

Guide

# Navigating Indirect Tax Risks



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# Introduction

In today's complex and ever-evolving tax landscape, proactively managing risk is more important than ever.

Businesses can avoid costly penalties, reputational damage, legal issues, and ultimately achieve greater financial stability and operational success.

A well-executed risk management strategy provides a solid foundation to navigate the intricacies of taxation.



# Impact of tax on enterprise risk

Tax plays a huge role in enterprise risk. The indirect tax laws, regulations, and compliance requirements in multiple jurisdictions nationwide constantly change. Failure to adhere to these changes can result in penalties, and fines, which all impact the overall stability of the company. Because of this, **an enterprise risk management plan must encompass an assessment of tax-related risks** to ensure mitigation strategies are in place and align with the broader risk management framework.

Including all areas of the business in a risk management plan is crucial because it helps identify potential vulnerabilities and threats across the organization, ensuring a comprehensive and holistic approach to risk mitigation. This inclusive approach also fosters better communication and collaboration among different departments, enabling the company to proactively address risks and minimize their impact on its operations and reputation.



# Importance of Managing Tax Risk

## Long-term Financial Stability

Indirect taxes can represent a significant portion of a business's cash outflow. Failure to manage these taxes effectively can lead to unexpected financial burdens, including penalties, interest, and fines, which can impact a company's bottom line. These penalties may also not be deductible for income taxes, which can impact the profit and loss of the company.

By proactively managing indirect tax risk, businesses can enhance their long-term sustainability. This includes better preparation for tax law changes and other external challenges that may impact financial health.

## Tax Compliance and Penalty Avoidance

It's no secret that tax compliance in the tobacco, vapor, and fuel industries is incredibly complex and always changing. For instance, A new tax rate for premium cigars could be issued for one county and not a neighboring county in the same state.

Non-compliance with tax regulations can result in penalties, interest charges, and additional tax assessments. Managing tax risk helps minimize the likelihood of incurring these costs, saving businesses money and resources.

## Trusted Brand Reputation

In some industries, like vapor, if you lose your license, you can't buy or sell in that jurisdiction temporarily or permanently.

According to [our sources](#), 29% of tax leaders are worried about the reputational risk to the business due to a tax dispute.

Maintaining tax risk helps protect your brand reputation. When you are constantly compliant and following best practices, you establish trust with your stakeholders and customers. This, in turn, establishes your brand as having authority in the industry.



29%

of tax leaders are worried about reputational risk

## Competitive Market Advantage

Businesses that effectively manage their tax risk are better positioned to compete in the market. They can invest in growth opportunities and adapt to changing market conditions without being burdened by unexpected tax liabilities.

# Types of tax risk

## Assessments

Assessments are a discrepancy that the state finds and bills you for. The more assessments you have, the higher your chance of an audit.

## Audits

The dreaded audit. Audits often happen when the government catches errors or anomalies in your tax documents or too many assessments are issued. Getting audited is a huge drain on the tax team, finance team, and operational team.

Audits can be exhaustive and time-consuming, and penalties can impact the business's profitability.

## Changes in Legislation

In indirect tax, changes in legislation happen all the time. To make things more complicated, changes in legislation may occur on the county, state, or national level, making it hard to stay on top of.

These changes require frequent updates to compliance procedures.

## Filing Errors

Filing errors could happen if you have unreported transactions and incorrect data.

Though this may be a small error in some instances, it could come with financial losses, trigger an audit, or increase compliance costs to correct the mistake.

## Incorrect Registration

Some businesses miss enrolling for registration and licensure correctly with the government, so the statute of limitations never begins, and the business starts tolling.

The government can audit a tax return within the statute of limitations, which varies by jurisdiction.

However, if you aren't registered correctly and are tolling, the government can audit you further back, like seven or even ten years.

This would require lots of manpower and hours digging for needed documentation.

## Late Filing

Many business file hundreds of returns each month, making it easy to miss a deadline, particularly one that's been adjusted for a weekend or holiday.

Late filings could incur penalties and interest, which can result in additional financial liabilities beyond the initial amount owed.

## Overpayments

An overpayment occurs when the business remits more money than it owes, leading to an impact on company revenues.

To address overpayments, companies must request a refund or credit from the tax authority.

Regularly [reconcile records](#) and verify excise tax liabilities to avoid overpayments.

## Tax controversy

Tax controversy happens when a dispute occurs between the business and the taxing jurisdiction.

This could be when a jurisdiction serves a business with a significant assessment that the business disagrees with. These disputes can be resolved in court or settled outside of court.

Tax controversies are often time-consuming and expensive to the business.



# Managing tax risk across the business

## 1. Develop a Risk Management Plan

The most time-consuming but important step to managing tax risk is developing a comprehensive risk management plan.

A successful risk management plan allows the tax team to implement effective strategies and controls to mitigate risks, reducing the likelihood of costly errors or non-compliance issues. It also enhances transparency and accountability within the team, ensuring that everyone understands their roles and responsibilities in managing tax-related risks effectively.

### 5 Steps Toward Developing Your Risk Management Plan



## 2. Apply Three Lines of Defense Model

The Three Lines of Defense model is widely used risk management.

The framework establishes clear lines of responsibility and accountability within an organization. It also enhances risk awareness and transparency, while fostering a culture of risk management throughout the organization.

### The First Line

The first line of defense is the tax team with boots on the ground. They're at the front lines, ensuring risk is managed at the source. In this framework, the tax team is responsible for the day-to-day responsibilities and helping to prevent risks before they emerge.

### The Second Line

The second line of defense is often the tax director or manager who oversees the risk management processes and ensures the policies are being enforced and in place. They provide guidance and oversight to the frontline.

### The Third Line

The final line of defense works as independent risk assurance. This normally looks like an internal audit in tax teams. The third line evaluates the effectiveness of the first and second lines of defense. The third line assesses the risk management processes and adjusts the framework as needed.



### 3. Encourage Visibility Throughout the Business

It's important for all business functions to be in sync and have visibility within each other.

Encourage collaboration between the tax team and other departments, such as finance, legal, and operations.

Cross-functional teams should work together to identify and mitigate tax-related risks that span multiple areas of the organization.

Your tax team should never be left saying, "We were the last to know," about something that impacts tax compliance, like selling in a new jurisdiction.

### 4. Establish a Risk-Aware Culture

Everything should be "audit ready". This means no cutting corners. Believe us, the extra steps are well worth it and become healthy habits the tax team adapts. By instilling a risk-aware mindset, you not only safeguard the company from potential risk but also enhance the team's ability to adapt and excel in an ever-evolving tax landscape.

### 5. Stay Up-to-Date

The excise tax industry can feel like a whirlwind some days. Staying current on tax rate changes and new legislation requires continuous education, subscribing to industry tax updates, and consulting with peers and other like-minded tax professionals.

### 6. Monitor and Control Risks

Mitigating risk includes accepting some level of risk. Refer to your risk management plan to determine what level of risk is acceptable.

Tax laws and business environments change, so your risk management plan should be reviewed and updated regularly to remain effective.

Tax technology is a fantastic tool to monitor deadlines, identify discrepancies, minimize human error.

Conducting internal audits and exception reporting can further ensure that the excise tax liabilities match the actual business activities.

# Incorporating tax into enterprise risk strategy

Tax teams are often left on the sidelines of enterprise-level strategy planning. In fact, according to a 2023 tax industry survey, 43% of tax and finance executives say they lack clarity about how tax fits into their organization's broader governance structure.

Lack of communication creates risk.

Excluding tax from the enterprise risk management strategy leaves the business vulnerable to large gaps in its risk management practices. Tax leaders must advocate for the tax function and encourage alignment with the business's operational functions.



43%

of tax execs lack clarity about how tax fits into organization's governance structure

## Educate Executive Team

The executive team doesn't know what they don't know.

Focus on educating them about tax's impact on the organization's risk profile and financial performance.

Highlight real-world examples of companies facing legal and financial repercussions from tax-related risks.

This can help the executive team better appreciate the potential impact of tax-related decisions.

## Develop & Share Risk Assessments

Develop a structured process for identifying and assessing tax-related risks.

- Encourage the tax team to provide reports and risk assessments in a format easily understood by the executive team.
- Use visualization tools to make the information more attractive and digestible.
- Conduct scenario analyses that demonstrate how different tax strategies or changes in tax laws could affect the organization's financial position and risk profile.

## Align Tax Objectives with Business Objectives

Show that the tax team's objectives align with the broader business objectives and risk management goals of the organization.

Emphasize that proactive tax planning can contribute to profitability and competitive advantage while minimizing risks.

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