PKF
Accountants & business advisers

PKF special

PKF Tax Compliance Management System

Take advantage of opportunities and avoid risks with the aid of the Four Phase Model

TAX COMPLIANCE | NOVEMBER 2018

Editorial

Dear Readers,

Stricter or new regulatory requirements are making it increasingly harder to orientate yourself in the morass of tax regulations and prevent non-compliance. In the event of non-compliance - for example, with documentation requirements under the German Principles of Proper Keeping and Retention of Accounts, Records and Documents in Electronic Form as well as Access to Data (GoBD) - there is a risk that tax auditors might deem that a company's accounting procedures generally do not to conform with the applicable regulations and, potentially, decide to make add-back estimates. Effective protection against this cannot be achieved through stand-alone solutions. In fact, what is needed is a comprehensive system of tax compliance.

That is why PKF has developed a model that can be tailored to your own company-specific requirements and applied in your enterprise. In this way you will be able to identify, analyse and measure the tax risks in your current processes. Based on the principle of *"Put your first things first! Be clear about your priorities and acting on them."* (Stephen Covey in: 7 Habits of Highly Effective People), the model is a tool for managing risks effectively and specifically.

In this PKF Special publication we have provided you with a description of the process. After an overview in Part A and drawing on the compliance analysis described in Part B, in Parts C and D you will be able to understand how any existing tax risks are identified and prioritised within the scope of a risk analysis. This, in turn, provides a basis that will enable specific process-related measures and controls to be developed in your enterprise. You will find examples of these in Part E.

Finally, in Part F we also point out that it is essential to review the effectiveness of the measures and controls that are developed with regard to their actual application. This is because we know that "paper is patient" but, frequently, tax auditors tend not to be. However, those enterprises that do set up tax compliance systems and are able to prove that these have been implemented in their day-to-day operations will be very well positioned vis-à-vis the German tax authorities.

Please do not hesitate to contact us if you require support in the management of your tax compliance.

Your Team at PKF

Contents

» TAX COMPLIANCE MANAGEMENT SYSTEM

Tax Compliance Management Systems – Part A: Take advantage of opportunities and avoid risks with the aid of the Four Phase Model

Whether it be price-fixing agreements, slush funds, unreasonable working conditions, discriminatory marketing campaigns, data and bribery scandals, or tax avoidance and tax evasion, such compliance violations in all recent cases have resulted in high costs, damage to a company's image and personal liability for the parties involved. In this special paper on Tax Compliance Management Systems (Tax CMS) we will be discussing how, in the area of tax, you can avoid risks, enhance the quality and efficiency of processes and, ultimately, save resources. PKF's so-called Four Phase Model plays a key role here (cf. Fig. 1) and our presentation of this model follows after a general overview.

1. Reason for, concept behind and aims of a Tax CMS

1.1 Conceptual and legal frameworks

In its administrative guidance on Section 153 of the (German) Fiscal Code, from 23.5.2016, the Federal Ministry of Finance (Bundesministerium der Finanzen, BMF) included a passage stating that an internal control system could be an argument against the existence of wilful intent or recklessness. Although no direct requirement can be derived from this text passage, the administrative guidance does recommend that the issue of implementing a Tax CMS should be intensively addressed - in particular by medium-sized enterprises, too.

The concept of a Tax CMS consists of the components of compliance and a management system and primarily relates to the tax area. Compliance means observing rules. A management system is understood to mean, among other things, the procedures and measures adopted by an enterprise for ensuring the effectiveness and profitability of its business activities, avoiding financial losses and complying with the relevant legal requirements.

A CMS includes all reasonable measures for an enterprise that ensure that it acts in a compliant manner and prevent violations by the legal representatives and employees.

1.2 Avoiding risks and taking advantage of opportunities

An existing and effective Tax CMS reduces risks when dealing with tax obligations and it should make it more difficult in the future for the tax authorities to justify a criminal accusation. A distinction can be made between three main risk categories:

- There are risks under liability law for company representatives if they breach their duty to supervise tax claims but also for individual employees who could be accused of tax evasion.
- There is also a risk of monetary fines for business owners with respect to potential *Organisationsverschulden* (liability of management for torts of employees based on the failure to establish and maintain proper organisational structures) (pursuant to Sections 30 and 130 of the German Administrative Offences Act). For example, if an advance VAT return is incorrect then questions will be asked as to whether or not the organisational structure is adequate and reasonable supervisory measures have been adopted in order to prevent such a mistake from happening.
- The risks under criminal law consist in the possibility of filing an incomplete or incorrect tax return and thus fulfilling the elements of tax evasion. This could also include acquiescence on the basis of inadequate supervision of the employees.

Defending against accusations under criminal and liability law and safeguarding the enterprise against reputational damage are of great importance. Then again, opportunities can also arise for the enterprise from the implementation of a Tax CMS:

- Clarity about existing processes
- New insights into structures and the exploitation of synergies
- Cost savings through fewer organisational inefficiencies
- Adaptation and realignment of current structures in accordance with future developments

1.3 Growing importance

In the future, it will thus be less about "whether or not" a Tax CMS should be implemented but rather a question of the extent to which it is necessary. The reasons for this are:

(1) an i**ncreasing risk of error** when fulfilling tax obligations due to, among other things,
- complex regulations on taxation in the international context and
- an increase in digital business processes as well as e-invoicing;

(2) an ever-greater **risk of errors being detected**, due to, among other things,
- special tax audits as well as
- the expert knowledge and IT capabilities that are being developed by the tax authorities.

Fig. 1 The Four Phases of the PKF Tax Compliance Management System

2. An overview of the Four Phase Model

2.1 Approach

PKF has developed a method that in particular meets the needs of medium-sized enterprises. Accordingly, starting with an analysis of the tax compliance status, tax risks are systematically identified and assessed. Subsequently, it is then possible to order the standard module, or other special modules individually. The "PKF Tax CMS Tool" provides support - this is based on Excel and can be used outside of an ERP system. The following four process phases (cf. Fig. 1), which are outlined in the overview below, are guided and documented via the "PKF Tax CMS Tool".

2.2 Phases of the PKF Model

(1) Phase I: Compliance Analysis

First of all, a company's tax compliance status has to be ascertained on the basis of questions that can determine its nature and which relate to seven compliance pillars.

- **Compliance Culture** - Which corporate values are important?
- **Compliance Objectives** - The achievement of which objectives should be ensured?
- **Compliance Organisation** - How has the structure and the workflow of compliance been set up?
- **Compliance Risks** - How is risk management organised?
- **Compliance Programme** - What measures are used to manage compliance risks?
- **Compliance Communication** - What guidelines or reporting systems are in place?
- **Compliance Monitoring/Improvements** - What ongoing measures are planned for monitoring and improvements?

The analysis is performed on the basis of interviews and checklists. The PKF Tax CMS Tool can be used to produce the documentation in the form of a short report. For standard modules (cf. Phase II) an assessment of the risk situation is then made within the scope of detailed tax compliance analyses.

(2) Phase II: Risk analysis

On the basis of the results of the compliance analysis performed in Phase I, a selection is made from among the standard modules - tax on earnings, VAT, transfer pricing, payroll tax/social security as well as documentation relating to procedures and processes in accordance with the (German) Principles of Proper Keeping and Retention of Accounts, Records and Documents in Electronic Form as well as Access to Data for social security – of those modules that should (initially) be examined in detail. The following steps are dealt with via the PKF Tax CMS Tool in a dialogue between the client and the consultant:

- identification of the risks related to these processes
- identification of the existing rules and controls for these processes
- assessment of the risks relating to the extent of loss and occurrence probability
- reporting on the risk situation
- definition of the action required to reduce the risks

Risk indicators (the product of the extent of loss and occurrence probability) are created on this basis for the respective modules and these indicators can be graphically represented via the software.

(3) Phase II: Measures for guidance and monitoring

In this phase, risks with high or very high indicator values - the so-called "red zone" - are prioritised. The following measures and controls are examples of what could be defined in this phase and then implemented with the aid of the PKF Tax CMS Tool:

- preparation of a tax handbook
- organisational guidelines, procedural instructions, checklists (manual or electronic)
- review of the appropriateness of transfer prices
- preparation of transfer price documentation
- description of controls (manual or electronic)
- definition of communication policy in the event of deviations from guidelines

The aim here is to move the risks out of the "red zone" into the yellow (medium risk) or green (low risk) zones.

(4) Phase IV: Effectiveness and review

This phase follows, somewhat later, phases I to III. It involves so-called functional tests, i.e. whether or not the measures and controls set up in Phase III are also actually being put into practice.

StB [German tax consultant] Oliver Heckner, (Section 1). WP/StB [German public auditor / tax consultant] Daniel Scheffbuch (Section 2)

Tax Compliance Management Systems – Part B: Compliance Analysis

The current tax compliance status for a company is recorded in Phase I of our tax compliance model. In the course of this, it is ascertained at a high level whether or not action is required in any of the divisions. On the basis of interviews and checklists an assessment is then made of how strongly the seven elements of tax compliance have already been developed. The nature, extent and definition of the rules and measures are scrutinised along with the documentation. Here, the scrutinisation as well as the assessment of the Tax CMS are conducted on the basis of standard modules while taking into account the company's individual tax risks.

1. The seven fundamental elements of tax compliance

The structure and workflow of tax compliance systems are based on the seven basic elements shown in fig. 2.

1.1 Tax compliance culture

Culture is generally understood to be a system of rules and practices that guide coexistence and behaviour. Compliance culture is shaped by the basic approach and behaviour patterns of the executive bodies and management; it can be communicated and documented, for example, in a code of conduct, a corporate mission statement or tax guidelines.

In the area of tax it is especially necessary for adherence to tax rules to be deemed to be important and for contraventions to be subject to sanctions within the company.

1.2 Tax compliance objectives

Achievable and measurable objectives for the Tax CMS should be defined on the basis of general company goals and an analysis and weighting (e.g. in accordance with sector-specific relevance). For example, these could include:

- correct and timely reports on non-deductible business expenses,
- annual reports on tax risks, or
- regular spot checks to ensure compliance with invoicing guidelines.

Fig. 2: Basic elements of tax compliance

Such stated objectives can and should be agreed in all the business divisions that are relevant for tax purposes.

1.3 Tax compliance organisation

The organisation is the formal set of rules that are necessary for the functioning of a system that is based on the division of labour. An organisational structure is also vital in order to ensure adherence to tax compliance rules. Competencies, including deputising arrangements, process flows and the assignment of responsibilities are frequently defined on the basis of written check-lists as well as documentation rules.

» **Please note:** A set of rules has to be reviewed regularly with respect to its currentness.

1.4 Tax compliance risks

The risk of rule violations should be identified and assessed on the basis of a system for risk detection and evaluation. In the course of this, the risks can be determined, e.g., for each type of tax. The constituent components of the compliance programme can be derived from these risks.

1.5 Tax compliance programme

The tax compliance programme describes the rules and measures that are supposed to counteract the risks as well as the steps that have to be taken if it is ascertained that rule violations have occurred. This compliance programme should be documented in writing. In this respect, a distinction has to be made between measures for the prevention of rule violations and measures for their detection:

(1) Preventative measures (cf. also section 1.3 on compliance organisation) are e.g.:

- regular staff training,
- drawing up guidelines and checklists,
- rules on authorising, deputising and signing.

(2) Detection measures could be:

- automatic plausibility checks, possibly computer-based;
- the “four eyes principle”;
- reviews to ascertain whether or not staff are acquainted with the tax compliance programme.

» **Please note:** The effectiveness of the measures that are adopted has to be regularly reviewed. The result of a review can lead to adjustments to the tax compliance objectives and the tax compliance programme.

1.6 Tax compliance communication

Communication, which is frequently underrated, is probably the key component of a Tax CMS. This is because it is an essential requirement for staff and also any third parties involved to be acquainted with the objectives, rules, guidelines and processes and for training in this regard to be provided for them on a regular basis. Without such measures there can be no expectation that the above-mentioned guidelines will actually be complied with and that staff will understand their responsibilities and be able to fulfil them. Therefore, communication also has to be regulated in a Tax CMS.

Frequently, companies already have functioning structures through which they are able to publish announcements (e.g. intranet, e-mails, notices displayed on a board). In most cases, structures also already exist for defining and reviewing objectives. Therefore, if deployed sensibly, a Tax CMS can make use of such structures that already exist.

» **Please note:** In order to be able to provide proof of the effectiveness of a Tax CMS it will be necessary to document all communications (e.g. about the training and measures that were carried out).

1.7 Compliance monitoring and improvements

An existing Tax CMS should be reviewed regularly and, if necessary, improved. The review could focus on, for example, compliance with training requirements and their documentation, or adherence to defined process sequences. Such diligent controls should likewise be documented.

When rule violations are ascertained then the existing tax compliance arrangements should be scrutinised and, if necessary, adjusted. Likewise, adjustments should be made if there are any changes to the organisational structure or the company’s business model.

» **Please note:** This means that the arrangements should scrutinised on a regular basis, not just in relation to specific events, and reviewed with respect to their effectiveness.

2. Taking into account individual tax risks

A reasonable analysis of the system as well as an appropriate evaluation of the existing Tax CMS will only be possible if the company’s individual tax risks are taken into account. The requisite – at least broad-brush – analysis of these tax risks should therefore be performed on the basis of questions related to subject areas that are focused on the modules that are listed under section 3.

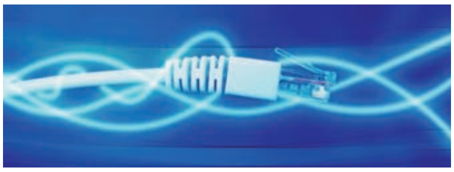
3. Result of the compliance analysis

Based on the compliance analysis, a decision will be taken as to which modules should be analysed in Phase II (cf. fig. 1 on page 4 for the sequence of the phases). This Phase II then includes an analysis of the extent to which there are controls and measures for the single risks that could reduce the amount of a loss as well as the occurrence probability. These modules cover the following areas:

- the (German) Principles of Proper Keeping and Retention of Accounts, Records and Documents in Electronic Form as well as Access to Data (abbreviated in German to GoBD), including documentation relating to procedures and processes
- VAT, payroll tax/social security
- international tax law and transfer prices,
- tax on earnings and deferred taxes as well as
- customs

In the following, in parts C and D from the risk analysis phase, we present in detail the modules related to GoBD and the area of payroll tax/social security.

WP StB [German public auditor and tax consultant] Thomas Rauert,
StB [German tax consultant] Christian Knörndel



Tax Compliance Management Systems – Part C: Risk Analysis using the example of the GoBD

In Phase I of the PKF Model – tax compliance analysis a rough analysis is performed of the standard modules for the (German) Principles of Proper Keeping and Retention of Accounts, Records and Documents in Electronic Form as well as Access to Data (abbreviated in German to GoBD), including documentation relating to procedures and processes, VAT, payroll tax/social security, tax on earnings and deferred taxes, international tax law and transfer prices. The result of Phase I is a decision as to which modules are going to be analysed in detail in Phase II.

Phase II, first of all, consists of an analysis of the extent to which there are controls and measures for the individual risks in the selected modules in order to reduce the amount of a potential loss as well as the probability of these risks occurring. In the following section we outline how documentation relating to procedures and processes should be organised for the GoBD module in order to ensure tax compliance in this respect. Process documentation is particularly important here as, for almost all businesses, it forms the basis for the other Tax CMS modules.

1. Legal requirements and GoBD

According to Section 146(1) of the Fiscal Code (Abgabenordnung, AO) as well as Section 239(1) of the Commercial Code (Handelsgesetzbuch, HGB), bookkeeping entries and other required records shall be made separately, completely, correctly, and in a timely and orderly manner. The tax authorities have specified what this means when information and communication technologies are used, as follows: “The taxpayer has to ensure that electronic bookkeeping entries and other required electronic records are made completely, correctly, in a timely and in an orderly manner from both the organisational perspective as well as the technological perspective.” (Subsection 82 of the GoBD). Businesses that use IT systems for the keeping and retention of accounts, records and documents have been obliged to comply with the requirements in the Federal Ministry of Finance *(Bundesministerium der Finanzen, BMF)* circular from 14.11.2014 (reference IV A 4 – S 0316/13/1003) since 2015. In accordance with the principles of proper keeping and retention of accounts, records and documents in electronic form as well as of access to data (GoBD principles), all electronic business documents that are subject to a retention obligation – especially data that are tax relevant – have to satisfy the requirements with regard to data security, inalterability, retention and machine analysability. The GoBD principles can be structured as shown in fig. 3 on page 8.

The audit trail for and the verifiability of the first three subject areas have to be ensured through a detailed documentation of procedures. This documentation can in turn be subdivided into four parts (more about this in section 3). User documentation – described in more detail in section 4 – assumes the greatest importance. This is understood to be process documentation including a presentation of the internal measures and controls. In section 5, we have provided a structured summary of the GoBD principles in terms of their contents – in the BMF circular from 14.11.2014 these extend over the first 30 pages.

» **Please note:** A breach of GoBD can lead to the validity of the financial accounts being rejected by the tax auditor and estimates being used to determine the basis for tax calculations.

2. Overview of Risk Analysis in the GoBD module

The analysis of whether or not there is compliance with the requirements under GoBD has been allocated to Phase II of PKF’s model for a Tax CMS. The aim of the analysis is to determine

- if the documentation of procedures exists in principle and
- if it is consistent with the requirements under GoBD.

The key object of the risk analysis is the process documentation including a description of the internal control system.

2.1 The documentation of processes

The actual risk analysis in Phase II, generally and for all modules, relies on the process documentation. If this does not yet exist, or is not complete then, together with the company, it has to be prepared. Here, first of all, the processes that are tax relevant are identified and described. Two methods can be considered for this purpose:

- Retrograde – Recording of all processes starting with the annual financial statements, tax returns and tax declarations right down to the underlying accounting transaction. The retrograde approach ensures that all the

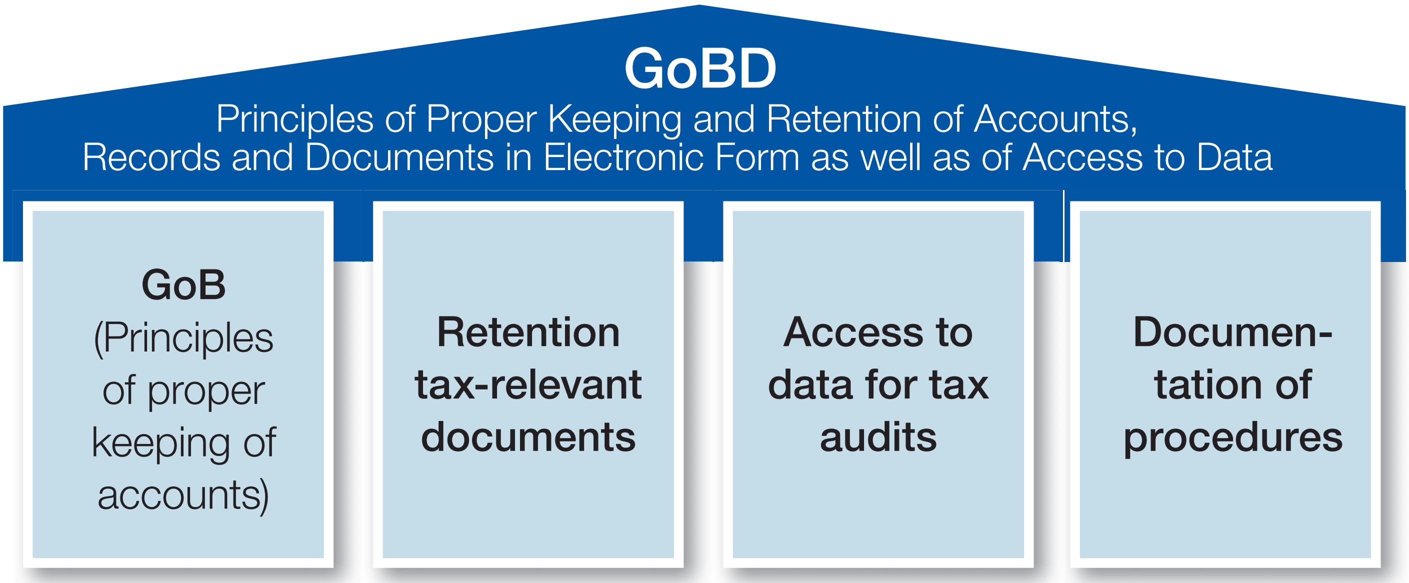


Fig. 3: The basic elements of tax compliance

processes are covered that relate to the data that are included in the taxable amount.

- Progressive – The starting point here is the accounting transaction that ultimately ends in the annual financial statements, tax returns and tax declarations.

» **Please note:** In the case of the GoBD module, in addition to the basic precondition of actually having process documentation, this also has to be "module inherent" and supplement the documentation of procedures. The documentation of procedures generally and process documentation in particular are presented in detail in sections 3 and 4.

2.2 Identification of existing measures and controls

First of all, an understanding is achieved of process workflows as well as the integrated measures and controls by analysing the available process documentation. If the latter is not available then the current process workflows, measures and controls have to be recorded on the basis of interviews with the people who are responsible for them. Subsequently, the understanding of the business processes thus gained has to be verified and any missing information has to be added to the process descriptions, in the course of the process, in discussions with the people who are responsible. The result of recording the process is presented in a Process Control Matrix, which is described in detail in section 6 on page 11.

2.3 Determining process risks

With process risks a distinction is made between:

- (1) inherent risk,
- (2) control risks that arise from processing business transactions,
- (3) risks that arise from the IT support for the processes.

(1) The inherent risk describes the risk that a business transaction carries with it. For example, the processing of a highly complex one-off matter harbours a greater risk than the processing of a standard business transaction where the processing is precisely regulated and has been practised for years.

(2) Control risks arise if the controls (e.g. four-eyes principle) that have to be provided in a process have not been implemented, or not adequately developed, or are not effective. Specifically, these are errors in and contraventions of the process that, despite regulations or internal guidelines, occur knowingly or unknowingly but are not detected through the measures and controls that are part of the existing internal control system.

(3) In the course of the implementation and operation of process-supporting IT systems, various risks can arise in relation to IT processes, IT applications, data, IT infrastructure, IT organisation and the IT environment. IT risks increase in tandem with the complexity of IT systems and the rise in the number of processed business transactions.

When identifying process risks, the question that arises is what errors could occur in the course of the individual process steps when determining the taxable amount. The starting point here is typically the tax requirements that have been specified and then questions are asked as to whether or not compliance with individual requirements could be put at risk due to an error in the process step. The process risks are determined on the basis of the criteria that are presented in detail in section 5 on page 10.

2.4 Assessment of the risks in relation to the extent of potential loss and occurrence probability

A distinction has to be made between a quantitative and a qualitative assessment.

(1) If the extent of the financial loss (increased tax assessment, ancillary expenses related to taxes, etc.) can be ascertained then there is a quantitative assessment of the identified tax risks and/or process risks while taking into account existing rules and controls for the respective extent of the financial loss. Furthermore, the occurrence probability for the individual risks is estimated. The so-called net risks result from the multiplication. These net risks form the basis for the design of other measures and controls in Phase III of the PKF Model.

(2) If the extent of the damage cannot be quantified (reputational damage, consequences under criminal law, etc.), then a qualitative classification into risk classes is performed.

3. Documentation of procedures

The documentation of procedures in accordance with the GoBD principles is intended for compliance with the legal requirements of the AO and HGB. A specific catalogue of requirements for the design and detailing of the documentation of procedures does not exist. However, according to prevailing opinion, the documentation of procedures should include process documentation as well as a description of the internal control system. The documentation for the IT system should include not only the main, source and ancillary systems but also other hardware and software components as well as the respective interfaces. The document should be organised in accordance with subsection 153 of the GoBD and on the basis of the IDW AcP FAIT 1 (an accounting principle prepared by the expert committee on information technology (FAIT) of the Institute of Public Auditors in Germany (IDW)) and should include the following constituent components:

(1) A general description – A presentation of the general organisation of the business (e.g. structural organisation, organisational chart, roles, competencies, responsibilities), the range of functions and business processes (e.g. workflow organisation, fields of application) and the legal environment (e.g. non-tax-related and tax-related obligations with respect to keeping accounts and records as well as retention requirements and retention periods).

(2) User documentation – This comprises all the information that is necessary for the proper operation of an IT application. Besides a general description of the range of functions and interoperating modules covered by the IT application, this can contain also, very specifically, the type and significance of the input fields used. If standard software is used then the documentation supplied by the manufacturer should be supplemented with information on the user-specific adaptations and documentation of the parameters (customising). Furthermore, process documentation, which is set out in detail in section 4 below, is also subsumed under this point.

(3) Technical systems documentation – This should be understood as comprising a description of the components of the IT system that underlies the documented processes and process functions as well as how they interact. The documentation should provide information, in particular, about the following areas (IDW FAIT 1):

- data organisation and data structures (creation of data records and/or tables for databases),
- modifiable table contents that are used when a posting is generated,
- programmed processing rules including the implemented input and processing controls,
- program-internal error handling procedures and
- interfaces to other systems.

(4) Operation documentation – This consists of a presentation of the organisational processes for the documentation of the proper application of the IT procedure (in particular, a description of the authorisation procedures, relevant workflows and data backup procedures). With respect to documentation, the main focus is on the following aspects:

- compliance with the principle of an audit trail for an expert third party,
- implementation of a process for creating a procedural organisation and organisational instructions,
- generation and safekeeping of documentary evidence of processing and controls (written records, etc.).

4. Process documentation as a constituent component of the documentation of procedures

4.1 Process description

A systematic process analysis is the starting point for the process description. Essentially, the question that needs to be asked here is: “who does what, when and with what?”

A member of the company’s staff should thus be able to process the business transactions in accordance with internal guidelines and in conformity with the provisions under tax law. Under GoBD a description of processes that have been implemented organisationally and technically is considered reasonable. The documentation of a process can be organised, e.g., as follows:

- Process Objective
- Scope
- Terminology and Abbreviations
- General Conditions
- General Rules for the Process
  - · Entry and Exit Criteria
  - · Feedback to the Process Owner (alerting, etc.)
  - · Audit Criteria
- Process Model and Activities
  - · Roles involved

- · Activities in the Process (process steps)
- Performance Indicators
- IT Systems and Operating Resources
- Other Applicable Documents
- Related Processes

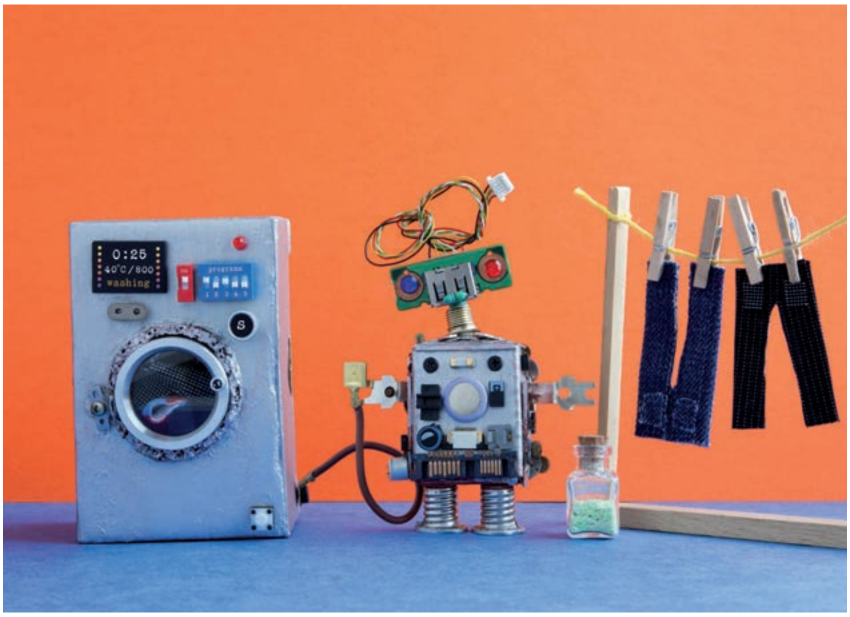
The tax authorities have provided an example in the GoBD – A description has to be provided for electronic documents of the organisational and technical processes starting from the generation of the data and including indexing, processing as well as storage, unambiguous retrieval and machine analysability right down to the safeguarding against loss and corruption as well as replication.

» Please note: In many cases, process descriptions that already exist (e.g. in connection with an ISO certification) can be used as a basis in many cases.

4.2 Process visualisation

It is advisable to illustrate the descriptions of the processes with images and diagrams. To this end, the descriptions of the processes that are tax relevant should be supplemented with process maps and process flowcharts.

Tools for the design and visualisation of a process (Office applications, process visualisation tools, Signavio, ARIS etc.) are used to produce the process flowcharts. In order to achieve consistency in the presentation across all the processes it is advisable to use a process visualisation framework (Business Process Modelling Notation, event-driven process chains, etc.). For the process documentation, as in the case of all document materials, there is a need to ensure that the changes in the process workflows are described in chronological order (versioning). Furthermore, the change management process has to ensure that any changes to the processes that are tax relevant will necessarily lead to the process documentation being updated.



Processes should be described and visualised

5. A target system for the Internal Control System within the meaning of the GoBD

The target system for the internal control system (ICS) within the meaning of the GoBD consists of the following constituent elements:

- principles relating to the creation of an audit trail, verifiability, truthfulness, clarity and ongoing recording;
- ensuring compliance with the requirements pertaining to the regularity and security of tax;
- definition of responsibilities.

5.1 Regularity and security

The following requirements pertaining to the regularity and security of procedures and IT systems that are tax relevant derive from the law and administrative opinion (GoBD, etc.):

- voucher, journal and account functions
- completeness
- accuracy
- timeliness
- order and indexation
- inalterability
- security
- storage incl. historisation
- making readable and decrypting encrypted data
- ensuring machine analysability in accordance with Section 147(2) AO and
- verifiability of in-house data conversions and proprietary data formats

5.2 Migration and archiving

With respect to migration and archiving, it has to be ensured that the following requirements are satisfied:

- Compliance with the requirements pertaining to regularity under tax and commercial law in the case of migration and in self-sustaining archiving systems
- Providing option of evaluating data that are tax relevant over the retention period (inalterability)
- Data migration or freezing of legacy systems when tax-relevant IT systems are replaced
- Properly transferring data into archiving systems that conform with tax law
- Taking into account the tax requirements relating to in-house formats and data conversions.

5.3 Verifiability incl. access to data by the tax authorities

The verifiability of the basis for tax calculations has to be ensured from both a progressive perspective (from the voucher to the tax declaration) and a retrograde perspective (from the tax declaration to the voucher). The basis for this is the documentation of procedures. The necessary condition for verifiability is that a right to access to the data on the IT applications is granted for the tax audit. This should be put in place by making the following key arrangements:

- Definition and implementation of user roles for the tax audit: read-only data access (Z1), or additionally with the right to prepare the data (Z2), or the right to data media transfer (Z3);
- Making available verifiable data formats in accordance with the supplementary information on data media transfer in the BMF circular from 14.11.2014;
- Giving due regard to particularities (e.g. setting up a participation process for cash inspections in accordance with Section 146b AO).

6. Process Control Matrix

All the process steps in the process workflow are listed in the Process Control Matrix (cf. fig. 4) and linked to the relevant measures and controls. The controls that have been set up (and planned) for the business are defined and described in a separate list. In the course of this, in particular, the type of control (e.g. preventative, investigative) and its frequency (e.g. monthly, daily, spot check, uninterrupted) should also be designated.

Subsequently, the appropriateness and effectiveness have to be assessed; at any rate, the latter can however only be reliably verified in Phase IV of the PKF Model – "Effectiveness and Review".

On the basis of the Process Control Matrix the actual risk analysis is then performed in the Risk and Control Matrix – this is effectively the DNA of the PKF Tax CMS Tool.

Determining process owners constitutes a particular challenge. Process owners are responsible, among other things, for maintaining complete and up-to-date process documentation as well as for the Process Control Matrix.

In the following, in Part D we present the risk analysis and risk assessment in Phase II on the basis of the 'payroll tax/ social security' tax module.

RAin/StBin [German lawyer/ tax consultant] Antje Ahlert,
WP/StB [German public auditor/ tax consultant] Tobias Hochow,
WP/StB [German public auditor/ tax consultant] Gerd Bichler,
WP/StB [German public auditor/ tax consultant] Dr. Christoph Swart,
WP/StB [German public auditor/ tax consultant] Daniel Scheffbuch

Process: GoBD_Documentation of Procedures_Process Documentation (abbreviated in German to GVP)

Process no.	(Sub-)Process	Description	Frequency in the business	System	Measures and controls
GVP_4: Digitise vouchers					
GVP_4.1.1.	Incoming mail and pre-sorting	Paper-based incoming mail is opened, stamped with the incoming mail stamp and filed in a precisely designated place that is protected against unauthorised access.	very frequently	(Specify the filing location)	
GVP_4.1.2.	Incoming mail	Incoming mail is checked for authenticity and external intactness. If there are any doubts then the executive in charge is consulted and, if necessary, the sender or the delivery agent. All critical documents have to be collected in one file document and the outcome of the consultation has to be put on record.	very frequently		
GVP_4.2.1.	Identification of vouchers	The opened, stamped and pre-sorted paper-based incoming mail is visually inspected and checked by the responsible staff member to determine the voucher character of the individual documents. In the course of this, all the documents are assigned a voucher function under commercial and/or tax law and filed in a precisely designated place that is protected against unauthorised access. With regard to the criterion "voucher character", the staff member has a list at his/her disposal that will have been explained in depth to him/her beforehand.	very frequently	(Specify the filing location)	

Fig. 4: Process Control Matrix

Tax Compliance Management Systems – Part D: Risk analysis using the example of payroll tax/social security

Following the presentation of Phase II of the PKF Model using the example of the (German) Principles of Proper Keeping and Retention of Accounts, Records and Documents in Electronic Form as well as Access to Data (GoBD) our series now continues with examples from the payroll tax/social security area (please see in Part C for a complete overview fig. 1 on page 4). For this area, too, we describe the requirements for the necessary documentation relating to procedures and processes in order to ensure tax compliance.

1. Risk analysis in the payroll tax/social security area

The Part C on risk analysis using the example of the GoBD, already included a detailed presentation of the process steps that should generally be carried out within the scope of Phase II:

- Documentation of processes
- Identification of existing measures and controls
- Determination of process risks
- Assessment of the risks relating to the extent of loss and occurrence probability

To this end, during the practical implementation, the risks in these processes are identified in the course of interviews. On the basis of planned questions, the rules and controls that already exist in the company are reviewed and the risks are assessed as well. The ensuing result is a report on the risk situation and the definition of action strategies for reducing the risks.

In the following section, the work involved in applying the PKF Model is illustrated by using the example of benefits in kind at a company. Benefits in kind are, e.g., company events, free meals and drinks for business partners and employees, gifts for business partners and employees, discounts for employees, travel expenses, the use of a vehicle, work clothes, medical care by a company doctor, employer loans, a company apartment, tickets for local public passenger transport and much more besides. In the course of the operating procedures it has to be ensured that the personnel department, or the staff member responsible for employee data receives all the information on the respective benefits in kind. Normally, this is only possible if, at the company, checklists and forms have been introduced that facilitate the collection of the necessary data.

2. Example of application – Company Events

2.1 Circumstances and principles

In most companies, there are parties at Christmas and in summer for the individual businesses but also for individual departments. Such parties are typical examples of company events. The definition of a company event is an event of a social nature that fosters contact between employees and is thus supposed to ensure that there is a good working atmosphere. A distinction has to be made between company events and, e.g., customer events or incentive events.

The group of those participating in a company event should consist of mainly, i.e. more than 50%, company employees, their accompanying guests and possibly temporary staff hired through an agency or employees who work for the corporation. The event has to be open to all employees, including the part-time employees and temporary employees. A company event will be tax-exempt if the costs per employee do not exceed the amount of € 110 and the employee has participated in a maximum of two company events per year. Participation in company events thus has to be individually recorded for each employee. If the expenses per employee for a company event exceed the above-mentioned tax-free allowance then the benefit will be taxed at a flat rate of 25% plus the solidarity charge and church tax. Gifts in kind in the context of company events increase the costs of the event. In the case of raffles there are particularities that have to be complied with. Travel costs incurred in connection with company events are not included in the (tax deductible) costs for the company event. Having due regard to the company's overall activities, the VAT will be deductible if the € 110 limit has not been breached.

One possible process risk could be that the requisite documentation obligations with respect to those participating in the company event have not been complied with. Owing to the complexity of the technical assessment and the relatively high additional amounts that you can expect to pay in case of detection within the scope of audits, this risk should generally be classified as major in relation to its occurrence probability and the extent of the potential loss.

2.2 Application of the PKF Model

In Phase II there is a check to see what rules are in place (e.g. organisational instructions, training courses, programmes, forms and checklists) that could prevent the occurrence of damage/losses. Furthermore, an analysis is carried out to determine whether or not compliance with these rules is monitored in the company. The amount of costs is called up and, on this basis the risk arising from these events is ascertained. If there is a well-structured operational instruction, which is demonstrably being used, then the actual risk of error is relatively small. The risk remains relatively high for businesses with several company events that have not implemented any instructions for execution and who are unable to provide evidence either of the completeness of the costs or the possible participation by all employees.

» **Recommendation:** In the case of high risks there is a need for action to mitigate the risks. The report on Phase II would have to describe the risk situation and outline the need for action tailored to the circumstances of the company concerned.

Company events are frequently associated with tax risks

3. Example of application – Travel Costs

3.1 Circumstances and principles

Travel costs (transport costs, subsistence allowances, accommodation costs, and the like) arise in virtually every company. For the reimbursement of travel costs there should be documentation that shows which amounts have to be reimbursed for which trips. In addition, the employee's workplace location should be defined; the records and evidence that are operationally stipulated should conform to the requirements of the tax authorities. If the agreed reimbursements do not conform to tax-exempt per diem allowances then the taxation and, if applicable, payment of social security contributions have to be ensured.

If trips abroad are a regular occurrence at the company then the social security risk is frequently higher than the payroll tax risk. Foreign assignments have to be promptly reported to social security agencies and the statutory trade association for health and safety at work and employer liability insurance (*Berufsgenossenschaft*). In particular, in the event of an accident in connection with a business trip abroad there could be problems with the Berufsgenossenschaft if there is a lack of cover. The employer has to pay the accident costs in advance. If the Berufsgenossenschaft does not assume liability for the expenses this could mean that the company suffers a big loss.

3.2 Application of the PKF Model

In Phase II of the Tax CMS there is a review of how the travel expense accounting is organised and how it is linked to the payroll. Furthermore, how much is paid out for business trips is ascertained. The risk that is determined is reported and a recommendation for action is given.

In addition, with respect to foreign trips, Phase II also provides an opportunity to have a look to see if the guidelines for the authorisation of foreign business trips, which have been put in place, not only guarantee that the travel costs are tax deductible but that they also ensure that the employee will have insurance cover abroad. Here, the risk will also depend on the travel destination but also the number and the duration of the business trips. After recording this information, the risks are identified and assessed. These results are then presented in the report and recommendations for actions are specified.

4. Interim conclusion

These examples give an overview of the approach used in Phase II. On the basis of the ensuing report and the recommendations for actions, the tasks related to the measures for guidance and monitoring that constitute Phase III (cf. Fig. 1 on p. 4) can be designed. This phase will be described in more detail in the next part.

StBin [German tax consultant]
Helga Sauerwald

Tax Compliance Management Systems – Part E: Measures for guidance and monitoring using the example of VAT

What now follows here, in Phase III, is the development and implementation of measures for guidance and monitoring on the basis of the tax risks identified in Phase II. Specifically, in the section that follows, we describe for the VAT Module how risks can be reduced in a targeted way and compliance violations can be prevented.

1. Legal requirements and VAT

Within the scope of VAT, erroneous incoming invoices constitute significant risks. A proper invoice has to include certain minimal constitutive elements. This information should be checked by the recipients of invoices if they wish to safeguard their input tax credits. In addition, taxpayers have to fulfil other obligations, such as the proper and timely filing of advance VAT returns and annual declarations. Advance VAT returns should generally be submitted to the tax authority by the 10th calendar day of the submission period and the annual declaration, if it is prepared by a tax consultant, by the 31.12. of the following year after the end of the assessment period.

Besides these general obligations, there are other requirements depending on the business model.

- Business owners who export supplies abroad have to document this accordingly with evidence in the form of accounting records and receipts.
- In the case of supplies to foreign countries within the EU, recapitulative statements have to be filed with the German Federal Central Tax Office on a regular basis.
- When certain sales thresholds for imports and exports are exceeded then Intrastat returns have to be submitted.
- For the respective transactions, attention should be paid to the rules on the reversal of the liability for the payment of VAT in the case of services provided to companies in foreign countries within the EU as well as the rules on intra-Community triangular transactions and consignment warehouses.

» **Please note:** If advance VAT returns are submitted late then the local tax office can impose a surcharge for late filing. If an advance payment is filed but the tax is not actually paid then there is a risk of penalties for late payment as well as of fines. If the taxpayer does not file an advance return or provides false information then this could be viewed as tax avoidance and would result in criminal proceedings.

2. Tax Compliance Program

2.1 Prerequisites for the implementation

It is crucial for the success of a compliance program that the staff in the tax department as well as those from departments with areas of responsibility that are relevant to VAT have the requisite knowledge about VAT. The processes for complying with statutory requirements should be documented and should include controls that already exist. In the course of this, the adjacent operating divisions (such as logistics or sales) should also be integrated. It should be ensured that the responsible staff members have adequate knowledge in the field of taxation in order to be able to identify potential risks and communicate them. The tax department should receive adequate staffing in order to counter the risk of not being able to perform elementary tasks, such as filing advance tax returns and annual declarations within the stipulated periods.

Quality checks for VAT data records and reports

2.2 Measures for guidance and monitoring

The following measures for guidance and monitoring lend themselves in particular to ensuring that VAT obligations are fulfilled.

- Regular training for staff with functions that are relevant to VAT
- The implementation of a “4-eyes principle“ for exceptional VAT cases
- Quality checks of VAT data records and reports (possibly also with the help of data analysis programs; e.g. VAT View)
- Regular updates of the automated VAT processes in the IT systems

2.3 Compliance monitoring and improvements

Within the scope of VAT, the appropriateness and effectiveness of a system can be monitored with the help of the following measures in particular.

- Reviews of the processing of VAT data in the ERP
- Regular updates of the master data
- Reviews of the overall transaction data with respect to risks
- Monitoring of the carrying out of and participation in training
- Checks of the controls for tax returns and tax declarations
- Reviews of procedural instructions

3. Tax Compliance Communication

It is crucial for the success of a Tax CMS to pre-define clear communication channels as well as the roles and responsibilities of each staff member for his/her scope of functions. A process has to be determined for reporting tax compliance risks as well as information on potential or established rule violations to the appropriate departments in the company. Communication can take place, e.g., in the form of letters to the staff, compliance manuals or training sessions. Here, the following aspects are of particular importance:

- periodic compliance reporting to the company’s management
- communication with the tax authorities
- information for staff about amendments pertaining to VAT
- communication about new or modified processes that are relevant for VAT
- providing to the accounts department information that is required for the annual financial statements

4. Conclusion for Part E

Within the scope of a Tax CMS a special focus should be placed on the sphere of VAT because the tax authorities usually ascribe a great deal of importance to this area in tax audits. For the tax authorities, a functioning VAT compliance system can be viewed as an indication that any actions have not been wilful or negligent.

WP / StB [German public auditor / tax consultant] Jens Düe / StB [Tax consultant] Enrico Kiehne

Fig. 5: Final phase: Check-up of effectiveness and review

Tax Compliance Management Systems – Part F: Effectiveness and Review

This last phase completes the sequence of phases in the PKF model for a tax compliance management system – possibly only temporarily however. If, in the course of this final phase, deficiencies in terms of effectiveness are exposed then a new iteration of the sequence of phases begins; although, depending on the circumstances, this might not involve a full repetition of the entire process but, instead, will start at the point where the deficit was identified.

Another point to be made here is that it should be understood that the model is supposed to be used in a dynamic way. Regular reviews at intervals that are not too long are supposed to counteract arrangements established at a particular time from becoming entrenched. In particular, the aim of the functional tests should be to determine whether or not the measures and controls set up in Phase III are also actually being put into practice.

WP/StB [German public auditor/ tax consultant] Daniel Scheffbuch

Accountants &
business advisers

PKF Deutschland GmbH Wirtschaftsprüfungsgesellschaft

Jungfernstieg 7 | 20354 Hamburg | Tel. +49 40 35552 - 0 | Fax +49 40 355 52-222 | www.pkf.de