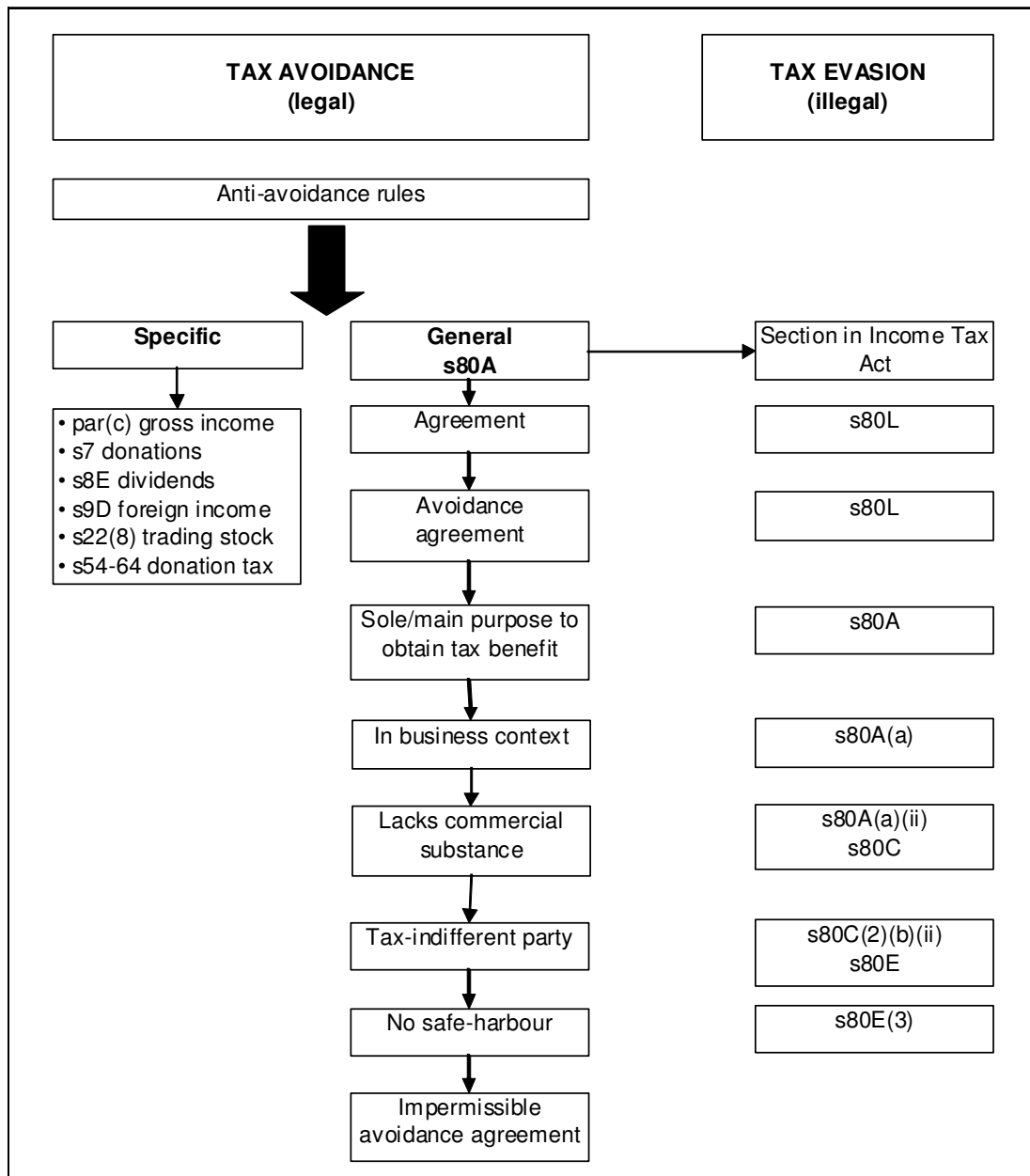
Not to explain the rules of tax avoidance set out in section 80 of the ITA in detail, a summary of this section is given here and shown in Diagram 1. The concepts of section 80L of the ITA are more or less based on three definitions, namely:

- **“arrangement”**: *any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property.*
- **“avoidance arrangement”**: *any arrangement that, but for this part, results in a tax benefit.*
- **“tax benefit”**: *any avoidance, postponement or reduction of any liability for tax.*

Diagram 1 below states that section 80 of the ITA can be summarised in reference to specific anti-avoidance rules in general.

The legal side of tax planning can be seen as “Tax Avoidance” as shown in the column on the left hand side. If proper planning and structuring of business is done within the scope of section 80 of ITA it will pass the tests summarised in Diagram 1.

**Diagram 1: Broad overview of tax avoidance or evasion**



Source: Du Plessis, L. (2008:20)

With this new section in the ITA and developments abroad the tax risks for companies increase.

As accounting moves also to a more rigid approach to give investors a better understanding of the tax burden companies have and sometimes do not disclose the required information. The FASB in the United States issued a financial interpretation note FIN 48 on the manner how uncertain tax risks should be disclosed under the US General

Accepted Accounting Principles (GAAP). This gave rise to a more in depth approach by companies to mitigate their risks both on the radar and off the radar (Erasmus, 2010).

This however will not defer companies to continue with planning transactions to have the lowest possible tax liability. This just increases the requirement for an even more in depth TRF approach to be applied within companies.

### **2.3 WHY THE NEED FOR MANAGING TAX RISKS?**

With legislative changes and reporting requirements as mentioned earlier, tax risk management is getting more attention worldwide. In the South Africa context more attention is given to the risk of taxes, as KING III is suggesting that board members of companies are made responsible on a much higher level for controls in their companies. The fact that tax is part of this control environment is sometimes overlooked by boards.

Erasmus (2010:2) indicates that 90% of companies did mention in a survey conducted in 2008 that tax risk will be an important area for them in the next two years.

According to a recent Ernst & Young survey by Byrne (2010:39) it shows that 63% of businesses in emerging countries see a tougher enforcement by tax authorities as compared to 39% in developed countries.

The above statements raise the question on how companies should handle this change in tax legislation enforcement. The depth and pure volume of transactions in companies can have a huge risk for those companies as every transaction is not reviewed every day by the tax department or tax function as the sheer volume is just too great. A conclusion can be made that systems should be implemented, but it should be kept in mind that interpretation of transactions are mostly where the tax risk arises.

The debate is driven further with increased focus by tax authorities. The Australian Taxation Office (ATO) issued a booklet on Large Business and tax compliance during September 2010. This booklet indicates the manner in which the ATO handles tax affairs

of large businesses and how the role of tax risk management within an organisation can improve tax reforming within a country.

The booklet issued by the ATO gives a broad overview of certain tax risk areas as well as the 10 questions which should be asked by company boards. The questions is taken from the ATO document and adjusted to fit any tax authority's regime:

1. What is the level of confidence in the correctness of advice?
2. How likely will the revenue authority take a different view on interpretation of the law and assess the organisation accordingly?
3. What is the risk if the higher court's decision is in favour of the revenue authority?
4. What is the potential downside of unsuccessful litigation?
5. When there is a dispute, what is the preparedness of the tax office and on what terms will it be resolved?
6. What will the likelihood be of increasing the tax risks and an audit?
7. Will it be a potential risk to approach the revenue authorities for a private binding ruling?
8. When a position was taken on a tax issue, would it be appropriate to disclose the manner in which the issue was handled with the revenue authorities and constructively handle any disagreement?
9. When advice is obtained is it on the actual transaction or on the way it will be implemented?
10. Is the factual basis checked when the opinion is presented to the board?

The above 10 questions were summarised from an interpretation done by Elgood, *et al.*, (2004:13).

The Africa Tax Administration Forum (ATAF) is working together with Oupa Magashula, the Commissioner of SARS, to establish this international body representing Africa countries; it gives rise to improvement projects to reform the tax systems within Africa. (South African Revenue Service, 2010:1).



Research indicated that managers get more optimistic about the tax risks in their business by systematically implementing tax risk management policies and procedures (Wunder, 2009:26).

All the above is an indication of good governance by companies; the risk lies within the fact that companies need to look at its internal controls to mitigate the risk with the implementation of proper controls. The above is a short summary of why it is giving statement to the fact why tax risk management is needed in business.

## **2.4 SUMMARY**

Tax is one of the major items impacting the lives of people and organisations. As the world is progressing towards a more regulated environment as can be seen from the introduction in this chapter and the way tax is regulated with the new legislative changes in the South Africa ITA with the introduction of section 80 in the ITA.

In chapter 3 the process of how this risk can be mitigated will be addressed. It will show how the process can be evaluated and the risks identified in this chapter can be dealt with in a systematic way. The basic outline discussed in the following chapter will give guidance on the 10 steps in putting the framework in place.

## CHAPTER 3

### TAX RISK MANAGEMENT FRAMEWORK

#### 3.1 INTRODUCTION

Tax risk management can be laid out in different areas. These areas can be outlined as follows (Elgood *et al.*, 2004:4):

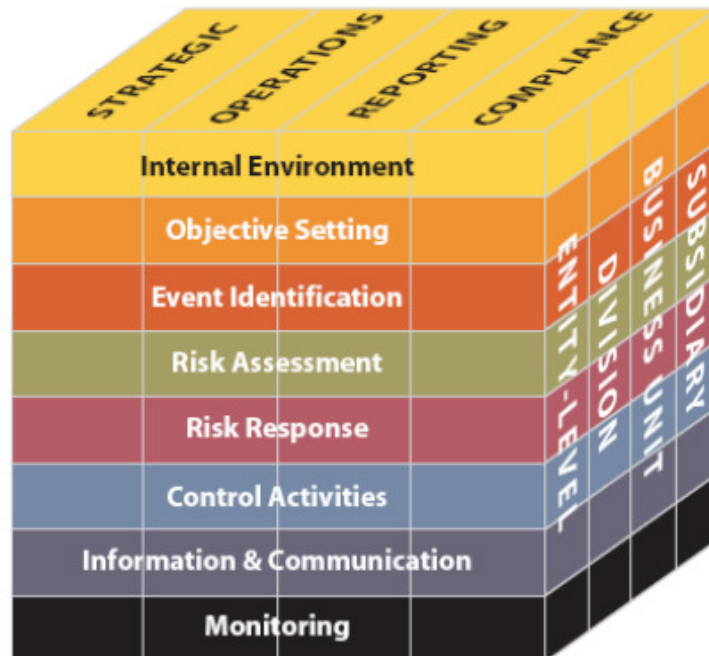
- Transactional risk;
- Operational risk;
- Compliance risk;
- Financial accounting risk;
- Portfolio risk;
- Management risk; and
- Reputational risk.

Without a proper plan to mitigate these risks within tax legislation, it can be a futile exercise. As the number of transactions in an entity can be large, the only manner in which tax risks can be mitigated or reduced is with a systematic approach. Internal controls can assist in managing these risks.

COSO defined internal control as a process which is effected by an entity's board, management and personnel. With the focus on internal controls it provides a reasonable assurance regarding the achievement of objectives of operations. Internal controls should be effective and efficient to mitigate risks. The control environment should give reliability to financial reporting and compliance to applicable laws and regulations (Elgood *et al.*, 2004:20).

The COSO definition of internal control environment can be graphically illustrated below:

**Diagram 2: Illustration of control environment according to COSO**



Source: Adapted from COSO (2004:5)

The COSO framework sets out five main area's for an integrated system of control. These components are:

- Control environment / Internal Environment;
- Risk assessment / Risk Response;
- Control activities;
- Information and communication;
- Monitoring.

The components of the COSO framework can be applied to all types and sizes of business as well as all levels within a business (Elgood *et al.*, 2004:21).

The main focus for most companies is to start with the control activities as this is seen as the “boiler room” of internal control. Control activities includes the policies and procedures or the day-to-day limits, approvals, reconciliations, confirmations as management deemed fit to safeguard their companies assets (PWC, 2010:7).

It is also stated by King III that audit committees are vital to the integrity of internal financial controls (IFCs) and should have oversight of financial reporting risks (PWC, 2010:1).

From the above and the diagram it is evident that the COSO framework is not only about control activities but a lot wider. The other elements are referred to as the “softer side” of the COSO framework (PWC, 2010:8).

The COSO framework can be explained as follows:

The **control environment** is the overall “tone” of the business. In other words it is how management demonstrates good communication, integrity, ethics, competence and accountability towards stakeholders. It also relates to how senior management “live” these values (PWC, 2010:8). The control environment is also forming the foundation for all other components of internal control. This also relate to areas where risk managements need to be implemented. If risk management is not taken seriously by the business to implement the various controls and policies it will have little chance of success within an area like tax (Elgood, *et al.*, 2004:21).

**Risk assessment** is the awareness and response of business to the way it is facing risks (Elgood, *et al.*, 2004:21). It will also test the functions which exist to assess the risks and what mechanism is in place to mitigate these risks. The process will also measure the effectiveness of the controls in place (PWC, 2010:8).

**Information and communication** in an organisation is important as it is the manner in which the people in the organisation will be informed as how and what to do when performing their tasks to establish a good IFC environment. This process is also ensuring that people in the organisation understands how to capture information which is needed to manage the business (Elgood, *et al.*, 2004:21).

**Monitoring** of controls is the only way to established if the process followed was effective to establish a sound IFC environment. By monitoring the controls and procedures for effectiveness will assist in identifying weaknesses in the system. Remedies or corrective

procedures can then be implemented for identifying those deficiencies (Elgood, *et al.*, 2004:21).

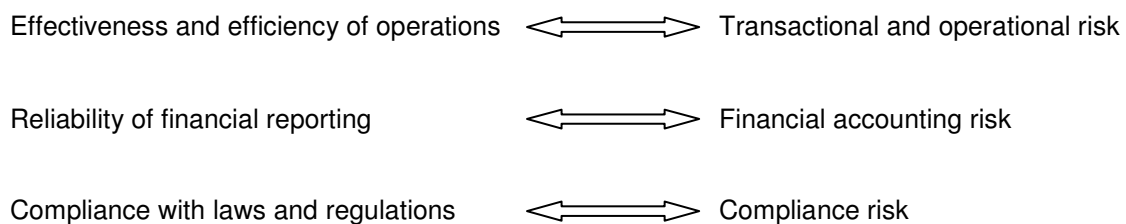
The above forms the basis of sound business principles. Embedded within these principles are the four objectives, strategic management, effectiveness and efficiency of operations, reliability of financial reporting and compliance with laws and regulations which should be brought in line with tax risk management and the COSO framework.

Strategic management is embedded within the “tone at the top” principles discussed in the above paragraphs regarding the control environment where executives should “live” the values by which the organisation is standing (PWC, 2010:10).

The other three objectives can correlate with the specific tax risk areas which can be defined in a business (Elgood *et al.*, 2004:23).

This correlation of the link between the risk objectives and the specific risk areas can be seen in Diagram 3 for the relation between them.

**Diagram 3: Risk objectives linked to specific risk areas**



Source: Elgood *et al.* (2004:23)

To define the link between the objective and specific risks it can further be explained. Specific risk areas linked to the risk objectives for transactional and operational risk are related to transactions undertaken by the company. Within any transaction there is a matter of uncertainty of interpretation as how the relevant tax law will be applied to the transaction (Elgood *et al.*, 2004:4-5).

Financial accounting risk is related to the processes of internal controls and arriving at the accounts figures (Elgood *et al.*, 2004:6).

Compliance risk is referring to and is mostly the submission of relevant tax returns as well as responding on queries from the Revenue offices (OECD, 2004:6).

As defined above COSO can give guidance on how the basis of internal controls should look like and can be adopted to fit the process for TRM and to assist in developing a TRMF.

### **3.2 HOW SHOULD A BASIC OUTLINE OF A TAX RISK MANAGEMENT FRAMEWORK LOOK LIKE?**

To start defining a TRMF the following should be considered for the outline of such framework:

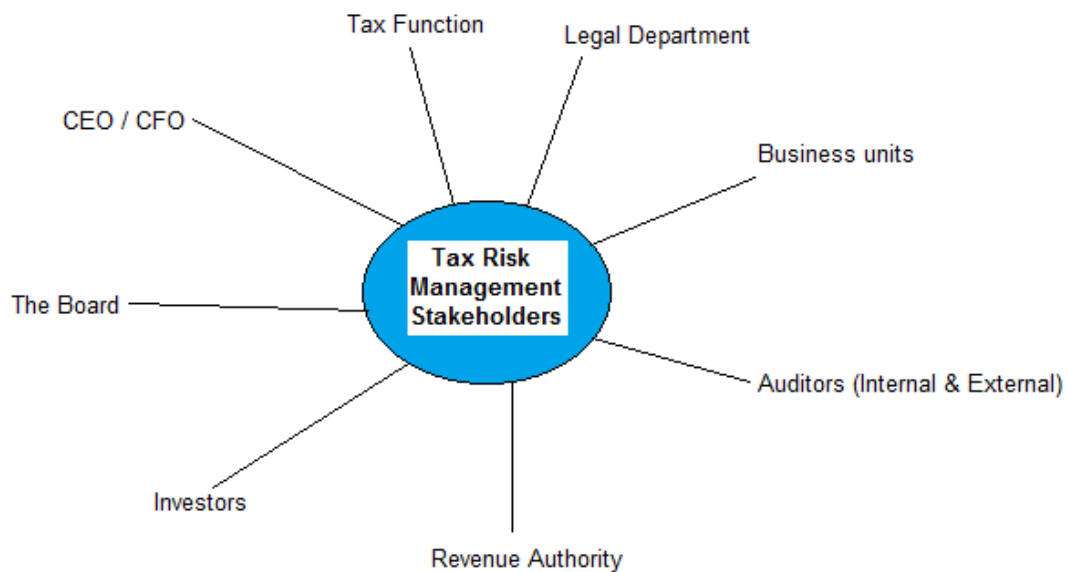
- Board approval should be obtained as the KING III report suggests that internal controls form part of the responsibility of the board;
- Identify the tax function within the business;
- Setup of Tax Risk Committee (TRC);
- Responsibilities of TRC members;
- Charter of the TRC;
- Develop tax strategy & policy;
- Identifications of tax risk within the current business processes as well as the tax control environment;
- Compile the tax register;
- Formulate the tax risk appetite;
- Identification of the transactions critical for the business and compiling a list of the top number of transactions;
- Determine the need and role of various enablers within the tax function, especially technology requirements;
- Compile a control sheet for the critical business transactions;
- Develop continuous monitoring processes.

The above list can be very wide and a time consuming exercise compiling it. For the purpose for this study the further discussions will give an outline on building a TRMF. This outline will be explained in the next section on the manner of implementation within an organisation.

The TRMF is not only for companies with enough resources like Tax managers, but can be applied to organisations of all types and sizes. Different parties can be stakeholders in the TRM process as they have an interest in an organisation's tax affairs (Elgood *et al.*, 2004:11).

Diagram 4 shows all the stakeholders needed in the process for TRM.

**Diagram 4: Illustration of TRM stakeholders**



Source: Adapted from (Elgood *et al.*, 2004:11).

The above diagram can be explained below with the proposed ten steps to set up a TRMF.

To establish a TCF the following steps should be followed to achieve a proper documented process of a TCF. In Table 2 is a summary of the steps that will be discussed in this chapter to be followed to develop a TCF and establish a TRC. In Table 2 the integration of the different departments within the steps to be followed is summarised.

**Table 2: Combine steps for TCF and tasks**

<b><u>STEPS TO ESTABLISH TAX CONTROL FRAMEWORK</u></b>	<b><u>Tasks</u></b>	<b><u>CFO</u></b>	<b><u>Finance Dep.</u></b>	<b><u>Tax Dep.</u></b>	<b><u>Business</u></b>
<b><u>Step 1:</u></b> Implementation of KING III and buy-in regarding risk management and especially TRM.	Strategy	X	X	X	
<b><u>Step 2:</u></b> Setup of the Tax Function within the organisation.	Operations Accounting Compliance		X	X	
<b><u>Step 3:</u></b> Setup of the TRC together with the Audit / Risk committees.		X	X	X	
<b><u>Step 4:</u></b> Responsibilities and duties of the TRC.		X	X	X	
<b><u>Step 5:</u></b> Defining the charter of the TRC.	Strategy	X	X	X	
<b><u>Step 6:</u></b> Developing the Tax Strategy and compiling the risk register on tax.	Strategy	X	X	X	
<b><u>Step 7:</u></b> Formulate the tax risk appetite.	Strategy	X	X	X	
<b><u>Step 8:</u></b> Identify major risks and compile control sheets.	Operations Accounting Compliance			X	X
<b><u>Step 9:</u></b> Develop continuous monitoring tools.				X	X
<b><u>Step 10:</u></b> Determine the resources required for monitoring of the tax risks.			X	X	

Source: Adapted from (Bakker & Kloosterhof, 2010:27)



The steps to follow to establish a TCF can be discussed as follows:

### **Step 1: Board approval**

As the board needs to address relevant business and other risk within the organisation, the board appointed the audit committee of that organisation to oversee the internal control environment. This is also according to KING III vital to ensure the integrity of reporting and IFCs in an organisation (PWC, 2004; 1).

The first phase is to present the importance of TRM to the board and seek approval from the board or audit committee, whoever is responsible for managing risks in the business. This can be seen as **STEP 1**.

### **Step 2: Tax Function**

To identify the tax function seems very easy as the responsible persons are usually the Chief Financial Officer and the Tax Manager or Financial Controller in an organisation. But to broaden the scope on a tax function, it should be considered that every time an invoice or contract is captured or completed the person, normally a bookkeeper or accountant is responsible for the correct capturing of the source document onto the accounting system. This includes the correct handling of taxes within the transaction captured (for example. Value Added Tax, Income Tax or PAYE).

As the Tax Manager or Head of Tax is mainly responsible for taxes within an organisation, the secondary environment of accountants or clerks are creating a shadow function which is necessary to support the total control environment of the business.

**STEP 2** is the identification of those personnel and the training required by them to handle tax issues within their line of work.

### **Step 3: Establishment of Tax Risk Committee (TRC)**

As the Audit Committee needs to review and approve the necessary mandates for the establishment of the TRC, it further needs to delegate the responsibility to the tax function.

The TRC will set the guidelines to which the committee will report and interact with the various stakeholders within the tax environment.

**STEP 3** will be to hold the first meeting of the TRC and set the standard of the TRC.

#### **Step 4: Responsibilities of the members of the TRC**

The responsibilities of the TRC will include the following aspects:

- Overall tax compliance;
- Tax reporting;
- Identification of on and off-radar risks;
- Overall management of tax risks;
- Ensure proper strategies, policies and procedures for tax;
- Effective tax planning;
- Integration with departments within the organisation;
- Technical advice;
- Open communication with the local revenue authorities;
- Be part of the strategy of the business; and
- To identify the weaknesses and opportunities within the business models (Erasmus, 2007).

**STEP 4** will be to draft these responsibilities into a mandate for all members of the TRC.

#### **Step 5: Charter of TRC**

Once the TRC is established the charter of the committee should be formalised. The charter should include the following:

- Mandate of the TRC;
- Roles and responsibilities as established in **STEP 4**;
- Identify representatives from Internal & External Auditors.

The charter should ensure proper procedures for reporting to the Audit & Risk Committees within the organisation. The Risk committee as part of the wider proposed governance of KING III is set to establish this committee for the wider sophistication of risk management

techniques. Smaller companies will include the responsibilities of this committee often with the audit committee (Wixley, & Everingham, 2010:77).

**STEP 5** is to draft the charter of the TRC and obtain the approval from the Audit Committee.

### **Step 6: Development of Tax strategy and compiling of risk register**

The tax strategy should be developed in line with the organisation's corporate governance environment as well as the future strategy for the organisation. It is imperative that the organisation strategy includes the tax aspects of the proposed and future transactions. Within a survey completed by Deloitte (2007:3) there were only 19% of the respondents which had a documented tax risk strategy.

**STEP 6** is the review of the current tax strategy by the Audit Committee. If no tax strategy exists the tax manager should compile it for the first time, and present it for review to the Audit Committee. To compile a tax strategy, the impact of the control environment of the organisation should be understood to achieve maximum identification of all risks within this area.

As mentioned in **STEP 6**, the risk for tax should be identified within the organisation. An exhaustive list of transactions and items that can be a risk should be compiled. To compile the list of transactions every transaction type in the organisation should be mapped out. The process will also give guidance on how to identify the key risk areas. All relevant personnel within the tax function and the shadow tax functions should assist in compiling this list.

### **Step 7: Formulating the Tax risk appetite**

The formulation of a tax risk appetite should be seen as **STEP 7** after the identification of the tax risks. As defined by KMPG (2008:3) the definition of risk appetite is at its simplest to be defined as the amount of risk, on a broad level, that an organisation is willing to take on in pursuit of value. Or, in other words, the total impact of a risk an organisation is prepared to accept in the pursuit of its strategic objectives.

This should not be more than the tolerable level of the combined tax risk of the organisation. This level should be calculated on the basis that is acceptable to the board members. The tolerable risk level should be presented to the board to receive their approval.

### **Step 8 and 9: Identification of transactions and compiling control sheets**

At this stage the IAD will be forming part of the whole tax risk identification process. **STEP 8** will be to identify the major or critical transactions of the organisation where the most money will be lost to taxes if wrongly handled or when compliance risk is more than the acceptable levels as identified in **STEP 7**.

A control sheet of the major transactions should be drawn up to identify the gaps within the transaction flow which can cause tax risks. The attitude of the organisation's personnel towards tax should be identified and dealt with accordingly.

**STEP 9** is to develop a continuous monitoring process which should give early warning signs when tax risks are outside the set boundaries or levels as in **STEP 7**.

### **Step 10: Determine the required resource**

**STEP 10** is the identification of required resources within the tax function. This can be better qualified personnel or better technology requirements for the continuous monitoring programs or risk identification software.

## **3.3 SUMMARY**

By making use of a combination of well-known models for instance. COSO and other processes as identified in this chapter a good solid method can be established of how to go about building a solid risk management process.

It is however important to get all the stakeholders to buy-in into this framework and the process of how to go by, to get this buy-in, will be discussed in detail in the next chapter.

## **CHAPTER 4**

### **STEPS TO ESTABLISH THE FRAMEWORK**

#### **4.1. ESTABLISHMENT OF THE FRAMEWORK**

The question of what is a Tax Control Framework (TCF) can be answered as a custom built process according to the needs of an organisation. A number of generic building blocks will apply to every TCF and is tailored around every organisation (Bakker & Kloosterhof, 2010:19)<sup>3</sup>.

The foundation of the building blocks of a TCF is based on the culture needs in an organisation. This was discussed in chapter 3 and is also very important regarding the COSO model or the Internal Financial Controls (IFCs) in an organisation. This is the groundwork of every TCF. The most important part of the TCF is to establish the ultimate goal of building a tax function that is effective, efficient and mostly transparent (Bakker & Kloosterhof, 2010:19).

For the TCF to work it is essential that the steps in Chapter 3 should be followed and implemented accordingly. This Chapter will attempt to explain how these steps should be implemented to establish a framework for an organisation in which it can manage the tax risk within the organisation.

#### **4.2. TO GET STARTED**

To understand the process of the TCF it is best defined to understand its ultimate goal. The goal of a TCF is to build a tax function within an organisation that is effective, efficient and transparent at all times (Bakker & Kloosterhof, 2010:21).

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<sup>3</sup> This reference is the second reference work used in this study.

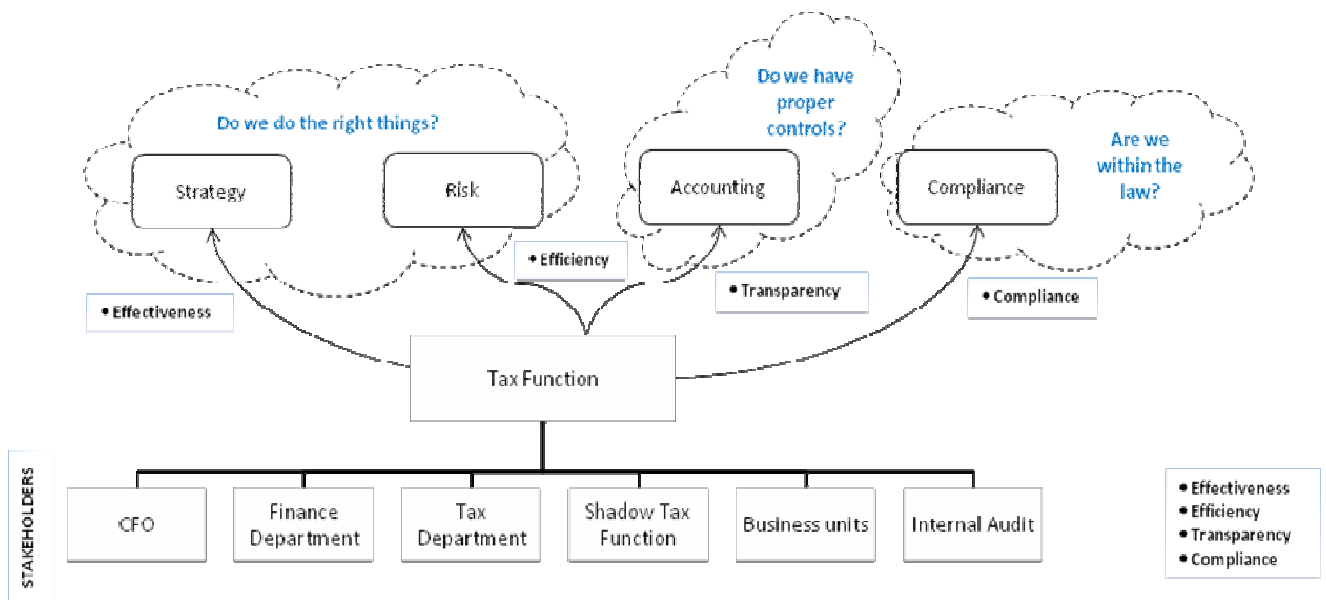
This can only be done as shown in chapter 3 that the first step of getting a good control environment is with buy-in from the board and all other stakeholders as illustrated in diagram 4.

Building the tax function is then the second step as indicated in Table 2: Combine steps for TCF and tasks, where the task and responsible stakeholders can be put together. To integrate all aspects of the TRF and TRM with COSO and other models mentioned in this study the process can be illustrated in Table 2: Combine steps for TCF and tasks.

The stakeholders were also shown in diagram 4 as part of the TRM process. With the above table the tasks of every stakeholder are grouped together to give a clearer picture of what their duties and responsibilities are.

The tax function has certain building blocks as can see from diagram 5. These building blocks are also giving a toolset for identifying the areas within the tax function which needs attention.

**Diagram 5: Setup of tax function in detail**



Source: Prepared from various sources.<sup>4</sup>

To identify the various aspects in the illustration of the tax functions detail it can be linked to all other areas already discussed. The areas to discuss further and link to diagram 5 are:

1. The tax strategy as core for goal setting and identifying the playing field;
2. The tax operations and risk process;
3. The tax accounting process; and
4. The tax compliance process.

Together with the above functions which are part of the building blocks of the tax function the various stakeholders as shown in diagram 5 can be discussed.

The role played by the different stakeholders is as important as the role of the tax manager.

#### **4.2.1 The CFO**

The Chief Financial Officer's (CFO) role is that of giving guidance on the overall strategy of internal control in most businesses. They clearly have an interest in the figures as the accountants and in the financial risks. The responsibility also lies with them to monitor how the tax risks are being managed and how the tax department is performing the TRM process. It is also important that the TRM process is not disconnected in today's world from the CFO / CEO so that there is no missed opportunities of effective planning on tax when savings can be implemented or inefficiency can be stopped (Elgood *et al.*, 2004;13).

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<sup>4</sup> This diagram was not only assembled from the experience of the writer but also from various sources. The resources use was Bakker & Kloosterhof, 2010:21-62, Elgood, Paroissien, & Quimby, 2004 and Erasmus, 2007 & 2010 from which different illustration was used to form the setup structure illustrated in diagram 5.

#### **4.2.2 The Finance Department / Tax Department**

In some businesses the finance department will almost always be responsible for the management of taxes. As they are also key role players in the process of TRM, they are instrumental when implementing new transactions or with mergers and acquisitions. They also produce the information required for the Tax Department to compile tax returns from the financial system (Elgood *et al.*, 2004:14). The TCF will facilitate the Tax Department's day-to-day activities in giving guidance on various processes. This will assist the Tax Department to be involved from an early stage with transactions to minimise surprises. The Tax Department can then assist in adding value to the business in the process of cash flow management and impact on the earnings per share of the business (Bakker & Kloosterhof, 2010:29).

#### **4.2.3 The Shadow Tax Function / Business units**

The shadow tax function can be explained on the basis that it is the function of non-tax department personnel in the business. These personnel are individuals within the business units which are capturing transactions on a daily basis. Within these transactions the tax effect is normally not seen on transaction by transaction basis by the tax managers but by the "shadow" team / personnel in the business. As these people are responsible for the reconciliations or reviews within departments over transactions, they are doing the first level of risk assessment and mitigation of those risks. It should be thought through what level of support they need to support the tax function / department (Elgood *et al.*, 2004:42).

#### **4.2.4 The Internal Audit Department**

Historically auditors found that reviewing the tax function is "too specialised". This hopefully has changed and it can be seen where internal audit functions are reviewing the tax department; this can help raising the profile of the tax function (Elgood, *et al.*, 2004; 14). Within the governance structures of the organisation an internal audit department is part of the audit committee's tasks to evaluate the IFCs (PWC, 2010:1). The internal audit department (IAD) is assisting in one of the important roles in the TCF. As tax is seen as the "black box", the IAD is essential in the process of control measures in the organisation.



The IAD will not audit the technical nature of the tax calculation but rather the process of the TCF or mitigating controls within the organisation to reduce tax risks (Bakker & Kloosterhof, 2010:28).

The use of the IAD is also shown in the study compiled by the Netherlands Tax and Customs Administration on TCF (21 March 2008) where it is stating that they are using the work of internal auditors in establishing the operational effectiveness of the TCF within an organisation (Netherlands Tax and Customs Administration, 2008:11).

The IAD is essential in the process of reviewing the mitigating controls within a TRM process. This is done by means of checklists or control sheets drawn up from the TRM control sheets and to confirm and verify if the controls stated to reduce the risks are in place to minimise the risk on tax.

#### **4.2.5 Tax Strategy**

The tax strategy as core for goal setting and identifying the playing field for tax should be in relation to the vision, mission and organisational strategy. Tax strategy is how the tax functions will assist in achieving the overall goals of the organisation (Bakker & Kloosterhof, 2010:32). Part of the strategy is building a TRM policy. The multi territory environment should be included for large business which have residency in other jurisdictions. The strategic document should have two layers, one which focuses on the strategic level and the other on the operational controls. The document should set out the goals which the tax function needs to achieve (Elgood *et al.*, 2004:32).

Examples of strategic and operational objective are set out in Table 3: Objectives for tax strategy. The process which is normally followed to getting a TRM approved is that the TRM policy is drafted by the Head of Tax within the organisation with the CFO / CEO approving it. The audit committee is actually buying-in into the policy after reviewing it (Elgood *et al.*, 2004:32).

**Table 3: Objectives for tax strategy**

TAX RISK OBJECTIVES	EXAMPLES
Strategic Objectives	<ul style="list-style-type: none"> <li>• Head of Tax will take responsibility of tax risk management on a global basis.</li> <li>• Tax planning strategies will be implemented that will impact positively on day-to-day business.</li> <li>• The aim will be to avoid tax affairs being aired in the public domain.</li> <li>• All returns will be filed in all relevant jurisdictions in accordance to tax laws and regulations regardless of local customs.</li> </ul>
Operational Objectives	<ul style="list-style-type: none"> <li>• No more than five significant tax planning ideas will be implemented in one year.</li> <li>• All transactions above R/\$ 5m the tax function will be involved in decision making.</li> <li>• No new acquisitions or setup of new subsidiaries may be done without the tax functions involvement regarding structuring and financing.</li> <li>• External opinions will be obtained where the amount of tax is at stake is above R/\$ 1m.</li> <li>• The calculated tax amount needs to be accurate within 3% of the final assessment.</li> <li>• Portfolio risk should not exceed at any time more than 10% of the annual tax charge in the accounts (actual / budgeted).</li> <li>• The cost of any investigation by a revenue authority should not cost exceed 1% of the tax payable.</li> <li>• Tax related or filing penalties should not exceed \$/R 200 000.00 in any one year.</li> </ul>

Source: Adapted from (Elgood *et al.*, 2004:33).

The goals of a tax strategy can include qualitative and quantitative goals as well. Qualitative goals can be some of the examples from above where topics like transparency, information and good corporate citizenship are included. Quantitative goals are more measureable goals, like earnings per share (EPS), tax cash flows and effective tax rates (ETR). Many companies have maximising EPS as part of their overall strategy.

EPS is directly linked to the shareholders' value. This is calculated by dividing the net income attributable to shareholders with the weighted average number of shares. To get to the ETR the tax expenses are divided by the income before tax. The reason for these two figures to be part of the goal setting for the strategy is that both is interlinked to each other as the net tax cash flows play an integrate part of the amount the shareholders is receiving in dividends as tax is part of the cash flow impact of the business. The ETR can further be broken down into the type of expenses / movements within the tax expense which is part of its calculation.

The three drivers contributing most to the EPS / ETR are:

- The current tax year expense is calculated on profit before tax adjusted with permanent items. Timing differences do not have an impact on the ETR. If the tax function has EPS as its key performance indicator (KPI), the focus should be on tax planning for permanent items and not on timing differences.
- Tax expenses of previous years can have a major impact on the ETR if the true-up of the previous year to the tax authority's assessments is not done properly. Tax calculations not done within a certain margin of the assessment can have risks of interpretation which is not done accurately.
- Deferred tax movement can have a negative impact on the ETR if it is caused by rate changes or when tax loss carry-forwards are (de)recognised.

As part of the qualitative goals the demand of stakeholders to have transparency within the tax affairs of the organisation is normally part of how they view the greater good of the company and if it is showing sound corporate (tax) citizenship. Furthermore by building a good working relationship with the tax authorities has a long-term benefit and should be part of the tax strategy (Bakker & Kloosterhof, 2010:31-38).

#### **4.2.6 Tax Operations & Risk**

The process of risk management can be done in three phases together with the underlying supporting systems.

- Phase one includes a zero measurement of identifying the key risks in an organisation.
- Phase two includes the implementation of TCF to mitigate these risks.
- Phase three is to maintain this process and constantly updating the TCF. To form part of this process the organisation should consider bettering the communication with the tax authorities. By building better relationships with the tax authorities can speed up tax filing processes with them (Bakker & Kloosterhof, 2010:67-68).

To identify the tax risks as mentioned above for phase one can further be explained by classifying the tax risks into different types. These types can be summarised in Table 4.

Risk management is also a process which is addressed by KING III. As risk management is foreseen by KING III to set the tone in an organisation, it is done by defining risk and risk management in a policy document. This document should include the objectives, approach and philosophy by which risks are managed in an organisation together with the responsibilities of who is managing these risks. This document should be distributed within the organisation as such that all employees have an idea of such process. Part of the risk management policy is the framework on risk management (Wixley & Everingham, 2010:85).

Types of tax risks can be summarised in Table 4 across the organisation; these risks are also referred to in this study in Chapter 3.

**Table 4: Types of tax risks**

STAKEHOLDERS	TYPES OF TAX RISK						
	TRANSACTIONAL	OPERATIONAL	COMPLIANCE	FINANCIAL ACCOUNTING	PORTFOLIO	MANAGEMENT	REPUTATIONAL
<b>BOARD</b>				√	√		√
<b>CEO / CFO</b>	√	?		√	√	√	√
<b>TAX FUNCTION</b>	√	√	√	√	√	√	√
<b>LEGAL &amp; TREASURY</b>	√		√				
<b>BUSINESS UNITS</b>		√		?			
<b>AUDITORS &amp; TAX ADVISORS</b>	√	√	√	√	√	√	√
<b>REVENUE &amp; OTHER REGULATORY BODIES</b>	√	√	√			√	
<b>INVESTORS &amp; ANALYSTS</b>				√	√		√

Source: From (Elgood *et al.*, 2004:17)

Risk identification should be done to assist in setting up the tax strategy of the business if done for the first time. Tax risks are no longer the fact how risk-averse organisations are but is more in today's terms how money can be saved by paying more correct tax or how tax saving or planning opportunities within the legislation may be missed if not identified. For risk identification it is very important to be transparent in this process and various tools are used by organisations. One of the tools is to build a risk register with a heat-map of risk where highly prioritised risks are dealt with first. This register and heat-map can be drawn up to rank the risks accordingly from likelihood of occurrence to the potential impact on the bottom-line. This can also be indicative to what the risk appetite will be (Bakker & Kloosterhof, 2010:38-39).

Some events give rise to tax risks; these events are set out in the table below and is only on a high level. The key to risk identification is communication, those responsible for TRM need to know what is happening in the organisation (Elgood *et al.*, 2004:36).

**Table 5: Events of tax risks**

TYPE OF TAX RISK	TYPICAL EVENTS GIVING RISE TO TAX RISKS
<b>Transactional</b>	Acquisitions Disposals Mergers Financing transactions Tax driven cross border transactions Internal reorganisations
<b>Operational</b>	New business ventures New operating models Operating in new locations New operating structures (e.g. JV's / Partnerships) Impact of technological developments (e.g. Internet trading)
<b>Compliance</b>	Lack of proper management Weak accounting records or controls Data integrity issues Insufficient resources Systems changes Legislative changes Revenue investigations Specific local in country customs, approaches and focuses in compliance
<b>Financial Accounting</b>	Changes in legislation Changes in accounting systems Changes in accounting policies and GAAP / IFRS
<b>Portfolio</b>	A combination of any of these events
<b>Management</b>	Changes in personnel – both in tax and in the business Experienced tax people leaving – intellectual capital leaving with them Knowledge management New / inexperienced resources
<b>Reputational</b>	Revenue authority raid / investigation Press comment Court hearings / legal actions Political developments

Source: From (Elgood *et al.*, 2004:35)

Tax risks are everywhere in an organisation. These areas are not only the fiscal or finance departments but can be any one or all of the following departments in an organisation:

- Sales;
- Procurement;
- Production;
- Human Resource Management;
- Finance / Treasury;
- Research & Development – This department is normally having the biggest risks as the tax function is not always consulted when a new product (including financial products) was developed (Bakker & Kloosterhof, 2010:38-39).

Included in the above is how organisations should manage their global tax risk. Some specific risks arise with multinational groups such as local tax risks; transfer pricing, withholding taxes, sales taxes, excise duties and payroll taxes. These risks are sometimes difficult to manage as different time zones, different cultures and different language are complicating the process (Elgood *et al.*, 2004:48-49).

#### **4.2.7 Tax Accounting**

Tax accounting was done and is still done today at year-end after the statutory requirements are met. This process does not give insight into the estimated tax assessment before year-end. To improve this process and anticipate the tax position at year-end a continuous monitoring system should be implemented. A monitored tax position throughout the year can assist in a pro-active approach on tax issues and to take corrective actions before it is too late. Tax accounting is a process that can be reported using various techniques such as monthly calculations for taxes to be paid or dashboards which highlight the issues of certain taxes measured against the acceptable tolerance for risks (Bakker & Kloosterhof, 2010:51-53).

Tax accounting is also made more complex with the Accounting standards set out to get better transparency on tax issues in a company.

General principles IAS 12 and ASC 740 are very similar to set out the requirements for which taxes should be reflected in the financial statements (Bakker & Kloosherhof, 2010:76).

Furthermore by compiling tax packs in the various departments or by financial managers in the various businesses or business units within an organisation or group of companies, it helps to do a review of the financial accounting treatment of various accruals or deductions for accounting purposes. This sounds simple enough, but a tax manager of a major international company reviewed the tax packs received from the various financial managers in the group. He discovered that expenses such as marketing costs were labelled non-deductible, which was in the concept of accounting for taxes, indeed deductible (Erasmus, 2007:73).

#### **4.2.8 Tax Compliance**

Monitoring of compliance is mainly the responsibility of the board as stated by KING III. Furthermore, the responsibility of compliance with laws and regulations is usually the responsibility of line management. This point is clearly emphasized by KING III in its principle 6.4 (p90) (Wixley & Everingham. 2010:196).

Tax compliance should not be a reactive approach but that of pro-activeness. This approach of acting only when needed on tax is costing taxpayer's money in the long run, with additional penalties and interest (Erasmus, 2007:6).

The previous paragraphs are all interrelated with compliance, as compliance is a global perspective with tax accounting and risk identification integrated in it. A company cannot get a clear picture on its compliance risk if it does not construct this picture in a concise manner. This shows that compliance is integrated in the TCF. A company should test itself by the following questions:

- Is our tax accounting process up to standard as our efficiency and effectiveness for the challenges of tax which lies ahead of us?
- Do we have the control over our tax filing process?



- Are our tax processes organised?
- Do we comply in time to the tax authorities?

The above process will give an organisation a clear picture if it is compliant with the rules and regulations in the organisation’s various jurisdictions (Bakker & Kloosterhof, 2010:56).

Diagram 6 is again showing the process and specifically where Tax Compliance is forming part of the overall picture. It is within the area of compliance where technology can play a very important role. With the tax authorities getting more involved in the process of identifying the gaps and risks within organisations’ data it is paramount that companies give attention to their technology systems. The right systems can also improve cash savings as opportunities can more easily be identified. The typical barriers facing tax functions to getting more accurate data out of their systems and make more accurate claims are as follows:

- Data required is not easily accessible;
- Data is not maintained in the accounting system or enterprise resource planning system (ERP) but kept somewhere else in the organisation;
- The data required does not exist within the organisation.

The challenge is to overcome these technology barriers to get a better tax outcome and the opportunity of cash savings (Bakker & Kloosterhof, 2010:58).

**Diagram 6: Building blocks of a tax function**



Source: Adapted from (Bakker & Kloosterhof, 2010:25)

### **4.3. SUMMARY**

Every tax control framework can be a custom built process for an organisation. This chapter showed the process of how to start with a custom built process. Every part of the process as set out in this chapter is an integral part of the next. The main mistake made by businesses is to see this in isolation and to do only parts of the tax control framework.

Tax risk is not only a process done at each year-end, it is an inescapable part of on-going business. With this it also comes with inherent as well as created risks within every aspect of the business. There is not only the risk of proper reporting of taxes in the financial statements according to financial reporting standards but also what effect tax can have on the financials is a risk in itself. Because tax can have an impact on EPS and the effective tax rate of a company it is a risk if tax is incorrectly calculated or any other form of risk is identified. Consequences like these can have a cash flow impact on the business as well as reputational damage. The cash flow impact can be additional audit fees or consulting fees. These are the reasons why the tax function is important in the business by accounting for taxes.

## CHAPTER 5

### TAX CONTROL FRAMEWORK

#### 5.1 WHAT IS A TAX CONTROL FRAMEWORK?

Chapter 4 described the TCF as a framework on how to establish the control environment within which a company can reduce its risk to tax. The previous chapter had also set the process out as how to get a process started for implementing a TRM process.

To obtain the answer of the question “WHAT IS A TCF?” it can be defined as a framework of control for the purpose of tax, within which the workings of tax are not necessarily defined but rather the process of formulating an environment on how to get the unknown process, of how to manage tax, out of the way.

#### 5.2 WHERE TO START?

Every organisation has a framework or more familiar a control environment within which it is operating. The best is to start by getting to know this environment by answering a tax risk checklist. This study can be concluded by an already existing checklist drafted by Elgood *et al.* (2004). The checklist in Table 6: Best practice “tax risk management” checklist, can then be summarised in any format according to the geographical data, type of risks, events in the business processes, tax types or specialised tax areas.

**Table 6: Best practice “tax risk management” checklist**

Internal control component	Question	Yes	No
Control environment	Do you have a documented TRM policy?		
	Are there specific TRM objectives?		
	Have all relevant stakeholders had input to the TRM policy?		
	Have all the tax risk areas been included?		

Internal control component	Question	Yes	No
	Has the TRM policy been discussed and agreed at board level? (King III compliance)		
	Is there an appetite in the business to implement the policy?		
	Does the board review the position at least once a year?		
	Is the TRM policy aligned with the wider objectives of the business?		
Risk assessment	Are there procedures in place to assess the tax risks in the business?		
	Do these cover all areas of tax risk?		
	Do these cover all taxes?		
	Do these cover all significant countries in the group?		
	Do you know who the key creators of tax risk are in your organisation?		
	Do you have a process in place to manage these persons?		
	Do you know what the five key tax risks are in the business?		
	Do you use scenario planning to assess risk?		
	Are tax risk considered in aggregate to allow an overall portfolio view of risks to be considered?		
	Is the tax risk assessment documented?		
Control activities	Are risk control procedures in place?		
	Are the five key tax risks in the business properly managed?		
	Is it clear to the business when they need to consult the tax function?		

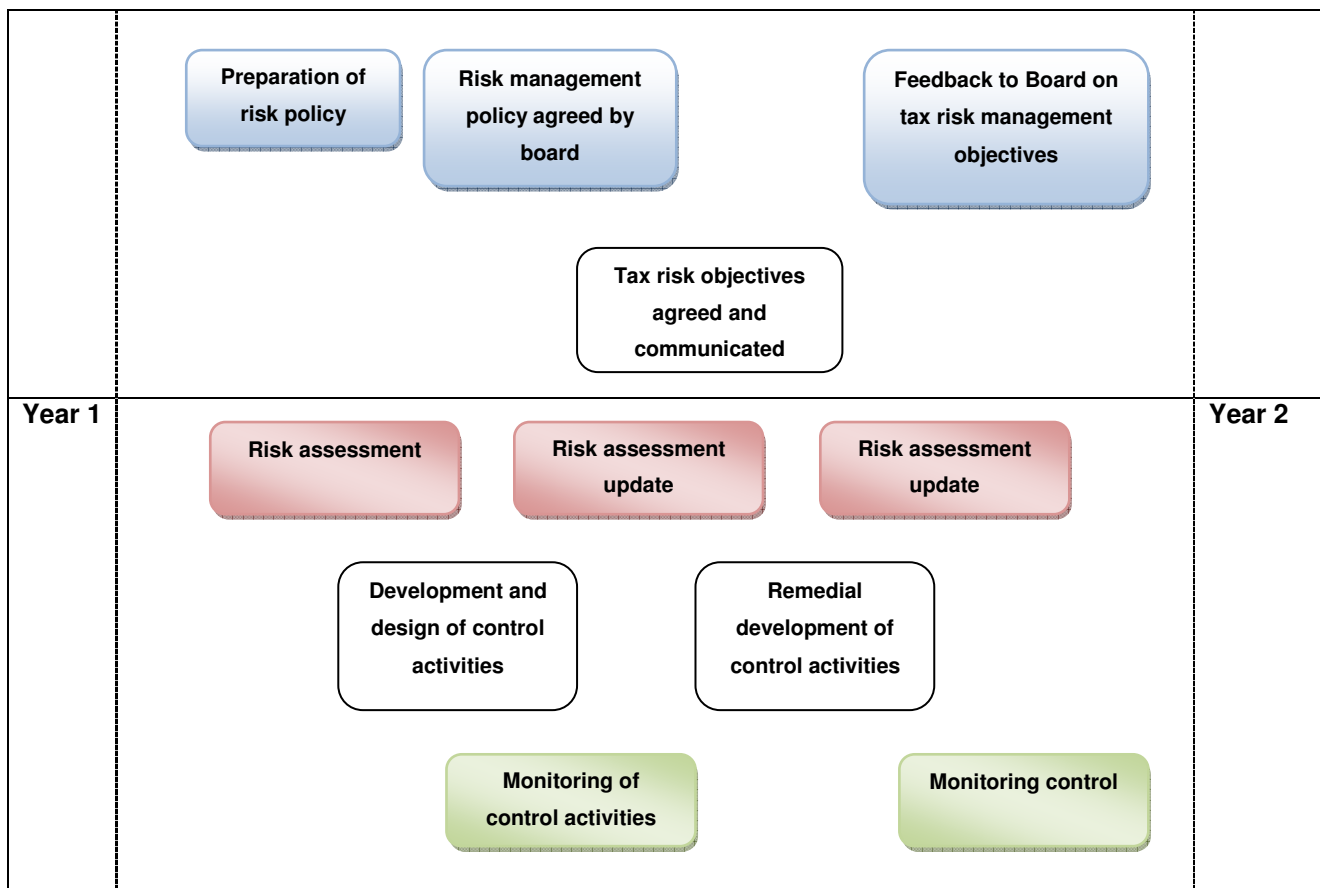
Internal control component	Question	Yes	No
	Is it clear when the tax function needs to consult with the board?		
	Are control activities communicated and embedded throughout the organisation?		
	Is it clear who in the organisation has responsibility for individual control activities?		
	Are the detailed control activities documented, agreed at board level?		
	Are you properly supporting those who have a risk mitigation role (e.g. the shadow tax function)?		
Information and communication	Is the board kept aware of the key tax risks in the business?		
	Is the board consulted on major tax risk matters?		
	Is there a central place people can find out about the business' tax risk policy?		
	Is there a list of people (or roles) that need to understand their role within TRM?		
	Are people new to roles within TRM briefed on TRM as it affects them?		
	Is the shadow tax department briefed on TRM?		
	Is there training in place to ensure key individuals understand their role in TRM?		
	Are processes in place to ensure the tax function is kept aware of operational changes to the business?		
Monitoring	Is there a process in place to ensure that TRM control activities are operating effectively?		
	Are internal audit involved?		
	Are the results of monitoring activities reported		

Internal control component	Question	Yes	No
	back to senior management?		
	Is the monitoring process documented?		
	Is remedial action taken where risk assessment and control activities are not found to be operating effectively?		

Source: From (Elgood *et al.*, 2004:54)

After completion of the checklist and dissecting it into the various datasets, it can be set according to a time-line for implementation. Table 7: Timetable for the process of TRM activities, provides a guideline of such a time-line.

**Table 7: Timetable for the process of TRM activities**



Source: Adapted from (Elgood *et al.*, 2004:44)

The above timetable gives an overview of the activities in planning and execution of the TRM process. The process can be broken down to be implemented in a two-year time period, or as decided on by the board / management. One of the purposes of a timetable is to have a disciplined manner in which to ensure that all activities are considered and put in place. This implementation will require the process as set out in chapter 4. The checklist will be used to give the board the proper oversight of the tax risks in the organisation.

This process needs to be upheld for continuity in the business. The myth of this is if you have done all that is set out in this study, you do not need to do it again. This is contradicting to the life span of the organisation and that as long as business is done taxes will be involved. Legislation changes and business expansions will always have an impact on the control environment process (Erasmus. 2007:89).

### **5.3 VARIOUS TAXES**

The various taxes involved in such process is one of the reasons for the non-stop effect of tax in a business can be summarised below. This is not a comprehensive list of all taxes but only a summary of the most common tax types.

- Corporate income taxes;
- Sales taxes / Value added tax;
- Excise duties;
- Payroll taxes;
- Withholding taxes;
- Property taxes;
- Municipal taxes;
- Stamp duty;
- Capital Gains tax;
- Intercompany / international rules such as transfer pricing.

## 5.4 TAX RISK CULTURE

As the previous list of the different types of taxes can be broadened, it is important to have the process of communication and monitoring run effectively. People are the key component in most of these transactions and it is important that the principles of a good TRM process is understood by the employees in the business.

As a lack of communication is sometimes the main reason of heightened risk exposure on different types of risks in a business it also includes tax risks.

Personnel often misunderstand instructions, is careless or distracted but also sometimes not adequately trained. To understand the weakness within the culture of the business it is done by testing the individuals by gathering information with a questionnaire testing their individual personality traits. This information will give a better understanding of where the weaknesses are within the system.

The test will include the following:

- Attitude to compliance;
- Attention to detail;
- Following directions;
- Respect for policies;
- Role awareness;
- Practical thinking;
- Consistency and reliability;
- Meeting standards;
- Personal accountability;
- Systems judgement.

By testing the above areas a company will get guidance on which areas require additional training or where better communication is needed. Some of the TRM strategies will include questions like:

- Do you know which perks or fringe benefits are subject to VAT?
- Have you accounted for VAT on any perks or fringe benefits?



- Have you exported any goods or services?
- Are your export documents 100% compliant with the tax regulations? Have you actually checked? Where are the documents kept?

The database of questions should be kept up to date and regularly tested throughout the business's operations (Erasmus, 2007:77).

## **5.5 SUMMARY**

Money is made by taking risks in business. Tax risk management is the process by which the process of taxes on business is managed to the minimum and not to make the tax payable zero. Tax compliance is one of the most complicated environments in the business arena. With changing legislation to keep the oldest form of tax in place as mentioned earlier in this study, it is imperative that the tax function especially the tax manager keeps himself abreast of the latest legislative changes.

The study gives an overview of a framework to assist the tax function of a business in managing tax risks within an organisation.

## CHAPTER 6

### CONCLUSION

#### 6.1 INTRODUCTION

The research question as set out of in this dissertation are to achieve a well-balanced way in which a proper proposed structure (framework) can be followed to implement a risk management approach specifically around taxes (TRMF) within a business.

In reaching this research question it was importing to understand the reasons why a TRMF would be important to a company, how does a TRMF process looks like and what is the methods involved in implementing a TRMF in an organization.

The reason why a TRMF would be important for a company is that taxes are one of the major items that impacting the lives of people and organisations. As the world is progressing towards a more regulated environment as can be seen from the introduction in chapter two and the way tax is regulated with the new legislative changes in the South Africa ITA with the introduction of section 80 in the ITA it becomes more and more important to have a TRMF in place so that the management of tax risks can be formalized.

There are various generic models available as discussed in chapter three for instance, COSO. All of these models have however the following in common where the internal control of a business should be reviewed and mitigating controls be implemented for the risks existing in those organisations. These models will also form the basis on which the framework as proposed in chapter five is built.

The methods involved in implementing a TRMF in an organization involve ten steps how to implement it. To summaries the ten steps an overview of it is the following;

- Board Approval;
- Setup a Tax Function;
- Establishment of a TRC with their responsibilities;
- Development of the tax strategy;
- Compiling a tax register;

- Formulating the tax appetite;
- Identifying transactions where tax risks can arise from;
- List the mitigating controls against these risks;
- Measure compliance towards taxes.

Every tax control framework can be a custom built process for an organisation. The main mistake made by businesses is to see this in isolation and to do only parts of the tax control framework. Tax risk is not only a process done at each year-end, it is an inescapable part of on-going business. With this also come inherent as well as created risks within every aspect of the business.

## **6.2 THE FRAMEWORK**

Tax Control Framework can be defined as a framework of control for the purpose of tax, within which the workings of tax are not necessarily defined but rather the process of formulating an environment on how to get the unknown process, of how to manage tax, out of the way.

The establishment of a framework is by completing a tax risk checklist as set out in chapter five, Table 6: Best practice “tax risk management” checklist. From heron a timetable will be formulated and implement as indicated in Table 7 of the same chapter. The steps to follow in formulating the framework are as follows:

- Starting with the checklists prepared as set out in table 6;
- Out of the answers from the checklist draft an action plan of implementation;
- Plan the corrective actions to be taken as illustrated in table 7;
- Identified the different types of taxes within the organisation that should be included in the process.

## **6.3 RECOMMENDATIONS**

The TRMF can only be effective implemented and kept alive within the organisation when the culture of compliance within the organisation is one of compliance and control.

To have a TRMF run effectively within an organisation is by having a TRC which takes its responsibility seriously and get assistance from the board of directors. When the board of directors assist the TRMF it will automatically involve the internal audit department with reviewing the mitigating controls on tax risks.

The TRC will also assist the proposed tax function working within the business where a separate Tax Manager will have mandate to implement the various mitigating controls. The Tax department main role will be the management of tax risks and also to keep abreast of all the new legislative regulations en acts of all jurisdictions where the organisation is doing business.

As tax controls and cash management is within every transaction in the business TRM should be taken serious because of the integral part it forms in every transaction. It is thus of utter importance that the Board of directors of the organisation buy into the concept and with their buy-in filter the concept down in the organisation.

## **6.4 FUTURE RESEARCH**

In this dissertation a framework for only income tax was design and discussed. Future studies can involve the design of a framework for other taxes like:

- Value added tax;
- Excise duties;
- Payroll taxes;
- Royalty Taxes;
- Withholding taxes;
- Property taxes;
- Municipal taxes;
- Stamp duty;
- Capital Gains tax;
- Intercompany / international rules such as transfer pricing and tax treaties.

These generic frameworks will then assist a tax department / manager in an organization to manage all the relevant risks surrounding taxes in their organization.

## **6.5 SUMMARY**

Money is made by taking risks in business. Tax compliance is one of the most complicated environments in the business arena as well as one of the most difficult risks to manage and control. By not starting to manage these risks can result in costing the organization a lot of money unnecessary. The study gives an overview of a framework to assist the tax function or department of a business in managing tax risks within an organisation.

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