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Tax Control Framework

Expert's opinion

Tax Control Framework procedures

Renato Sesana

Partner Grant Thornton FAS

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To this end, it is necessary for a company wishing to create a Tax Control Framework to have an internal control system which allows a preliminary self-assessment of tax risks, providing a continuous and updated monitoring of the situation and which can help to eliminate, or at least mitigate, the uncertainties related to the management of tax risks.
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Paolo Besio

Partner Bernoni Grant Thornton

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Focus on

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Leonardo Fortunato

Manager Bernoni Grant Thornton

Over the last few years, an increased focus on the prevention of tax crimes has clearly played a major role in business leaders' approach to risk management. The reasons for this change compared to the past - characterised by a low perception of some tax compliance topics, combined with a significant lack of specific regulation - can be attributable to:
(i) the introduction of measures aimed at reducing tax litigations through the regulation of some tools useful to promote preventive actions by the taxpayers;
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Overview

TCF as a tool to manage tax risk

Paolo Besio
Partner di Bernoni Grant Thornton

A definition of tax risk

Tax risk is defined as the risk of operating in violation of tax regulations, i.e. in a way contrary to the principles and purposes of tax law. These risks are, in particular, risks related to the total or partial lack of relevant information, to the misinterpretation of a norm, or to the wrongful performance of tax fulfilments.

Tax risk can have both a financial nature, in terms of higher taxes, fines and interest, and a non-financial one, considering in particular the reputational risk.

Most taxpayers declare to be attentive to tax issues but, analysing the matter, significant shortcomings emerge: on the one hand, there is a tendency to strongly limit the identification of corporate flows relevant for tax purposes; on the other hand, those who hold information do not have a tax awareness to process them and the control systems usually adopted do not consider tax risks.

In case of tax audit, this casual attitude results in higher taxes, fines and interest (considering just the administrative side), i.e. cash which cannot be used for new investments or to pay labour and capital.

The approach of lawmakers and tax administrations in various States is changing, giving more and more importance to a proactive exchange between taxpayers and tax authorities and providing tools suitable to this end. Those taxpayers intending to adopt a virtuous behaviour, not only as concerns their core business, need to carefully consider how they manage tax issues. The adoption of a Tax Control Framework is, to date, the correct behaviour to adopt.

This is also an approach showing to all stakeholders that the corporate management adopted tax management tools which are up to date and fit for the purpose.

A brief overview

The focus on tax risk and on its management is relatively recent: in the third meeting of the Forum on Tax Administration held in Seul in 2006, the participating tax administrations resolved to start globally coordinated actions against tax elusion and evasion and mandated the OECD to analyse the issue and propose solutions.

Two years later, the OECD published the report "Study into the role of tax intermediaries", which analysed the activity of taxpayers and tax intermediaries, in the broadest sense of the terms, as well as of tax administrations.

Said report is key, as it lays the foundations for all the actions which will be implemented in the following years: on the one hand, it promotes a voluntary and proactive interaction, with the introduction of the Tax Control Framework, cooperative compliance and, within certain limits, voluntary disclosure; on the other hand, it envisages more effective tax avoidance and evasion measures, such as the exchange of information and the actions of the BEPS project, just to mention the most significant documents.

Most of the documents mentioned have been implemented in our tax legislation: as far as cooperative compliance is concerned, in 2013 a pilot project was launched and, in compliance with the enabling law on tax reform, the Tax Control Framework and the cooperative compliance regime were introduced within the Legislative Decree on legal certainty, and thus in the Italian law system, in 2015. Voluntary disclosure became law in 2014, together with the execution of various agreements for the exchange of information with States which had always been considered as tax havens and staunch defenders of banking secrecy.

Some actions of the BEPS project have been turned into Italian norms and praxis, also through the transposition of some EC directives (actions 5, 8-10, 12, 13 and 14, among others); other are still to be finalised, basically through the implementation of the multilateral instrument.

Tools for a proactive dialogue between taxpayers and tax administrations

If we consider the strategies to promote a proactive exchange of information aimed at voluntary compliance, we can observe that even before the implementation of the Tax Control Framework and the introduction of the cooperative compliance regime there already were in the Italian law tools to manage tax risks relevant to specific activities or operations: general rulings, rulings for the non-application of provisions, anti-avoidance rulings, ruling on new investments, unilateral, bilateral and multilateral advance pricing agreements, mutual agreement procedures.

The cooperative compliance regime has a broader scope, i.e. it focuses on corporate direct and indirect taxation and thus allows to cover all activities and operations in a way that it is impossible to attain with other tools.

A necessary but not sufficient condition to access the cooperative compliance regime is for the company to have a Tax Control Framework.

This is an internal control system, aimed at guaranteeing the correct application of tax norms and the correct management of tax fulfilments.

The strategic role of a Tax Control Framework

The concept of Tax Control Framework was initially introduced in Italy on the occasion of the relevant pilot project in 2013 and of cooperative compliance in 2015.

Most taxpayers tend to connect the Tax Control Framework with the cooperative compliance regime and consequently, as long as they cannot access the cooperative compliance regime (the turnover thresholds to do so are still very high to date, as detailed below), they consider the implementation of a Tax Control Framework as not advisable.

We deem this evaluation essentially wrong and irresponsible.

An effective management of tax risks is key to avoid exposing a company to risks, both financial and of a different nature, arising from the wrongful application of norms and form the management of incorrect tax fulfilments. A modern and responsible management of tax matters implies that the company's top management can guarantee that tax risks to which it is exposed are identified, assessed, managed and monitored, and thus that the company's exposure to risk is minimum.

In other words, the adoption of a Tax Control Framework should be seen as a strategic choice for a responsible approach to risk management, which in itself justifies the required investment. The access to the cooperative compliance regime is a further and subsequent step, very important but not always necessary.

There are many corporate taxpayers which do not have a tax office able to monitor all the activities and the fulfilments. In a similar situation, part of the tax activities and fulfilments are outsourced to external providers. The real risk for the taxpayer in these cases is that the corporate tax procedures as for tax matters are partial and that the outsourcers do not have a full picture of the situation. The outcome is that the internal office and the outsourcer are not sufficient to guarantee a good tax risk management and, consequently, expose the taxpayer to major tax risks.

Tax administrations have for some time declared to consider the Tax Control Framework as important and to keep into account the existence of a suitably structured one when evaluating the taxpayers' risk profile and in case of a tax audit.

By way of comparison, which we do not consider to be far-fetched, the above is the same evaluation made, mutatis mutandis, in the transfer pricing context with reference to the preparation of the documentation required under the Order of the Revenue Office Director and to the submission of an Advance Pricing Agreement. The preparation of the transfer pricing documentation is an optional fulfilment which allows to provide an overview of the taxpayer's group, operations and methods used to determine arm's length prices. If the documentation is prepared consistently with the scheme and the contents of the relevant Order and the tax inspectors confirm its appropriateness, the possible adjustment of the applied prices does not expose the company to the risk of penalties. The submission of an Advance Pricing Agreement application is the obvious outcome of a proactive tax compliance management, but it is not necessary.

A company can decide to prepare the transfer pricing documentation and not to submit any application, or to submit an application covering only one of the various intercompany transactions. The choice not to submit one or more Advance Pricing Agreement applications does not detract from the strategic importance of the preparation of the documentation.

The Tax Control Framework is a valid tool to manage tax risks, key to avoid exposing the company to risks, both financial and non-financial ones, arising from the breach of tax norms.

After having worked on the tax procedures and created a Tax Control Framework, a company can thus consider, once evaluated the subjective conditions, whether to access the cooperative compliance regime.

Brief overview of the cooperative compliance regime

As mentioned above, having a Tax Control Framework is the necessary though not sufficient condition to access the cooperative compliance regime.

As far as the subjective requirements are concerned, there exist one rule and a few exceptions. The rule is that the taxpayer must have a turnover equal to at least 5 billion Euro.

When the law was approved, the turnover threshold was equal to 10 billion Euros. As soon as it entered into force, it was decided that the turnover threshold should have been progressively reduced, until allowing access to all taxpayers with revenues not lower than 100 million Euro.

Exceptions to the rule above are taxpayers which took part in the 2013 pilot project (in this case the turnover had to be equal to at least 1 billion Euro), taxpayers which firstly implemented and manage a Tax Control Framework (provided that the minimum turnover thresholds are met), taxpayers which have obtained a reply to a ruling on new investments and intend to behave as suggested by the Revenue Office and, lastly, taxpayers belonging to a VAT group, where one of the participants adopts the regime.

The cooperative compliance regime guarantees an ongoing exchange with the Revenue Office (Central Department), which becomes the sole point of contact for the taxpayer (with the exception of other local offices of the Revenue Office and of the Tax Police) for inspections and activities relevant to said regime.

The adoption of the regime implies the possibility to reach a preliminary evaluation jointly with the Revenue Office of situations which could give rise to tax risks before filing tax returns, as well as to benefit from shortened ruling procedures.

In case of a differing opinion, the taxpayer can maintain its position and, should it lose the litigation, it could benefit from a 50% reduction of fines and from the suspension of the collection until the tax assessment is complete.

In case of applications for refund of direct or indirect taxes, the taxpayer will not be required to provide guarantees.

The beneficial regime that should be introduced in the Italian law

The Italian tax authorities should invest significantly in their relationship with taxpayers, also by simplifying and facilitating voluntary fulfilments, to be able to distinguish between those who correctly and promptly comply and those who do not, in order to focus the assessment activity on the latter.

They should also promote the adoption of a Tax Control Framework by a significant number of taxpayers.

To achieve this result, the lawmaker and the tax administration should, on the one hand, provide more specific indications on the set up and contents of a suitable Tax Control Framework and, on the other hand, exclude administrative and criminal penalties when a Tax Control Framework is considered acceptable.

The target is very ambitious and challenging: to date, even those taxpayers which are included in the cooperative compliance regime do not benefit from the disapplication of penalties.

Administrative penalties are actually reduced to 50%; as for criminal ones, the adoption of the cooperative compliance regime is considered as a mitigating circumstance, not a cause of disapplication.

If the situation above was acceptable in the first years in which the regime was in force from the point of view of the Revenue Office, nowadays it is no longer sustainable in a situation in which the intent is to promote and encourage proactive and voluntary compliance.

Laws need to be introduced, but also revised and adjusted to the changed domestic and international context on an ongoing basis.

The disapplication of administrative and criminal penalties in case of adoption of a suitable Tax Control Framework would be a strong incentive to a substantial improvement of the relationship between Revenue Office and taxpayers and to the increase of voluntary compliance.

To this end, the so-called Colao Commission has already expressed its favourable opinion, but the proposal has meanwhile been forgotten. It would be advisable for the legislator and the tax authorities to reconsider it as soon as possible.

Expert's opinion

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Renato Sesana
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To this end, it is necessary for a company wishing to create a Tax Control Framework to have an internal control system which allows a preliminary self-assessment of tax risks, providing a continuous and updated monitoring of the situation and which can help to eliminate, or at least mitigate, the uncertainties related to the management of tax risks.

Generally speaking, the tax risk detection, measuring, management and control system needs to be integrated in the corporate management and internal control system, with a clear assignment of roles and responsibilities to guarantee an ongoing mapping and monitoring of the most significant risks.

A key role to this end is played by management bodies (usually the Board of Directors) which can perform an assessment and evaluation of said risks, identifying the criticalities and the proper corrective actions.

This obligation also involves, to a given extent in terms of corporate liability, the supervisory bodies (such as the internal audit function, the board of statutory auditors and the legal auditor) and is a commitment by the corporate top management with reference to the activities planned to remedy gaps possibly identified in the period considered.

A tax risk management framework should include the following elements:

- a clear representation of the tax strategy, highlighting the objectives pursued by the top management when managing tax matters and thus reflecting the corporate tax risk appetite;

- a clear distribution of roles and responsibilities to people with a suitable training and expertise within the organisation, according to the segregation of duties criteria;
- the inclusion of effective methodologies and procedures for the identification, measurement, management and control of tax risk;
- an ongoing monitoring of the control system functioning and the activation of remedies in case of faults or errors;
- the system's ability to adjust to changes in the internal organisational context and in the regulatory framework;
- lastly, the inclusion of a report to the management bodies (usually the Board of Directors) on the findings, the remedies implemented and, in general, the activities planned within the tax risk control system on a yearly basis at least.

It is clear that such a system cannot do without a correct circulation of relevant information within the organisation, as well as a suitable information flow and reporting to all corporate levels.

Below are analysed in detail the factors above.

Tax Strategy

This implies a document undersigned by the Directors, containing a long-term action plan which defines the company's targets in the management of tax risks, both from a strategic and operational point of view.

The tax strategy needs, first of all, to reflect the company's risk appetite and should include the operational paths to be followed in order to align the company to the selected risk levels, such as for example the rationale of incentives granted to managers with reference to the tax factor, the adoption of detailed procedures to guard against tax risks with the identification of roles and responsibilities and the approach towards the Tax Authorities.

It should also include codes of conduct related to tax matters, training plans for employees, management commitment towards a correct tax approach, as well as penalties for those breaching the code of conduct rules.

Roles and responsibilities

The development of a Tax Strategy and of a TCF in general is the primary responsibility of the company's senior management, but a critical success factor for an effective implementation is the involvement of people with the right abilities and expertise.

Therefore, there needs to be a clear assignment of roles and responsibilities, also according to segregation of duties criteria, both horizontally and vertically:

- horizontally, by dividing duties and responsibilities among people taking part in the same process. A critical factor in this area is also the configuration of information systems;
- vertically, guaranteeing the necessary separation between operational functions and control ones, also in order to avoid conflicts of interest.

Control functions include:

- first level controls (line controls): carried out by operational functions;
- second level controls: aimed at evaluating the efficiency and effectiveness of first level controls;
- third level controls (e.g. internal auditing): aimed at assessing the adequacy of the risk control system in general.

Tax Risk Assessment

The map of tax risks identified by the tax risk control system plays a key role within the Tax Control Framework.

It is worth making a preliminary distinction right away between tax risks which can originate within ordinary activities related to the usual corporate functioning cycles and risks related to specific transactions which, for their qualitative or quantitative aspects, cannot be considered as routinary activities (e.g. M&A operations).

Consequently, the approach to the assessment of the relevant tax risks should be adequately adjusted keeping into account the specific features of the relevant areas.

Tax Risk Assessment should start from the mapping of processes to identify tax risks. Therefore, the Risk Owners will have to be involved, i.e. the corporate management in charge of the process, for the identification of tax risks potentially related to a specific process, tracking information on taxation (direct taxation, indirect taxation, local taxation) and the type of tax on which the risk impacts (e.g. IRES, IRAP, VAT, etc.).

Each risk will have to be assessed in terms of probability and impact (economic/fines, reputational, legal) to determine the inherent risk; the controls in force to address the risk then need to be identified and the residual risk evaluated. For those risks in which the residual risk is higher than the acceptable risk, the controls will need to be integrated with further ones.

In the Risk Assessment phase, the use of a RIsk Assessment Criteria Matrix, in short RACM, can be of help to break down processes into activities and, within activities, to identify and evaluate risks and the relevant controls.

As far as non-routinary operations are concerned, instead, it is clear that the method to assess related tax risk should necessary be simplified and that, even if it is applied basing on criteria of probability and impact, it implies a case-by case analysis.

Within Tax Risk Assessment, it is possible to capitalise on what possibly already analysed about the company with reference to tax offences ex Legislative Decree no. 231/01; this analysis can be a good starting point, though not comprehensive, to address the activities related to tax risk management.

Monitoring and information flows

The internal control system must include effective monitoring procedures allowing the identification of possible gaps or errors in its functioning and the consequent activation of corrective actions.

It will also be advisable to identify Key Risk Indicators (KRI) to measure the performance of the TCF as a whole and the effectiveness of the controls put in place; besides, the TCF must adjust to the main internal changes, i.e. concerning the business, and in the external scenario, such as possible amendments to the tax legislation.

The system is to be based on accurate, complete and timely information flows and guarantee the circulation of information to all corporate levels, each insofar as it concerns them; in particular, it must include, on a predefined basis (e.g. yearly) the sending of a report to the management bodies, containing the result of the assessments made on tax fulfilments, planned activities, results obtained and actions implemented to remedy possible gaps identified further to the monitoring.

Conclusions

Considering the above, it is evident that the devising and implementation of a Tax Control Framework requires a multi-disciplinary approach involving tax, legal, organisational, risk governance and technological skills.

The devising, preparation and maintenance of a TCF over time must be included within the wider internal government and control system, without being a tax appendix of other control systems.

A full and constant involvement of the tax function will be necessary, also prior to business decisions; this involvement will need to be granted by processes which involve the participation of the head of the tax function in committees in which operations and significant project regarding the company are evaluated or resolved upon.

All the above, together with the monitoring and continuous improvement requirements, leads to the need to create a Tax Management System with a consistent approach with other management systems, possibly already in place in the company.

Focus on

Tax Control Framework, 231 & 262

Leonardo Fortunato
Manager Bernoni Grant Thornton

Over the last few years, an increased focus on the prevention of tax crimes has clearly played a major role in business leaders' approach to risk management. The reasons for this change compared to the past - characterised by a low perception of some tax compliance topics, combined with a significant lack of specific regulation - can be attributable to:

1. the introduction of measures aimed at reducing tax litigations through the regulation of some tools useful to promote preventive actions by the taxpayers;
2. the growing interest of business leaders in avoiding burdensome and expensive litigations with the tax authorities in order to prevent the risk of incurring in administrative and criminal penalties;
3. the certain reputational damage which the perpetration of a tax offence could cause to the company, as well as to its management and to the various stakeholders.

As mentioned above, one of the key drivers of this change was the innovative approach - although still limited to date - adopted by the Italian tax lawmaker, in line with the international context (e.g. the various work by the OECD aimed at promoting transparency and exchange of information between taxpayers and tax authorities. To this end, it is worth recalling:

- the introduction of the cooperative compliance regime by art.3 and following articles of Legislative Decree no. 128/2015;
- the broadening of the list of predicate offences regarding administrative liability of entities (Legislative Decree no. 231/2001) to include some types of criminal tax offences ex art. 39 of Law Decree no. 124/2019.

The regulatory interventions above, although different as concerns their scope, have provided a strong incentive to businesses - and moreover to their managers - to adopt systems aimed at the prevention rather than the treatment of tax risk. The analysis of the abovementioned regulatory interventions allows to appreciate the soundness and effectiveness of some tools aimed at providing businesses with protection tools. Below in this article, we will try to outline the main features, highlighting the possible opportunities and obvious benefits.

The update of tax protections ex Law no. 231 as a first step for the implementation of a TCF

Legislative Decree no. 231/2001 regulates the administrative liability of entities originating from crimes, i.e. the potential imposition of sanctions in those cases in which a third party (e.g. a top manager) commits specific types of crimes (the so-called predicate offences) in favour of the entity.

In order to avoid the application of penalties and the subsequent entity's liability to prosecution, which in some cases may lead to significant consequences for the business organisation (e.g. suspension of the activity), the entity has the opportunity to adopt risk prevention systems with effective control measures (also including the setting up of a dedicated independent, third-party board) aimed at the prevention and reduction of risks.

The list of the abovementioned predicate offences has recently been extended to include some specific types of tax offences. Actually, Law no. 257/2019 entered into force on 25 December 2019, converting the so-called Tax Decree (Law Decree no. 124/2019, containing urgent norms on tax matters for non-delayable requirements), introduced specific tax crimes within the scope of predicate offences (art. 25-quinquiesdecies of Legislative Decree no. 231/01) from which the administrative liability of entities originates. In particular, the following new offences have been introduced:

- Fraudulent tax return through the use of invoices or other documents for non-existent transactions (art. 2 of Legislative Decree no. 74/2000).
- Fraudulent tax return through other means (art. 3 of Legislative Decree no. 74/2000);
- Issuance of invoices for non-existent transactions (art. 8 of Legislative Decree no. 74/2000);
- Concealment and destruction of accounting records (art. 10 of Legislative Decree no. 74/2000);
- Tax evasion (art. 11 of Legislative Decree no. 74/2000);
- Inaccurate tax return (art. 4 of Legislative Decree no. 74/2000), omitted tax return (art. 5 of Legislative Decree no. 74/2000) and undue tax credit offsetting (art. 10-quarter of Legislative Decree no. 74/2000), should they be committed exclusively within fraudulent cross-border systems in order to evade VAT for an amount exceeding 10 million Euros.

The inclusion of the abovementioned offences: (i) on the one hand, led to the update of Organisation Models already in force through the drafting - where missing - of dedicated procedures aimed at reducing tax risks (limited to the cases above) and (ii) on the other hand, drove all those businesses lacking a suitable Organisation Model to adopt appropriate procedures to limit possible negative consequences of tax offences (actually, the potential perpetration of tax offences is certainly of interest to more taxpayers, as opposed to other types of crimes - including predicate offences - which refer exclusively to some categories of taxpayers).

In such context the update of control systems brings significant benefits in terms of systematisation of actions to prevent tax risks.

Actually, the adjustment (and/or ex-novo implementation) of control systems ex Law 231, though limited to the updates above, allows to:

1. identify and assess the so-called sensitive activities, whose performance may imply the perpetration of tax offences (with exclusive reference to the new predicate offences);
2. identify and recognise the control systems already in place;
3. evaluate the soundness and completeness of information flows with reference to both supervisory bodies and the various interrelations among the various functions;
4. highlight the main weaknesses and gaps in the process (gap analysis).

A significant part of the activity also concerns:

- the formalisation of ad hoc procedures useful to identify operating methods, general principles of conduct, information flows and people in each function accountable for monitoring the most important tax activities such as, among others, the drafting and finalisation of tax returns (VAT return, IRES and IRAP returns);
- the integration and update of procedures aimed at strengthening the protections already in place with a view to the prevention of tax risk.

The update and/or implementation of control systems in line with the predicate (tax) offences under Law 231 is to be considered as an effective first step for the introduction of systems/procedures guaranteeing a high-level tax risk monitoring and control within the organisation. Actually, the mere implementation of the abovementioned activities and tools - useful to correctly update the Organisation Model to the most recent regulatory novelties - is aimed, generally speaking, at the mere prevention of specific tax offences. Therefore, the broadening of some categories of tax offences within the scope of predicate offences under Law 231 and the relevant required updates can be a significant opportunity to consider the adoption of a more systematic and comprehensive strategy for the prevention of tax offences, i.e. the possibility to undertake a path aimed at the implementation of a Tax Control Framework (also TCF).

This opportunity is even more relevant for those organisations which, besides an Organisation Model ex Law 231, also have procedures in place deriving from the provisions of art. 154-bis of the Consolidated Law on Finance (so-called TUF), i.e. the drafting by the director in charge of preparing corporate accounting documents, of suitable administrative and accounting procedures for the preparation of the financial statements for the FY and, where provided, of the consolidated financial statements, as well as of any other financial communication.

Said procedure, although reserved to specific contexts and taxpayers, is significant as it undoubtedly helps to strengthen the prevention system, focusing on one of the most relevant aspects related to tax, i.e. the correct compilation and management of accounting records.

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