Tax governance in Germany: evolving demands for a documented tax control framework

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Introduction

"Get the numbers right and then keep them right" is a mantra that has long sat at the center of any tax department's approach and is a direct objective of any company's approach to tax compliance and governance.

For certain companies operating in Germany, tax governance will be more important than ever now, due to a new *Act on Strengthening Financial Market Integrity* (*Finanzmarktintegritätsstärkungsgesetz* – FISG). This recently introduced German law is designed to strengthen the integrity of German financial markets after the 2020 collapse of a large, Munich-based financial services company. The FISG is aimed at restoring and enhancing confidence in the German financial market and provides changes for companies, their auditors and the wider financial reporting enforcement. The main changes affect statutory audits, the risk management and internal control system, the composition and competencies of the audit committee and stricter liabilities for executive directors. This will consequently also result in significant implications for the tax departments of many multinational companies (MNCs), as tax should be a cornerstone of any risk management and internal control system.

While the global or regional tax leader of an MNC may have little interest in delving into the minutiae of German tax law (in fact in this case, the financial law) they should work to ensure they understand the broad impact and implications of FISG, as the new law. FISG came into force on 1 July 2021, but the reporting aspects came into play on 1 January 2022 and contain an important new requirement under which companies listed on the German stock exchange must establish an appropriate and effective internal control and risk management system. A system is generally effective when it is suitable for identifying, managing and addressing all material risks – including tax risks as an integrated part of the group-wide internal control and risk management systems. Companies must therefore and be able to demonstrate that they adhere to an effective Tax Compliance Management System (TCMS). This aspect is very similar, but not identical, to a Tax Control Framework (TCF) as defined by the Organisation for Economic Co-operation and Development (OECD).

More than this, Environmental, Social, and Corporate Governance (ESG) metrics are rapidly rising up the corporate agenda. Investors and other stakeholders want better ESG information that can help them understand more about how a company performs, makes decisions and creates value. They want to understand the external impact of a company's actions, both in absolute terms and in comparison to other companies. The taxes a group pays – as well as those they are indirectly, responsible for, via their employees and suppliers – are central within ESG metrics. As such the approach a company takes to planning and tax risk management, the taxes they pay and what tax and financial data they voluntarily disclose has an important bearing on public perception. The presence of material weakness and/or significant tax disputes can therefore weaken such perceptions, and a properly functioning TCF or TCMS is essential for German companies wishing to perform well under such demands.

FISG, meanwhile, has impacts on the German tax environment and possibly beyond, both immediately and, potentially, in the longer term. MNC tax leaders should therefore consider taking a wide view of FISG, including the consideration of whether the German approach may at some point influence the design of tax compliance assurance programs, themselves rapidly growing in number and complexity, and co-operative compliance programs elsewhere in the world.

In this article, we will provide some high-level background context around the German developments, put them in context of what is occurring globally, describe the component parts of a TCMS and share some final thoughts regarding how the German approach may develop over time.

This is not an article providing in-depth analysis or advice on exactly what to do if you are listed on the *Frankfurter Wertpapierbörse* (Frankfurt stock exchange) and directly impacted by the new law. This article is for those managing their enterprise's tax approach and operations, and who are likely outside the Federal Republic of Germany but wish to understand the most important local developments.

Background

Several factors highlight the evolving need for strong governance in tax. The way in which business is conducted continues to grow in sophistication as companies drive globalization, digitally focused business models, complex supply and value chains, employees working from "everywhere" and new ways of creating value that challenge the very fabric of existing tax legislation.

Some of these factors have led to the broad geographic distribution of those responsible for tax within an MNC, with the number of professionals in what has historically been called the "shadow" tax function (typically finance professionals) arguably growing with rapid pace as companies expand their geographic footprint.

As a result of these converging issues, several things have occurred. Internally, the "connective tissue" of tax – the ecosystem by which relationships are formed and maintained – has, it can be argued, considerably weakened over time in many enterprises. Externally, significant changes to cross-border taxation have been made (indeed, continue to be made), coupled with high levels of local tax reform in many jurisdictions. Universally, there has been a paradigm shift in tax transparency and disclosure. There is a lot to deal with and a lot of moving parts.

These new pressures on cross-border business have been further compounded by a series of new regulatory requirements that now require companies to demonstrate the efficacy of how they manage and control their taxes. Tax authorities, keen to capitalize on a period of profound change, and experiencing unprecedented pressures on traditional tax compliance models, are rapidly shifting toward a new way of engaging with large business taxpayers. Indeed, this is a way that represents a fundamental shift in the relationship and the balance of power between the two parties.

The rise of "co-operative compliance"

This shift in the relationship finds its genesis almost two decades ago, starting when the Australian Taxation Office (ATO) created the first in a series of compliance programs among national tax authorities that quickly became known as "co-operative compliance."

Under the ATO program, for example, companies qualifying for an *Annual Compliance Arrangement* would, in return for ongoing access and transparency into their tax decision-making processes, receive almost real-time assurance from the ATO (assuming they agreed with the tax positions the company was taking) that the tax authority would not challenge those positions once the company filed their tax return.

Fast forward to 2008 and the OECD's Forum on Tax Administration[1] (FTA) published a report – the *Study into the Role of Tax Intermediaries*[2] — in which it encouraged revenue bodies to establish more of these types of relationships with large business taxpayers that were based on trust and cooperation. Via such segmentation, the OECD reasoned, tax authorities could more effectively filter lower risk taxpayers from higher risk companies, targeting their limited resources more effectively.

This first report was followed in 2013 by a second, *Co-operative Compliance: A Framework – From Enhanced Relationship to Co-operative Compliance*[3] in which the successes of early co-operative compliance programs were shared. As can be noted from the report's title, the FTA at that point also took the opportunity to undertake a rebranding exercise, moving from "enhanced relationships" to "co-operative compliance," a reflection of their concern (and that of individual countries) that the earlier description could potentially be misconstrued – itself a distinct possibility during a period in which the "fair share of tax" debate was raging.

[1] The Forum on Tax Administration (FTA), created in 2002, is a unique body bringing together Commissioners from 53 advanced and emerging tax administrations from across the globe, including all OECD and G20 members

[2] *Study into the role of tax intermediaries*, OECD, 2008: https://www.oecd.org/tax/administration/39882938.pdf

[3] Co-operative Compliance: A Framework – From Enhanced Relationship to Co-operative Compliance, OECD, 2013: https://www.oecd.org/publications/co-operative-compliance-a-framework-9789264200852-en.htm

Beyond co-operative compliance and into "compliance assurance"

Today, these programs are both shifting in nature as well as being accompanied by a completely new class of program, perhaps best described as "compliance assurance programs."

Looking first at the shifting nature of co-operative compliance, we now see many tax authorities are following similar pathways. Their programs tend to expand over time, focusing more on the "how" of taxes are governed and managed as well as how the figures in the tax return were calculated. They are becoming available to a far larger swathe of companies; they have a far greater impact on the future treatment of the company (in effect giving them a "lighter touch" audit approach in return for their transparency and collaboration). And finally, they are increasingly becoming mandatory, though mostly only for the very largest companies operating in a jurisdiction.

It is here that co-operative compliance is becoming largely indistinguishable from Compliance Assurance Programs. Under this latter approach it is not just the tax positions being taken by a company that are reviewed and monitored by a tax authority, but the overall approach to tax management they take, including the company's tax approach, tax policy, tax risk appetite, tax controls environment, testing processes and internal communication, escalation, and approval protocols. Where co-operative compliance has historically been almost exclusively voluntary in nature, these new programs are largely mandatory for the largest companies - the 1,000 largest, in the case of Australia's Combined Assurance Program.

The OECD's relatively new International Compliance Assurance Programme (ICAP) sits firmly in this camp, too. While focused largely on the multilateral assurance of a company's cross-border tax transactions among a set of national tax authorities (the OECD says a group of between six and eight countries is ideal), the ICAP handbook[4] notes that three things will be considered when the group's suitability for ICAP is initially assessed:

1. Whether the MNC group has a group tax strategy that is clearly documented and owned by the group's senior management, at board level
2. Whether the group has internal structures to set and manage its tax policies
3. Whether the group has an effective tax control framework (or equivalent) over the risks that will be reviewed within the program

In addition to being considered at the application stage, the main documentation package submitted by a taxpayer once their group has been admitted to ICAP requires the submission of the actual documents to which the above points pertain.

[4] https://www.oecd.org/tax/forum-on-tax-administration/publications-and-products/international-compliance-assurance-programme-handbook-for-tax-administrations-and-mne-groups.pdf

A simple conclusion can be drawn from this quick review of evolving global tax governance requirements: that there is a growing onus on companies to not only file the correct figures in their tax returns, but to also demonstrate that they are in control of their management of taxes. In essence, this represents not only an operational change but a strategic one: by demonstrating they are "in control" companies thereby help the tax authority marshal their limited auditing resources toward the non-compliant. Germany is no different in this regard; it is simply a case of "the devil being in the detail."

The German context

Co-operative compliance is, in fact, conspicuous by its absence in the German tax regime, though the German tax authority (*Bundeszentralamt für Steuern* or BZSt) was part of the founding group of ICAP and continues to participate in the program.

That said, the enactment of FISG is not the first time that business taxpayers in Germany will have been introduced to the topic of tax governance. In May 2016, the German Federal Ministry of Finance published a letter in which it amended the Application Degree of the Fiscal Code regarding art. 153 AO. In effect, said the Ministry, a company that can indicate its adherence to an effective TCMS will in turn be far more likely to be successful in countering any accusations of disorganization within the company, thus limiting the risk of administrative penalties under Germany's Administrative Offence Act. Moreover, the Ministry noted, the company would similarly be more likely to be able to counter any future accusations of premeditated tax evasion. The message was simple, yet important: while no legal requirement to have a TCMS exists, those companies with one in place (and are able to demonstrate that they follow it) will be better placed than those who don't, should the German tax authority's scrutiny turn in the direction of either negligence or tax evasion. Effective adherence to a robust TCMS can therefore be seen as a form of "insurance" by German taxpayers.

Four factors make the position of the German tax authority slightly unusual – at least when compared to the approaches of other tax authorities:

1. There is no formal requirement in the law (administrative law or otherwise) for a company to have a TCMS.
2. There is no segmentation of taxpayers into different groups requiring, for example, the Top 100 largest taxpayers to conform to such a model. Instead, the 2016 letter effectively applies to companies of all sizes (though FISG is limited to companies who are listed on the German stock exchange).
3. There are no statutory requirements governing the exact form or content of a TCMS, though the German Institute of Auditors (*Institut der Wirtschaftsprüfer* – IDW) subsequently published details of how a TCMS should be structured in accordance with a new standard, the IDW PS 980 auditing standard – itself different from both the *Committee of Sponsoring Organizations of the Treadway Commission*[5] (COSO) recommendations and the OECD definition of a TCF.

[5] The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of five professional organizations and is dedicated to helping organizations improve performance by developing thought leadership that enhances internal control, risk management, governance and fraud deterrence.

4. There are no specific reporting requirements under which a company must either document or periodically present their TCMS to the tax authority. Instead, they must simply be prepared to prove its existence and efficacy should the issue be raised (within a tax audit or similar inquiry) by the German tax authority.

Why use a TCMS?

A TCMS is part of an organization's wider control and governance framework and aims to provide the taxpayer with full awareness and control of all tax risks, irrespective of whether such risks arise within the company (as the result of weak or incorrect data handling controls, for example) or outside the company (for example, as the result of changed tax legislation), of which the taxpayer was not aware and therefore did not apply to an active transaction or tax position.

Before looking at the component parts of a TCMS as outlined in the IDW standard, it is useful to look at the perceived benefits of following such an approach because over and above the simple meeting of requirements, a well-implemented and adhered to TCMS can be a good starting point for giving the tax function a futureproof, largely error-free foundation with improved data and process quality, digitized workflows, co- or outsourced processes and a greater focus on strategic planning.
More specifically, the benefits of a TCMS can be described as following:

- It can help the company achieve full and timely compliance with tax legislation in all jurisdictions.
- It can increase the efficiency of business processes, providing the opportunity to better integrate the tax department with wider company processes.
- It can increase the likelihood of the timely identification and management of tax and controversy risks.
- It can help the company limit and manage unexpected reputational damage or monetary exposures.
- It can help increase tax authority trust and confidence in the company.
- It generally promotes effective and efficient operations.

One of the most important benefits, however, is the "insurance" point noted in the previous section – that adherence to an effective TCMS will likely place a company in a better position to counter future administrative penalties or accusations of premeditated tax evasion. In effect, the adherence to a TCMS generally discharges company management and tax department officers from their personal liability. This is enshrined within a series of different German laws, as well as in German case law.

Finally, those with responsibility for tax management outside of Germany may also consider one further point, that a TCF may not only be a pre-requisite to entry into some national co-operative compliance programs, but can also improve the MNCs chances of achieving a favorable result therein, as the OECD's F TA indeed notes in its 2016 report *Building better tax control frameworks*[6]:

> *"When the tax control framework of a multinational enterprise participating in a co-operative compliance programme is determined to be effective, and when the enterprise provides complete disclosures that include relevant information and tax risks and is transparent to the revenue body, the extent of reviews and audits of the returns submitted to it can be reduced significantly."*

Of course, a TCF (or in the case of Germany, a TCMS) may also have some perceived downsides. That is hardly surprising, given the high resource intensity that typically goes into its design, implementation, ongoing testing, maintenance and where necessary, remediation. According to respondents to the 2021 *EY Tax Risk and Controversy Survey,*[7] 55% of respondents from companies of MNC size[8] say their company adheres to a TCF or broadly similar framework approach. Among those who don't, 60% say that it is that resource intensity that is the primary barrier to doing so. Less than half that number (24%) say they don't use a TCF as they perceive them as being too complex, with the same percentage saying that getting personnel to adhere to a TCF is the primary reason for not having one. Just 16% say that TCFs don't return the intended results; so, from these data points we can infer that TCFs do work, but they are clearly a challenge to build and maintain.

Component parts of a TCMS

Any company developing a TCF has no shortage of options to pick from during the design phase. In essence the German IDW PS 980 auditing standard provides a level of comprehensiveness that is commensurate with the design of a TCF as outlined by both the COSO and the OECD.[9] Furthermore, IDW PS 980 is itself certifiable by an external auditor, once applied by a company, an activity that will be even more important as companies operate under FISG. In simple terms, the German standard, though setting out a total of seven criteria, finds that those seven are all present in the OECD's definition, one upon which many companies outside Germany typically rely on.

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[6] https://www.oecd.org/publications/co-operative-tax-compliance-9789264253384-en.htm

[7] ey.com/taxrisksurvey

[8] In this case, in the annual revenue band US$10b-$49.9b.

[9] The OECD definition can be found in the OECD report listed in footnote 5 of this article.

The OECD identifies six essential building blocks of a TCF,[10] which in turn are also broadly consistent with existing enterprise-wide models of internal control such as COSO. The six can be summarized as follows:

1. That a group-wide tax strategy is established: The strategy, says the OECD, should be clearly documented and approved by the senior management of the enterprise - i.e., at the board level.
2. That the TCF should be applied comprehensively: All transactions that the company enters into and which are capable of affecting its tax position should fall under the control of the TCF, which itself should be embedded in the day-to-day management of business operations.
3. That responsibilities are clearly assigned: Here, two points are made – firstly, that the company's board has the mandate for the design, implementation and effectiveness of the TCF, while the company's tax department has day-today responsibility for its operation. Secondly, that the tax department should be properly resourced to do so.
4. Governance of tax should be clearly documented: The OECD report notes that the TCF should include a system of rules and reporting so that transactions and events are compared with expected norms and potential risks of non-compliance. This governance process should be explicitly documented, and sufficient resources should be deployed to implement the TCF and periodically review its effectiveness.
5. Regular testing of the TCF should be performed: Ongoing compliance with the policies and processes embodied in the TCF should be the subject of regular monitoring, testing and maintenance.
6. Assurance should be provided: The TCF should be capable of providing assurance to stakeholders (including external stakeholders such as a tax administration) that tax risks are subject to proper control and that outputs such as tax returns can be relied upon.

The basic elements of a TCMS are:

1. Compliance culture

- Management's attitude and example ("tone from the top")
- Development/publication of a tax policy as a basis for the TCMS
- Guidance on taxes in the code of conduct

2. Compliance objectives

- Definition of significant objectives to be achieved with the TCMS
- Definition of significant areas and the rules to be observed in those areas

[10] See page 15 in this OECD report: https://www.oecd.org/publications/co-operative-tax-compliance-9789264253384-en.htm

3. Compliance risks

- Identification of the company's significant Tax Compliance risks
- Systematic risk identification and assessment

4 Compliance program

- Based on the identified risks, policies, procedures and controls are implemented to manage risk

5 Compliance organization

- Roles and responsibilities
- Structure and procedures
- Resource planning and deputy arrangements

6 Compliance communication

- Employees and any third parties concerned are informed of the tax compliance program, and their roles and responsibilities
- Definition of a reporting channel for identified risks, non-compliance and incoming information

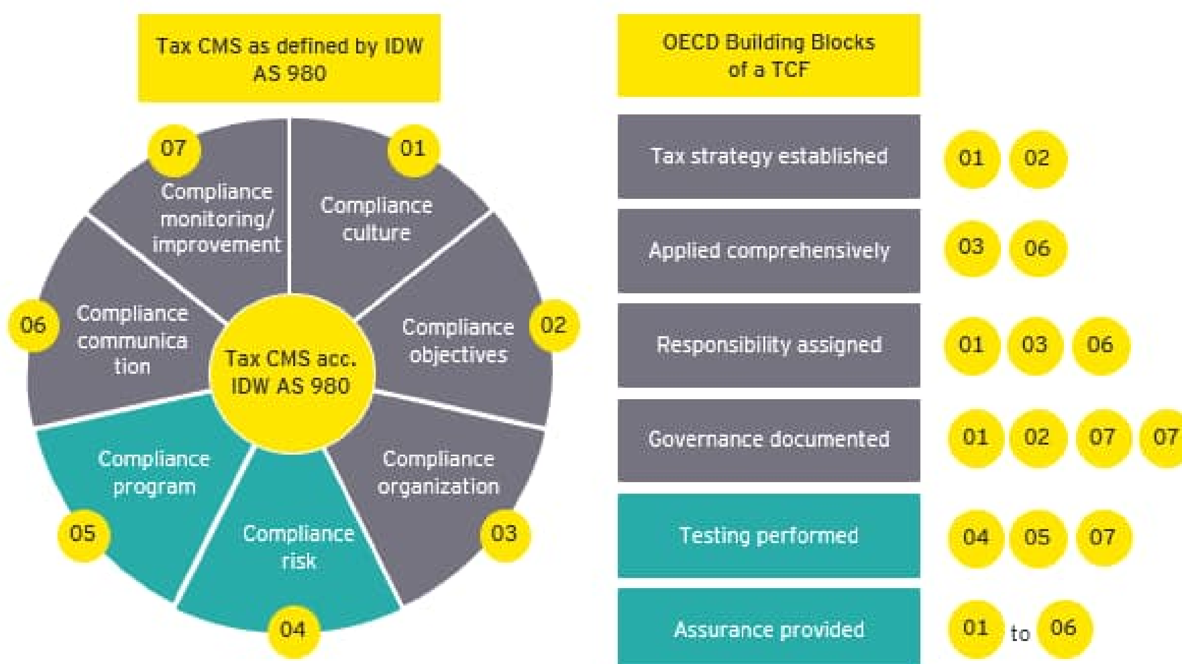
7 Compliance monitoring/improvement

- Implementation of monitoring, control and reporting processes within the tax function and associated functions
- Documentation of monitoring
- Responsibility remains with management

This list is not exhaustive and is merely designed to illustrate the elements. Not every single point mentioned in the list must be met for a TCMS to be appropriate. The elements as such must be appropriately addressed on the whole. The entity-specific risk situation determines what level is appropriate.

Mapping the seven German criteria to the OECD's six is a relatively simple exercise illustrated in the diagram below. The location of the IDW criteria within the OECD definition is illustrated using numbered circles, illustrating that some of the German criteria may be indicated in more than one area of the OECD definition.

Figure 1: Mapping the seven German IDW AS 980 criteria to the OECD's six criteria



Source: EY

Enforcement of FISG

Enforcement of the tax governance elements of FISG is something that is expected to grow over time, though the immediate lack of defined reporting requirements at present should not be viewed by taxpayers as a reason to avoid developing their TCMS.

While listed companies do effectively have a legal obligation to have a properly resourced and functioning TCMS in place, there are neither specific tests in place on behalf of the German tax authority (outside of their reference to it during an audit or similar exercise) nor any annual or other similar reporting exercise the company must follow. It is worth noting, however, that details of a company's TCMS are being asked for with more and more regularity within the context of a German tax audit. If the company can provide evidence of a working TCMS, it is often the case that the tax authority auditor will tend to take a more process-oriented approach to scrutiny, as opposed to conducting a detailed review of the company's tax calculations against the exact piece of tax law under which said calculation occurs.

What's next?

The question of how the German tax governance environment may change over time has global and German implications, given how local requirements may inform and influence the future actions of other tax administrations in Europe and beyond.

To answer the question what's next it might be useful to set out some of the leading questions we hear from MNCs:

1. Will the requirement for a company to maintain a TCMS be fully codified in German tax law? The TCMS requirements could potentially become enshrined in German tax law at some point in the future, and indeed there is known to be intensive discussion within the German tax authority on this point. Given the very recent inclusion within FISG, however, it is unlikely that we will see definite movement on this issue in the short term. Moreover, it is expected that the new German government will introduce a corporate criminal law shortly, in which an effective TCMS will also play a decisive role in cases of non-compliance from a tax perspective.
2. Will the requirements that a company utilize a TCMS become mandatory for other (or smaller companies) operating in Germany? Again, this is potentially possible, and indeed expected by many, given the direction other jurisdictions seem to be heading in. That said, we do not expect to see this in the short term, and the German tax authority will be closely studying the results from the initial approach for some years first, against the background of FISG
3. Are the German tax authorities known to be looking at any other areas of tax governance? The answer here is no, as all elements of tax governance are included in a TCMS. That said, however, against the background of FISG many companies are now looking at a second standard from the IDW, the *Principles for the Proper Performance of Reasonable Assurance Engagements Relating to Risk Management Systems* (IDW AsS 981). This standard sets out a series of principles and suggested activities regarding tax risk assessment and tax risk management, and though there has been no sign that they may one day become a formal requirement, adherence to the standard is fast becoming a focal point for large companies in Germany.
4. How (and how often) should we test our TCMS? Once implemented and in place, many companies find it beneficial to conduct an appropriateness and effectiveness audit as an immediate step. Thereafter, a general rule of thumb is to test the effectiveness of a TCMS every two or three years.

More widely, taxpayers should remain on close watch as other countries implement similar programs. In Asia-Pacific in particular, there is known to be substantial activity occurring behind the scenes, and tax leaders would be well placed to monitor developments in Japan, Malaysia, New Zealand and Singapore, among others.

Irrespective of where the change occurs, it is now clear that the shifts in how tax authorities manage compliance are gathering speed. Couple that with an ever-more-challenging tax enforcement environment globally and TCFs – particularly those that subscribe to a second mantra, that of "think global, act local" – are fast becoming a necessity for companies of all sizes, whether mandatorily required or not.

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