MyRinggit

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Protecting the Future

Tax risk management – have you addressed this?

The current economic reality, both internationally and domestically, is that we need to brace ourselves for challenging times ahead. The euro zone problems will have an impact on regional growth, which, in turn, will have an impact on Malaysian businesses. Although stronger demand in Asia may counteract lower demand from the EU, there will inevitably be some backlash on our economy. External pressures, combined with the year-on-year increase of Government debt to Gross Domestic Product (GDP) ratio paint a challenging picture for 2012. Government revenue collection will be a priority and we will undoubtedly see the tax authorities carrying out their responsibilities more zealously than ever, given a higher 2012 tax revenue collection target.

Against this background, it is important for businesses to review their tax policies from a tax risk management perspective. What does this mean? The issue of tax risk management is not merely the need to assess tax risk in relation to potential challenges from the tax authorities, but is wider than that. Tax risk management involves a process of ensuring that an organisation's tax affairs will not impact the business objectives and ultimately ensure that there is no adverse impact on shareholder value.

HOW DOES TAX RISK ARISE?

Tax risks can take several forms and could arise for various reasons, including the following:

- Risks arising from operations, which could include frequent changes of personnel within an organisation/department resulting in lack of familiarity with the organisation's reporting and compliance requirements, inadequate tax and financial reporting flows, inadequate documentation to support transactions and positions taken, reluctance to obtain assistance from professional service providers, etc.
- Compliance risks associated with not meeting tax filing, payments or other compliance requirements
- Technical risks as a result of inadequate tax knowledge and lack of regular reviews of policies and reporting structures within an organisation
- Risks arising from poor communication within an organisation
- Reputational risks arising from adverse publicity where tax positions are challenged by the authorities, or as a result of inadequate tax provisioning, etc.

The above highlights some of the key areas which give rise to tax risk in an organisation. It should be noted that tax risk does not merely arise as a result of potential additional tax liabilities, but tax risk could also stem from situations where organisations do not maximise potential tax benefits available to them, which clearly would have an impact on shareholder returns. This would include situations where organisations do not make use of available tax incentives or other avenues to legitimately tax plan. Hence, it is important to ensure that there are personnel within the organisation with appropriate tax knowledge as well as the need to engage tax advisors where necessary.

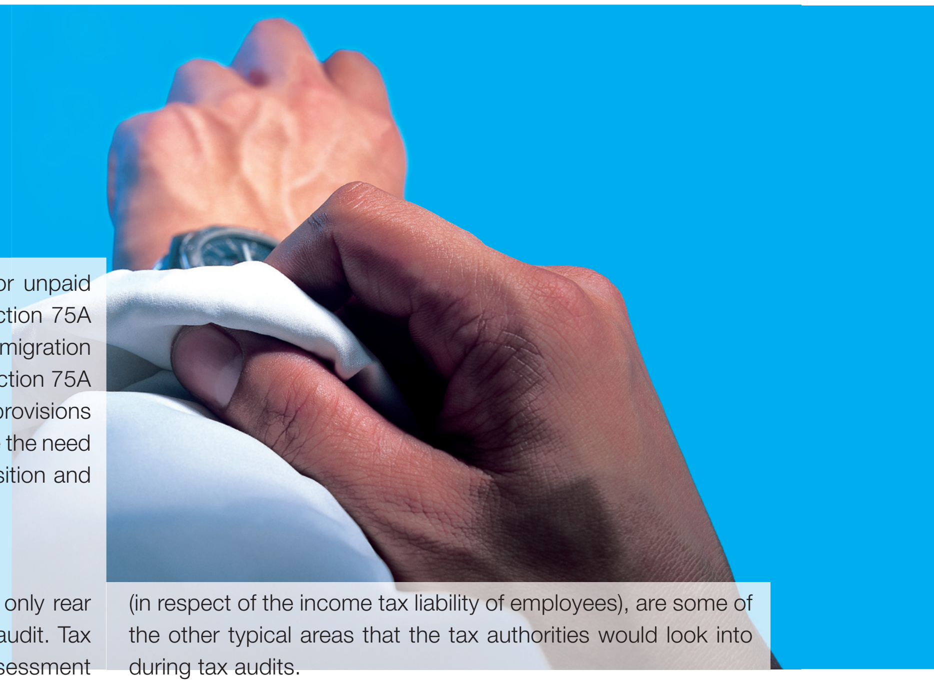
From the Board of Directors perspective, being alert to tax risks is important, particularly as the Income Tax Act, 1967 (Section 75A) imposes an obligation and potential liability on directors as follows:

'Notwithstanding anything contrary to this Act or any other written law —

(a) where any tax is due and payable under this Act by a company, any person who is a director of that company during the period in which that tax is liable to be paid by that company; or

(b) where any debt is due and payable from an employer under any rules made pursuant to Section 107 and the employer is a company, any person who is a director of that company during the period in which the debt is liable to be paid by that company, shall be jointly and severally liable for such tax or debt, as the case may be, that is due and payable and shall be recoverable under Section 106 from that person."

The tax authorities are authorised by the Income Tax Act



to take civil action against directors of companies for unpaid taxes, and further, directors who are liable under Section 75A may be prevented from leaving the country by the Immigration authorities, where the tax authorities have invoked Section 75A and the relevant companies' taxes are unpaid. These provisions place an onerous responsibility on directors, and hence the need for directors to be fully aware of a company's tax position and potential tax risks.

TAX AUDITS

A tax risk may often lie latent in an organisation and only rear its ugly head when the tax authorities conduct a tax audit. Tax audits are part and parcel of the Malaysian self-assessment tax framework, and all companies can expect to be audited at some stage.

Several factors could indicate a potential tax risk, and these factors would typically instigate a tax audit, although tax audits can also be conducted randomly. The typical factors which attract scrutiny include the following:

- Persistent losses – companies which consistently have tax losses will attract the scrutiny of the tax authorities, simply because there is a reasonable expectation that businesses are set up to earn profits. Undoubtedly, losses can, and indeed often arise for commercial reasons, but companies which make losses year-on-year, particularly those which transact with related companies would interest the tax authorities.
- Reduced effective tax rates – where the effective tax rate in a company or a group of companies is persistently low, without a reasonable explanation (eg, tax incentives), this is likely to attract the attention of the tax authorities.
- Significant related party transactions – where a company has significant related party transactions, and particularly where the factors mentioned above are also present, transfer pricing would be an area of focus of the tax authorities. Transfer pricing is not only a domestic issue, but is an important issue regionally and globally, with tax authorities around the world increasingly focussing on transfer pricing matters. Hence, there is a need to ensure that there is adequate documentation to substantiate that all related party transactions are on an arm's length basis.
- Divergence from industry norms – where the performance of a company diverges significantly from industry norms, this would interest the tax authorities.
- Use of 'tax havens' or low tax jurisdictions within a group structure – the use of such jurisdictions would attract the scrutiny of the authorities. While it is possible to use such jurisdictions legitimately, the issue of substance over form must be considered, and commerciality is important.

Aside from the above, withholding tax on cross-border payments, incentive claims, marketing and promotion costs, entertainment costs, valuation issues, schedular tax deductions (in respect of the income tax liability of employees), are some of the other typical areas that the tax authorities would look into during tax audits.

The self-assessment system (as opposed to the old traditional assessment system) arguably gives rise to greater tax risk, particularly given the mindset of the tax authorities, which is often restrictive. Case law has established the principle that where there is any doubt, tax statutes should be interpreted in favour of taxpayers. The maxim in revenue law is that where there is no clear provision, there should not be any tax, and where there is doubt, it must be settled in the taxpayer's favour. However, the reverse is generally the case in practice. The tax authorities will typically interpret uncertainty against the taxpayer. Although the position may ultimately be reversed if appeals are lodged and litigation pursued, tax liabilities are to be paid notwithstanding any appeal. Problems could arise where such liabilities have not been provided for in the accounts, particularly in the case of listed companies. Hence, awareness of uncertain tax positions is important to enable informed decisions to be made for disclosure purposes.

CONCLUSION

Tax risk will nearly always be present in some form within an organisation. This need not always be a bad thing, provided the relevant tax risk has already been considered and evaluated, and provided there is a reasonable basis from a technical analysis to adopt a certain tax position. Tax risk, which has not been identified and has not been evaluated, is adverse to an organisation and to the directors. To mitigate tax risk, it is therefore essential for organisations to ensure that tax matters are addressed upfront, appropriate measures are in place to identify and minimise tax risks, and that there are people in the organisation with requisite knowledge or have access to appropriate resources (including professional advice) to deal with tax matters. Organisations should design and implement a tax risk policy, which should be reviewed from time to time. The famous saying Ignorantia juris non excusat or Ignorance of the law is no excuse holds true for tax laws as it does for all other laws, and the repercussions can be severe. mb

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