

Communicating with the Board of Directors on Taxes

By Richard G. Larsen

This article was developed from a Chief Tax Officers Breakfast Forum hosted by Tax Executives Institute in Washington, D.C., during the Institute's 61st Midyear Conference. The April 5, 2011, discussion was facilitated by Richard G. Larsen, and featured comments by panelists Mitchell E. Salamon, Chief Tax Officer of American Airlines and a member of TEI's Executives Institute, and Lester D. Ezrati, Senior Vice President of Tax at Hewlett-Packard Co. and a former president of TEI, as well as by many of the nearly 100 participants. Mr. Larsen expresses his appreciation to Messrs. Salamon and Ezrati for their involvement in the session.

Boards of directors are increasingly requesting information and input on tax matters and tax risk, as well as on operational aspects of the tax function. They have expanded their role in most companies to provide guidance in balancing the often competing goals of tax minimization, risk management, and certainty in the reported financial results of their companies. Before the enactment of the Sarbanes-Oxley Act in 2002, many boards of directors (as well as internal audit departments) questioned their competency to oversee the tax function and thus paid little attention to the tax function, perhaps viewing it as a "black box." After the implementation of Sarbanes-Oxley and the alarming number of tax-related material weaknesses and restatements reported by a number of companies, many boards realized that they could — and should — provide more guidance and oversight in key areas of managing risk, ensuring that the tax function is operating appropriately and that the significant tax positions a company takes on its tax returns are aligned with the company's overall risk tolerance level.

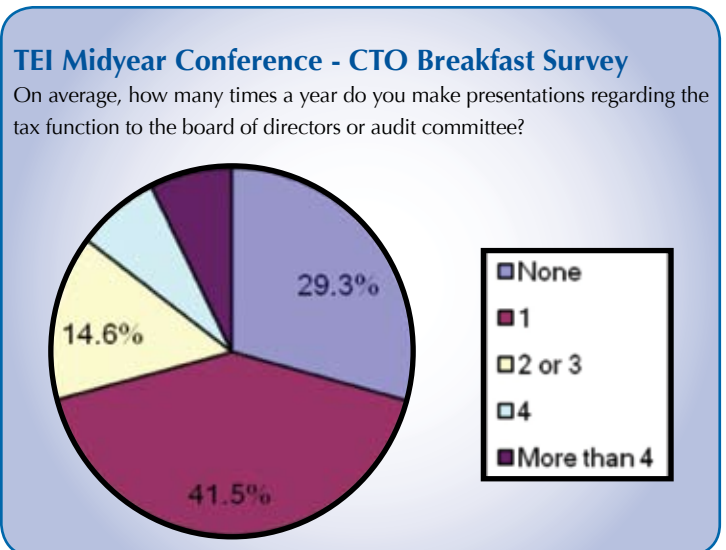
Beginning in 2004, the Australian Commissioner on Taxation strongly encouraged boards of directors to take a more active role in overseeing their company's tax function. Commissioner Michael Carmody said that "an important issue of a board and CEO is to consciously decide the position they wish to take on tax planning, rather than have it made for them by others." A similar message was delivered in the U.K. by Dave Hartnett, the Permanent Secretary for Tax at H.M. Revenue & Customs, who encouraged "top management and audit committees of larger enterprises to take a greater interest in, and personal responsibility for, tax strategies."

More recently, in the United States, the Commissioner of Internal Revenue, Douglas Shulman, during a speech at the 2009 Corporate Governance Conference of the National Association of Corporate Directors, said boards of directors can play an important role in overseeing corporations' tax risk and tax strategies. Commissioner Shulman's goal was to start a discussion concerning the board of directors' role in overseeing tax risk. He noted that many companies have instituted regular meetings between their audit committee and tax director to ensure open dialogue.

A discussion among Chief Tax Officers attending the 61st Midyear Conference of Tax Executives Institute on April 5, 2011, fo-

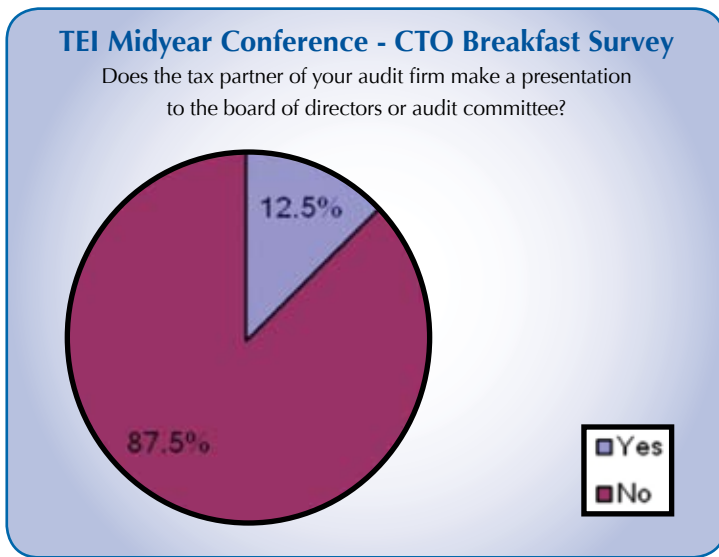
cused on two primary topics: (1) the dialogue between chief tax officers and their boards; and (2) the board's involvement in tax department oversight. This article addresses the first topic.

How Often Do CTOs Meet with the Audit Committee or the Entire Board of Directors?



Twenty-nine percent of the briefing participants reported that they do not make presentations to the board or to the audit committee. In those cases, the CFO is usually responsible for briefing the board on tax matters. This is in sharp contrast with the results of TEI's 2004-2005 corporate tax department survey, which indicated that 73 percent of the CTOs did not meet with the board and 57 percent did not meet with the audit committee. Of those CTO breakfast briefing survey respondents who do make presentations, 77 percent make them to the audit committee and 23 percent to the entire board. In both the CTO breakfast briefing survey and the TEI 2004-2005 corporate tax department survey, most CTOs who reported making presentations said they did so once a year. Almost 15 percent of the respondents, however, reported that they

made four or more presentations each year, an increase from the 2004-2005 survey.



How Do Outside Tax Partners of Your Audit Firm Interact with the Board of Directors, if at All?

Of the participants at the CTO breakfast briefing, only 12.5 percent said the tax partner of their audit firm is asked to make presentations to the board or audit committee. This request was virtually unheard of 10 years ago. Directors often ask the independent tax partner for his or her personal opinion of the tax function, its leadership and operations, and operational issues, as well as of tax matters reported in the financial statements. When the tax partner does not personally make a presentation, the coordinating audit partner typically handles the discussion of tax matters as part of his or her overall presentation in private session. Tax matters are always discussed with the audit committee by members of the accounting firm. The question is: Who should make the presentation?

The merits of having the audit firm's tax partner make the presentation were discussed by the participants of the CTO breakfast briefing. One participant commented on the risks of an audit partner's raising unexpected tax issues with senior management or with the board without first discussing them with the tax department. Another participant related an experience in which the audit partner had been unfamiliar with the technical tax issues and risks associated with a transaction that he discussed with the audit committee. The audit committee asked the CTO to make another presentation on the transaction so the directors could better understand it. The briefing participant said he believed possible tax errors and similar matters brought to the board should be presented by the tax department because it is better able to explain the issues, address concerns, and propose possible solutions. He added that when those matters are discussed by the audit firm, they should be presented by someone who has tax expertise and is familiar with the company's tax function and planning strategies. Along these same lines, another participant said the tax partner, rather than the audit partner, should make the presentation because the CTO could better coordinate the presentations and that person would be more familiar with the tax function.

What Topics Are Commonly Discussed with the Board?

Directors require information to fulfill their governance and oversight roles. They understand the need to balance the often competing goals of tax minimization, risk management, and certainty in their companies' reported financial results. One participant in the CTO Breakfast Forum noted that his company is now a subsidiary of a foreign corporation and that the foreign directors are much more involved with the tax function and cash flow management. Another participant suggested having the CTO meet with new board members to familiarize them with tax matters — which the group agreed is a best practice.

Board members often have information that is not commonly known within the tax function, such as consideration of the sale of the company or other structural or strategic initiatives. Conversely, the tax department's knowledge and perspective can be markedly different from the Board's. A CTO participant overheard two board members commenting after her presentation, "There are certain sounds only a dog can hear. There are certain concepts only a tax person can appreciate."

The survey participants were asked to identify the topics most frequently presented to the board or audit committee. A sampling follows.

What Are the Company's Key Areas of Technical Tax Risk and Exposures?

Sixty-seven percent of the respondents to the survey reported that they addressed this topic in their presentations making it the most commonly discussed topic with the board. One CTO said his board is interested in "anything that addresses risk. They are keenly interested in managing risk." The board generally wants to ensure that the tax department's view of risk is in alignment with the company's risk profile.

What Are the Tax Function's Strategic Objectives and Key Initiatives or Projects?

Fifty percent of the survey respondents said the board wanted to be informed of this topic. At a minimum, boards want to ensure that the tax strategic objectives are aligned with overall corporate objectives. One respondent said his board was particularly interested in the "level of risk associated with tax projects being undertaken." Some CTOs present a value score card to the board to illustrate the savings generated by their planning. It is of course especially helpful to have board endorse and support initiatives that require cooperation from the various business units. Understanding the tax department's initiatives also assures the directors that the company's tax function is appropriately minimizing the company's tax costs.

What Are All Significant Pending Revenue Authority Examinations and Litigation?

Directors — especially those of multinational companies — have noticed the increased cooperation among, and scrutiny by, federal, state, and foreign revenue authorities. Thirty-six percent of survey respondents said this topic was on the agenda for discussion with their directors. Directors have also become more aware of the risks

of indirect taxes like VAT and import duties, as well as of the evolving area of state sales taxes on Internet transactions. The recent recession has made tax authorities more aggressive in pursuing revenue. One participant suggested having the law firm litigating partner present these matters to the board.

What Are the Pending Legislative and Regulatory Matters that Will Affect The Company?

Of the survey respondents, 36 percent said they address legislative and regulatory matters affecting the company. This area has become increasingly important as governments seek ways to raise revenue and capture a larger share of the global marketplace. As the U.S. government considers major changes to the tax system, tax directors must be well aware of proposals and help shape the debate. Directors, senior management, and companies' lobbying firms need clear guidance from CTOs on pending legislative and regulatory matters.

What Are the Various FIN 48 Reserves Established for, and What Items Will Affect the Effective Tax Rate?

Surprisingly, only 39 percent of the CTOs responding listed FIN 48 reserves as a topic for board discussion. Given the new Schedule UTP requirement and other tax authorities' transparency initiatives, more interest among directors was expected. The result suggests that directors may need to know more about these developments, given that information on the key areas of technical tax risk and exposure was the most frequent item on the agenda for CTOs' board presentations.

What Are the Company's Key Nontechnical Tax Risks and What Processes and Controls Are in Place to Reduce Those Risks?

Survey respondent: 'The board is focused on three areas: Risks, risks, risks.'

Directors understand both financial and reputational risks, and managing them is an important part of their governance role. More and more frequently, they require internal audit departments to include the tax function in their enterprise risk assessments and monitoring. The Sarbanes-Oxley Act has led to more discipline in and documentation of tax department processes. Several participants said their boards evaluate the tax department for succession planning and to determine whether it has sufficient resources. Only 11 percent of the survey respondents, however, included this item on their agenda for board or audit committee meetings. Knowledge of the key nontechnical and nonfinancial reporting risks for the tax department, and establishing processes and controls to reduce them, is a cornerstone of good risk management.

What Are the Tax Issues Related to Any Major Events and Transactions — for Example, Pending Mergers, New Plant Locations, or Advance Pricing Agreements?


Because the board of directors is often heavily involved in these matters, this was expected to be a common topic for discussion. In

the survey, only 36 percent of respondents listed it as a matter for board consideration. For tax-related major events like an advance pricing agreement or a tax structured transaction, the CTO should initiate this discussion.

What is the Company's Effective Tax Rate, How Does it Relate to the Company's Tax Strategy, and How Does it Compare to Peers'?

A primary measure of the effectiveness of the corporate tax function is the effective tax rate, especially in comparison with corporate peers' rates. Thirty-nine percent of survey respondents include a discussion of the effective tax rate when speaking to the board or audit committee. CTOs must explain not only their own company's effective tax rate and the factors used to determine that calculation, but also those of the peer group.

Who are the Primary Tax Service Providers, and What Services Are Being Provided By the Company's Audit Firm?

Public company boards must monitor and pre-approve non-audit services, such as tax services, provided by their independent audit firm. Many directors disagree over the extent and propriety of the audit firm's providing tax planning services. Some directors like the fact that the audit firm has provided planning services and is therefore familiar with the transactions and inherent (or attendant) risks. Of the CTOs surveyed, 28 percent said they discuss this topic with the board or audit committee. At the CTO breakfast briefing, the group discussed the importance of briefing the audit firm's tax partner on all major tax planning initiatives or material transactions during the year to avoid year-end disruptions to the annual audit tax review. 

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Companies are expanding the role of Chief Tax Officers in providing tax information to their boards. Many directors are requiring face time with both the CTO and in some cases outside tax service providers to better fulfill their governance and oversight responsibilities. CTOs must not just react to the information requested by the board, but must also use their judgment in selecting other topics for board consideration.

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