CORPORATE GOVERNANCE AS A TOOL FOR EFFECTIVE TAX MANAGEMENT

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Abstract

Tax is undeniably essential for a country and a corporation. Both parties have a similar interest of tax. For a country, it is its source of income, while for a corporation tax will reduce its net income.

There are different financial management tools, where the role of tax management is becoming essential. We have looked through existing literature on tax management and discussed trade-offs for companies and for tax office of such activities on reducing tax payments by companies. We made our recommendations to both parties on optimization of this process based on reviewed documents and literature and suggested corporate governance as a main tool for effective tax management.

Key words: corporate governance, tax management, tax planning, tax reduction

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1. Introduction

To measure performance of a corporation, one can use a financial statement for a particular accounting period. It is the primary communicator of corporate performance to all interested stakeholders. In this research, we highlight interests of two sides in the process of taxation and corporate finance namely: management and government.

Usually, management tries to pay lower total tax amount, as it significantly reduces corporate net income, which is considered main indicator of firm's performance. Management of earning, tax management tools are used to minimize corporate tax obligation. In the same time, government wants to levy tax as high as possible; as it is one of main income source for the country. This is considered as a conflicting situation in any corporation. This kind of conflict of interests could be minimizedthrough implementing of aligningmechanism of interests of external and internal stakeholders. In science literature this mechanism is known as corporate governance. This mechanismis a way of control for corporation which helps it to run effectively in order to meet both interest of external and internal parties.

The amount of losses because of increasingly aggressive use of tax-avoidance schemes by multi-national companies (MNCs) is hard to estimate, but is considered very significant. Press reports have highlighted the low tax paid by well-known, very successful companies. The tax reduction methods which are used by MNCsare well known for a long time. Such methods asthe use of lower-tax jurisdictions, transfer pricing, over-charging entities in higher-tax countries to reduce taxable profit and (legally) completing a transaction in a lower-tax country, different to the country, which the business relates to are popular among most of large companies. These actions have been significantly aided by the digital economy and a rise in the value of intangible assets e.g. brands. Tax law is not able to reach and be in the same level compared to MNCs' business practices. Here is another issue is that Multinational companies are gaining from these actions, while domestic local firms in most cases are not able to benefit from similar tax advantages.

The problem is relatively clear and lawmakers want a situation where businesses not only operate within the letter but also the spirit of the law. MNCs have responded that they are complying with tax laws; pay all the taxes that they should by law, and that it is not companies but governments that decide tax regimes.

The national and international corporation tax environment has complicated system of interactions, with many constraints, and a solution to this issue will be difficult to achieve.

MNCs account for a large part of the world's GDP, where the contribution of intra-firm trade is growing. They have global operating models with integrated supply chains and functions centralized at regional or world levels. The digital economy is another tool, which helps them locate their activities far from customers.

2. Literature review

2.1. Tax planning

Scholes et al. (2015) emphasize in their classic textbook Taxes and Business Strategy: A Planning Approach that effective tax planning should take "all parties" into consideration.

Tax planning one of important components of business operations, but still there are not that many studies where tax planning behavior of companies have been researched, due to confidentiality of tax planning data. Ke (2001) in his research studied the effect of the 1993 increase in the personal tax rate relative to the corporate tax rate on managerial compensation in privately held insurance companies. He finds that after 1993, in response to the changes in the relative rate schedules for individual and corporate income taxes, management-owned insurance companies pay their shareholders/managers less tax-deductible compensation than a control sample of non-management-owned counterparts. This finding shows that when forming optimal shareholder/manager compensation, firms try to minimize the overall tax costs of both firms and shareholders.

Ke (2001) and Enis and Ke (2003) show that contingent upon the relative corporate and individual tax rates, managers do engage in strategic shifting of corporate taxable income to shareholders to minimize the overall tax burden for both firms and shareholders. This coheres with the conclusion of Scholes et al. (2015) that an effective tax-planning framework considers all stakeholders. After analyzes of changes in documented earnings and other financial variables corresponding to changes in tax policies, these investigations provide indirect evidence that firms seek to minimize the overall tax burden of their stakeholders in their strategic tax planning. We can summarize thatreviewed literature support a broader hypothesis that rational firms will attempt to maximize the overall tax and nontax benefits of their stakeholders by making effective tax planning decisions.

An alternative hypothesis to firms trying to minimize the overall tax burden of stakeholders is that they balance this goal with the need to minimize financial reporting costs. Financial reporting costs (Klassen, 1997) are non-tax costs, such as debt covenant violation, reduced

executive compensation and the perceived negative stock market consequences associated with reductions in reported earnings (Cloyd et al., 1996; Klassen, 1997; Armstrong et al., 2012; Graham et al., 2014). Based on results of a survey of financial executives of large and medium-sized public and private manufacturing firms, Cloyd et al. (1996) show that public firms with higher financial reporting costs are less inclined than private firms with lower financial reporting costs to choose financial accounting methods that conform to an aggressive tax position.

We can assume that private firms are more likely to choose accounting methods that are less optimistic but are likely to increase the probability of successfully defending their tax positions if challenged by the tax office. From findings of reviewed literature we can see that in defending an aggressive tax position, managers have to deal with the choice between financial reporting costs and corporate tax benefits.

In his research Klassen (1997) finds that in the trade-off between financial and tax reporting, firms with greater inside ownership concentration tend to favor corporate tax benefits, whereas those with lower inside ownership concentration tend to favor financial reporting costs. Based on proprietary data on the incentive compensation of tax directors of public companies, Armstrong et al. (2012) found a strong negative relationship between the incentive compensation of tax directors and the GAAP effective tax rate, but found weekconnection between the incentive compensation of tax directors and other tax attributes. These findings show that tax directors of public companies are provided with incentives to reduce the level of tax expense reported in financial statements.

In his research where he used data from survey results of almost 600 corporate tax executives, Graham et al. (2014) found that financial accounting incentives play an important role in tax planning. They state that 84% of surveyed publicly traded firms responded that the top management at their company do care at least as much about the GAAP ETR as they do about cash taxes paid. Beside of it, their regression analyzes indicate that the primary driver for determining the relative importance of financial concerns is capital market incentives. Prior research shows that public companies have strong incentives for considering financial reporting concerns in tax planning decisions (Klassen, 1997; Armstrong et al., 2012; Graham et al., 2014). Nevertheless, reviewed studies do not test the trade-off between corporate financial reporting costs and shareholder tax benefits. Scholes et al. (2015) have assumed before that a potential

trade-off may exist under the principle that effective tax planning should take into account all parties

2.2. Tax management

Corporate governance arises due to principle-agent problem. Corporate governance could reduce monitoring cost by creating a higher level of control and transparency. It is a system that influence how a corporation directed and controlled (Turnbull, 1997; Cadbury, 2000). Brown and Caylor (2004) showed that corporation with better corporate governance will have a better performance compare to corporation with worse corporate governance.

Earnings management occur when management make an accounting decisions that change bottom line of corporation and distorting the application of generally accepted accounting principles. Matsumoto (2002) states that corporation with better growth prospects are tend to be more motivated to do the earnings management.

Tax management is a process to organize a corporation so its tax liabilities stay in the minimum position according to tax code with opportunity cost and political cost (Scholes et al., 2009; Hanlon and Slemrod, 2009).

Erickson et al. (2006) in their research claim that earnings management and tax management is affected by corporate governance. The optimal number of board in a corporation differs depending on characteristic of each corporation (Coles et al., 2008). Opposite to thisBhagat and Black (1999) and Minnick and Noga (2010) found that less number of board will create better oversight function which will be more focused to convince management for conducting an earnings management and tax management.

Beside of it,Bhagat and Black (1999) found that more independent board will give better oversight function. Minnick and Noga (2010) also state that with the existence of independent board, corporation willfocus on overall performance where effective tax rate plays an important role. Yermack (2004) in his research results that the main objective of board is to maximizing shareholders wealth through an effective tax management in the corporation. Jensen and Murphy (1990) and Brown and Caylor (2004) alsoin their research concludethat board compensation and its disclosure has a high degree of positive correlation in determining corporation performance. Rego and Wilson (2012) finds evidence, which result in negative correlation between compensation and tax management.

3. The problem: conflict of interests

A country or in some cases reasonable to say government does not look at an MNC as a whole for tax purposes, but only the part operating in its jurisdiction. With the purpose to avoid the double taxation of profits of growing global MNCs, from the 1920s an international tax regime started its operation. Based on model OECD / United Nations treaties, with shared principles and common standards, over 2 500 worldwide tax agreements now exist between countries to eliminate double taxation. Despite of fact, these structures still allow under-taxation or no taxation at all. This has become more prevalent from the 1960s onwards, as tax competition increased.

Countries have different tax rules and rates and offer different tax advantages with the purpose to attract investment from other regions. Some countries may not tax some income at all, or may tax it in a very low rates comparing with others.

In addition, MNCs now have a muchmore ability to split up their different functions. The digital economy allows MNCs to operate in distance from their customers.Internet business processes has given more value to intangible assets, like intellectual property rights, to increase profits.

With these elements, managers of MNCsusually are able to operate in the most effective and profitable way, they can easily adjust their structures and locations in order to be as tax efficient as possible.

It will be in concern if there is as a result low or non-taxation through the use of different tax rules which lead to double non-taxation or to the taxation lower than the level of either jurisdiction.Profitsare shifted away from the jurisdictions where these profits actually were created. This kind of situation is known as "base erosion and profit shifting". This can be particularly true when there is a possibility of internet-enabled transactions.

Most double-taxation treaties tax the income of a firm where it has its permanent establishment. The main way to determine whether a business has a permanent establishment in a country or not is to know if the business sells or not in the location where contracts are signed. In the internet era sales activities may occur in a country but can be legally finalized electronically in any another place in a lower-tax state. Thus, MNCs now often do not pay tax where they do business, but instead of it, they pay in the place where they finalize their activities. A company thus legally moves revenue there from its business market. It gains a competitive advantage, which is not normally available to domestic businesses.

Governments' tax authorities usually try to verify and understand MNCs' increasingly complex tax structures.

4. Existing methods of tax reduction

The methods of tax avoidance by MNC in developed countries are well documented, although there is a lack of reliable and consistent data, while those for developing countries are not that clear and hard to understand. The method revolves around shifting income from higher-tax to lower- or no-tax countries. We have made our own research on this issue and have collected data through interview materials of experts, official documents and data from secondary sources, and then we have analyzed all the data and made a summary of main existing methods of tax reduction, whichis used in practice by most of large companies.

Profit shifting strategy

This is achieved by limiting operational activities and related income in the higher-tax state, by moving them to a subsidiary located in a lower-tax state.

Transfer pricing

This is realized through establishment of prices for transactions between companies that are part of the same MNC. Before this mainly concerned physical goods but now involves the rights to use intangible goods, and use of services such as headquarters' support.

More than half of international transactions are inter-company transactions, and are therefore not at "arms-length" prices, for example, if it has been purchased from an unrelated third party. Where the price is inflated, "abusive transfer pricing" usually occurs. This is one of ways to move profits. Here a subsidiary in a medium or higher-tax jurisdiction buys products from another group of companies in a lower-tax country. It is often not obvious how arms-length prices should be determined.

Corporate debt-equity

Inter-company loans given from entities in lower-tax states to subsidiary companies in higher-tax countries pass interest income to the lower-tax state, reducing the taxable profit in the higher-tax country. This profit is further reduced the higher the interest rate or level of debt. Luxembourg has beneficial tax treatment of interest income.

Payments for intangibles

Group of companies in a lower-tax environment with company intellectual property ownership rights, charges another group entity in a higher-tax state for use of an intangible, such as a

technology royalty, licenses, brands or patents. The pricing should reflect the value of the technology, i.e. how important the technology is in the creation of the profits. An MNC can have a company owning its intellectual property rights in a country where no taxes are payable on license fees, and then charge its affiliates around the world for their use.

Shell holding companies

These are found mostly in jurisdictions with an extensive tax-treaty network and offering low tax rates on dividends and capital gains e.g. Belgium, Ireland, the Netherlands and Switzerland.

The holding company may be a shell company (no real trading, production or distribution activities) or may have centralized financing, licensing and other management activities. Shell holding companies are used in multiple ways for tax planning activities.

Hybrid entities

These revolve around obtaining a deduction of the same cost, such as loan interest, from two different countries based on the company's affiliates' structures. Similar happens when countries allow dual-residence companies. Ireland, for example, has companies that are legally based in Ireland and another country – typically a tax haven, such as Bermuda.

Conduit

This is where a corporation lets money go through a country (e.g. the Netherlands, Luxemburg or Mauritius) so benefiting from a favorable tax rate. Large sums pass via these preferential tax regimes: 30-40% of all of India's investments are via Mauritius, which has received the investment money from other countries, often India itself ("round tripping"); the British Virgin Islands were the second largest investor in China (14%) in 2010; the top investor in Russia in 2010 was Cyprus (28%)

5. Proposed solution: corporate governance

Corporate governance deals with the rights and responsibilities of a business's board, senior executives, management and employees, shareholders and other stakeholders. Successful business running directly influences on performance and market confidence. Good corporate governance is essential for businesses that want to reach capital and for governments that want to stimulate investments from private sector. Poor corporate governance on the other hand weakens a business's potential and at worst can pave the way for financial difficulties and even fraud (OECD, 2007).

Recent global financial crisis consolidates the importance of good corporate governance. If to look thoroughly, the recent recession was a result of poor governance and reduced transparency in some businesses and markets. This all make it difficult to see the true scale of risks and does not allowforming a true view about business and market integrity, which in the endbecomes a reason ofbusiness decisions made under the lack of information and increases the risk of financial collapse. Good corporate governance is central to the integrity of business, financial institutions and markets. It supports decision-making including how a business manages risk and how it chooses the decision on implementing or not implementing of transactions and business strategies. The way that a large business manages its tax risk has a serious impact on its financial performance and reputation. CEOs and Boards of large businesses are increasingly considering tax risk management as part of their overall corporate governance approach (TEIC, 2007).

Tax risk is generally referable to ambiguity about the interpretation of tax law in connection to particular transactions and the business's view about whether a tax administration could have a different view to its own or the view of its advisors. We can say that nowadays many large businesses have changed the way they look at corporate governance, compliance, and business ethics. Countries are introducing legislation and standards that require large business to provide greater transparency in their financial reporting. According to our results from interviews, we found that the tax function accounted for around one third of „material weaknesses‟ that were reported. This coincides with reports of Ernst and Young (2007a) and it seems that these trends keeps continuing.

Most of practitioners and experts in many countries are promoting the approach when the tax risk is managed same as any other enterprise risks. Recent international surveys by major accounting firms indicate that tax risk management is increasingly gaining acceptance at board level (Ernst and Young, 2007b). Our findings also show that senior executives are increasingly looking for better insights into tax because of its potential material impact on financial statements and that the tax function can no longer focus only on tax compliance and only on managing the effective tax rate. Top managers of companies are interested more and more to know how their organization manages its tax risk exposure. There is now a greater awareness of tax in the boardroom (OECD Forum, 2006).On the other handtax administrations are also tend to be more collaborative and build cooperation on mutual respect, trust and transparency. Definitely, both tax administrations and large businesses want greater certainty. Tax

administrations look for certainty around voluntary compliance with tax laws and large businesses having good governance arrangements in place. Large businesses look for certainty about which of their behaviors and transactions the tax administration is likely to see as risky, and how the administration is likely to respond to those risks.

As we see from our research results there, is a positive trend where several tax administrations have introduced and are further developing initiatives that encourage large businesses to consider good corporate governance and enhanced relationships that support tax risk management.

6. Conclusions and recommendations

Changes in their operating environment made multinational companies rethink their approaches and led to a modification in the design of tasks for the financial and tax functions on the basis of an integrated approach. From reviewed documents, we found that responsibility for the tax position in the published financial statements, and therefore tax reporting for the whole group, has been shifted to the group tax function, which now requires increased transparency and improved internal controls and documentation. In the same time, international developments established a need for international tax strategies: capital markets expect a company to present their global tax situation from a benefit cost-perspective. Increasingly, these developments have led to benchmarking the effective group tax rate.

Also it is important to mention that the interaction between tax and finance is key to optimizing processes. It is a collection of interrelated workflows. Workflows typically range from strategic processes to operational and technical advice.

The essential cost driver for today's tax functions is the cost of resources. Qualified tax specialists are a scarce resource. The complexity of most tasks usually requires a great deal of technical expertise, particularly in specialized areas such as tax accounting. One negative result, which we found, is that tax personnel are often too busy focusing on issues.

Today's world of numerous tax functions is heterogeneous and complex. External stakeholders such as banks, financial analysts and investors require different information than internal stakeholders such as management. In addition, due to the sensitivity of data, the preparation of information for tax authorities requires a different mindset than the due diligence of a potential merger. As a result, the same set of numbers needs to be addressed from different perspectives and for different purposes. In our opinion, finance should help the tax function to think from the point of view of external users, as we consider financeto be more experienced than tax.

On the other hand, from the perspective of tax offices and fiscal policy of the government the following considerations may assist other tax administrations to encourage good corporate governance and enhanced relationships with large business. It is essential to work towards a relationship of trust between business and the tax administration. In order to build trust, tax administrations should consider starting with the assumption that large businesses: minimize their compliance risks through effective internal controls; closely manage and examine their material risks and issues; seek to properly apply the law.

After implementing these actions, tax administrators can pay attention on developing relationships built on mutual respect, transparency and openness. In building trust, it also can be very effective to involve large businesses early in the design of initiatives and approaches to improve tax risk management.

We recommend tax administrations to consider initiating direct dialogue with CEOs, directors and boards about the administration's expectation that they to recognize their role in ensuring that the business has good corporate governance approach to managing tax risks.The experience indicates that having the following features in their large business compliance programs has helped to encourage good corporate governance and enhanced relationships:

- A robust risk-assessing approach that identifies non-compliance and poor governance as early as possible.
- Early and direct communication with CEOs, boards and senior managers about concerns the tax administration has about a business's governance and tax compliance.
- A professional workforce with adequate resourcing to resolve compliance issues and respond to businesses in a timely manner.
- Appropriate legislative tools to ensure compliance.
- In relation to cross-border issues, good collaboration with other jurisdictions through treaties and exchange of information agreements.
- Special diligence and strong deterrence where there is evidence of the inappropriate use of tax avoidance or tax havens.
- Consider legislative solutions that place responsibility on senior executives and boards in places where poor governance is widespread

In our research, we have tried to discuss tax management issues and briefly had a look at a problem of conflict of interests between the large companies and tax offices. Future research is

suggested to use other types of data as well, in order to see to define main factors, which influence on effective tax management, rather than just qualitative data, such as secondary documents, reports and academic literature.

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