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TAX

# Tax Risk Management in China

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# New era of tax administration in China – tax risk management

During the last few years, governments in many countries have been continuously encouraging good corporate governance and developing guidance for sound tax risk management. Despite these countries' diverse regulatory and business environments, they all come to the understanding that an effective tax risk management system is vital for both tax authorities and large taxpayers.

Due to rapid economic growth and limited government resources, the State Administration of Taxation (SAT) in China started to focus on the tax administration of large-scale enterprises in recent years. In 2008, the SAT set up a separate division for the purposes of managing and monitoring the tax affairs of large-scale enterprises and developing an open and transparent working relationship between Chinese tax authorities and the taxpayers.

Since 2009, the SAT has issued a series of regulations to address the tax administration of large-scale enterprises. In particular, the SAT identifies tax risk management as an increasingly important area of tax supervision and as such, requires that the senior management should ultimately be responsible for the tax strategies and outcomes of its organisation. Consequently, senior management has a personal stake in the implementation of an effective system to ensure that tax risks are adequately controlled and that tax considerations are properly factored into the corporate decision-making process for major transactions and business strategies.

# Key components of tax risk management

## Considerations for senior management:

- Are there any frameworks or policies prepared by your organisation for managing tax risks? If yes, are they still applicable to your current business operations?
- Is your organisation applying an appropriate mechanism to identify and assess potential tax risks?
- Are you confident that your control systems enable your organisation to meet its tax obligations properly?
- Is your organisation making necessary changes to its processes and procedures so that new developments in the applicable tax laws and regulations are properly taken into account in major transactions and business strategies?
- Are there any areas of major disagreement between your organisation and the tax authorities? If so, are you satisfied with the way they are being handled? Have any additional tax liabilities been adequately provided for?
- Depending on the nature of potential tax risks, and your need for certainty, would it be desirable to approach the Chinese tax authorities proactively for guidance?

An effective tax risk management system that can reduce the tax risks of an organisation to an acceptable level normally includes the following six components:

### 1. Tax risk management environment

*This component manifests itself in the development of a tax risk management policy that reflects the attitude and culture of the organisation towards tax risks. A tax risk management policy has both a strategic layer and an operational layer. The strategic layer sets the tone for how tax risk should be managed in the entire organisation. The operational layer prescribes more detailed tax risk policies, such as procedures for transaction sign-offs, requirements for external tax opinions, and protocols for consultations with Chinese tax authorities.*

### 2. Tax risk objectives

*This component amounts to a yardstick to benchmark whether an organisation's tax risk management policy is enforced effectively. If the tax risk objectives are achieved, the organisation should be delivering against its tax risk management policy. These objectives will also, to a large extent, determine where resources are focused and directed within the organisation. Tax risk objectives can also be strategic or operational, depending on whether the objectives are high-level or day-to-day in nature.*

### 3. Tax risk identification and assessment

*This component represents the awareness and response of the organisation to different types of tax risks facing the organisation. Tax risks may arise from changes in business operation or from day-to-day activities. Amendments in tax laws and regulations can also create significant tax risks. Organisations should develop a thorough and disciplined approach to identify these tax risks. Once tax risks are detected, organisations should consider the potential tax impacts of these risks and the likelihood of the underlying events occurring.*

### 4. Design of tax risk controls

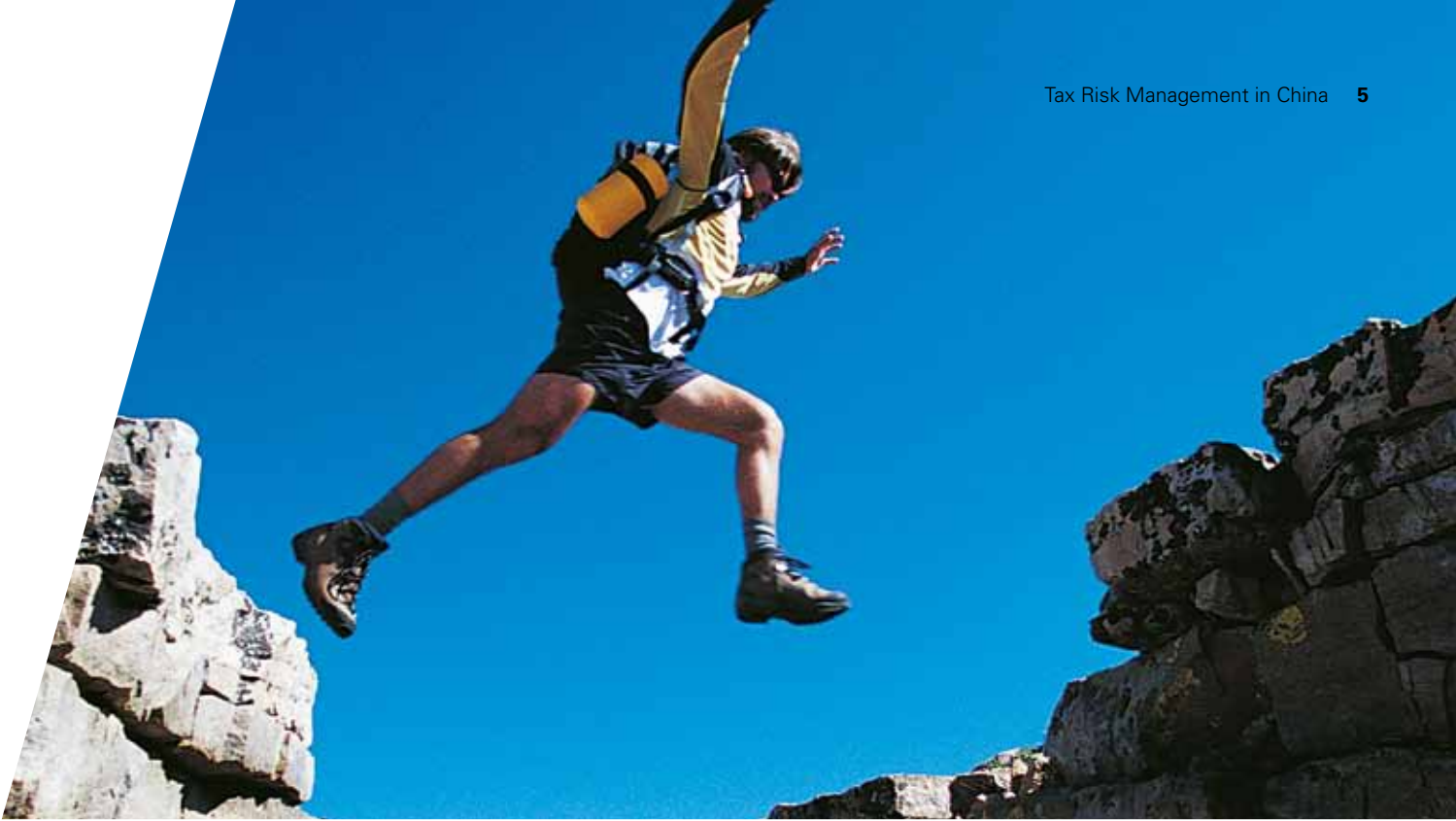
*This component refers to the design of specific processes or procedures to respond to the identified tax risks while taking into account their respective importance to the organisation. This component also includes the design of policies and procedures to ensure that the entire tax risk management process is complete and that all relevant tax risks are identified and considered. Control activities include a broad range of actions such as approvals, authorisations, reconciliations, and reviews as well as policies on areas such as segregation of duties.*

### 5. Tax information management and communication

*This component entails the development and implementation of communication strategies and procedures to efficiently collect and distribute tax risk related information with all stakeholders in a timely manner. Information needs to flow across an organisation effectively to ensure that tax risk management policy is followed, tax risk objectives are pursued, tax risks are identified, and control functions are fulfilled. As each organisation is different, the relevance, format and types of communication that best meets each organisation's individual needs will be different.*

### 6. Monitoring

*This component corresponds to the establishment of a monitoring mechanism to evaluate the success of tax risk controls and communicate the results to the relevant parties. To assess the efficacy of the control activities that have been designed and implemented, it is necessary to monitor their operations. Furthermore, procedures should be put in place to ensure that the results of the monitoring activities are fed back into the tax risk management process. An organisation can then conclude on the effectiveness of its tax risk control system, and take remedial actions, if necessary.*



## The potential benefits for implementing tax risk management

Tax risk management should be considered as part of the overall risk management of the organisation. The relevant tax risk controls and documentation requirements should also be integrated into the enterprise-wide internal control program of the organisation. By implementing effective tax risk management, an organisation is poised to realise the following benefits:

### **1. Reducing tax exposure and related financial costs**

Through effective processes and controls, taxpayers can discover tax exposures and take appropriate corrective actions within a short period of time. This would minimise potential late payment surcharges and penalties in China.

### **2. Lowering tax audit risk and compliance costs**

Chinese tax authorities tend to pay more attention to taxpayers with higher risks of non-compliance and focus their audit efforts on these taxpayers. When a taxpayer can demonstrate that it operates a sound tax risk control system to manage tax compliance, its likelihood of being audited by the Chinese tax authorities may potentially decrease.

### **3. Increasing certainty in preparing financial statements**

By conducting early and open communications with the Chinese tax authorities, taxpayers can achieve greater certainty for their tax return positions and more accuracy in their financial statements.

### **4. Avoiding the 'surprise' element which affects business's reputation**

Proper management of tax affairs can reduce the possibility of unwelcome 'surprises' from a Chinese tax perspective, e.g., tax audit followed by an assessment of significant penalties. Such tax surprises may adversely affect the reputation of the company and other related companies in China.

### 5. Enhancing corporate governance

Implementation of tax risk management will improve the general internal control process of an organisation, and contribute to the enhancement of overall corporate governance.

### 6. Increasing understanding of the tax strategies and position of a business

Carefully prepared documentation, e.g., a tax risk management manual, provides more useful information to the board of directors and senior management, enables them to better understand the tax strategies and positions of the organisation, and facilitates the corporate decision-making process.

### 7. Building a trusting and transparent relationship with tax authorities

Maintaining a good tax risk management system and providing relevant documents to the Chinese tax authorities as requested helps to develop an open and transparent relationship between the organisation and the Chinese tax authorities.

### 8. Facilitating the signing of a Tax Compliance Agreement

Implementing tax risk management helps facilitate the signing of a Tax Compliance Agreement (TCA) with the Chinese tax authorities. This will increase the chance of building a collaborative relationship with the Chinese tax authorities.

### 9. Increasing the likelihood of obtaining an 'advance ruling'

While an advance ruling mechanism in Chinese tax is still in SAT's internal discussion and consultation phase (except for Advance Pricing Arrangement's from a transfer pricing perspective, which is already in place), maintaining a tax risk management system is expected to be a prerequisite for any taxpayer to participate in a future advance ruling regime in China. Taxpayers with tax risk management systems are more likely to obtain the privilege of seeking 'advance rulings'.



## Candidates for implementing tax risk management

Nowadays, investors, corporate executives, and board of directors increasingly emphasise the importance of tax matters because of their significant impact on financial statements. Board members and corporate executives need to anticipate potential tax risks before they materialise into real issues. Presuming that the tax risks will go away without taking actions to control these risks is not a viable solution given the heightened level of transparency demanded by today's corporate governance and social responsibility standards.

Hence, in view of the enumerated benefits of tax risk management and its increasing significance to tax administration, it is the right time to consider establishing a tax risk management system for your China operation.

Which organisations should view the implementation of tax risk management as one of their top priorities? Below are some examples:

- Companies which have been identified by the local Chinese tax authorities as large-scale enterprises.
- Companies that want to sign a TCA with Chinese tax authorities.
- Multinational corporations that have a number of subsidiaries in China.
- Companies which have significant tax issues or uncertain tax positions.
- Companies which consider tax as a key element of their strategic plans in China.
- Companies that want to enhance their corporate governance for public listing purposes.
- Companies which want to review their existing tax status and better control their Chinese tax risks.

## How we can help: Our services

KPMG China's Tax Risk Management Services team can provide a range of services to you in order to develop and implement an effective tax risk management system within your organisation.

### **Preparation of a tax risk management framework**

A tax risk management framework is the foundation for all other components of tax risk management. This framework provides clear guidelines and mechanisms and influences (1) how tax strategies and objectives are established, (2) how tax risks are identified and evaluated, and (3) how processes and controls are designed and implemented. The tax risk management framework should be formally documented, approved by the board, and communicated to the relevant parties.

We can help you prepare a tax risk management framework based on the relevant tax rules and regulations, as well as the specific situations of your organisation, such as your corporate structure, your business process, and your tax attributes. Alternatively, we can review your existing tax risk framework or policy and provide recommendations to ensure that the current framework meets the need from your business operations and the requirements from the Chinese tax authorities.

### **Review of tax risk controls**

A well-designed tax risk control system should be able to identify and manage tax risks associated with ordinary business operations and special transactions of the organisation, e.g., mergers & acquisitions. Ineffective controls may foster tax irregularities that will have significant negative impacts on the organisation's financial performance and corporate image.

We can help to identify the potential tax risks in your organisation and assess the efficacy of the relevant controls currently in place. We can also help you evaluate the completeness of your tax risk control system and provide practical recommendations to improve its effects.



**Preparation of a tax risk management manual**

The extent of documentation of an organisation's tax risk management varies with the company's size, complexity of business operations and other commercial factors. The fact that the components of a tax risk management system are not documented does not mean that they are not effective or that they cannot be evaluated. However, an appropriate level of documentation usually makes monitoring by senior management or tax authorities more effective and efficient. The preparation of a tax risk management manual can also enhance collaboration between the finance team and other functional departments of your organisation when it comes to managing tax risks.

Our team has extensive experience in preparing tax risk management manuals. Such a manual documents all components of an organisation's tax risk management system, e.g., the tax risk identification and assessment mechanism, the details of potential tax risks in different aspects and the related control procedures. We can also help incorporate the process maps for various tax filing procedures into the manual to facilitate review by your internal audit teams or the Chinese tax authorities.

**Evaluation of a tax risk control system**

All tax risk control systems should be monitored and evaluated periodically to ensure they are functioning effectively and efficiently. The scope and frequency of the evaluation will primarily depend on the complexity of the business operations and the effectiveness of ongoing monitoring procedures.



We can help evaluate the tax risk control system of your organisation to gauge the effectiveness of the relevant controls. By performing proper walk-through tests for different business transactions and conducting interviews with the relevant management personnel, we can provide you with a comprehensive assessment on your existing tax risk control system and our suggestions for improvement.

**Assistance in a TCA application**

Entering into a TCA with the tax authorities will provide various benefits to your organisation, e.g., relaxation of supervision from tax authorities, earlier resolution of outstanding tax issues, and enhancement of corporate governance. Organisations need to have a clear understanding of the TCA requirements and the application process in order to take advantage of the program.

We can help you to understand the process and requirements for entering into a TCA with the Chinese tax authority in charge. We can also advise you closely during the application process to ensure that the content of the agreement is properly aligned to your corporate strategies and tax objectives.



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