

CFO insights: Taxing board discussions? A framework for action

Internal Revenue Service Commissioner Douglas Shulman has urged Boards of Directors to take an affirmative role in overseeing tax planning and risk. In several recent speeches, beginning with his address to the National Association of Corporate Directors (NACD) Governance Conference in October 2009, Commissioner Shulman encouraged directors to consider:

- Setting a threshold confidence level for taking a tax position
- Discouraging or eliminating opinion-shopping by tax departments, and having an independent tax firm that reviews major tax positions
- Transfer pricing and the relative profit allocated to low-tax jurisdictions, and ensuring that they reflect real economic contributions made in those jurisdictions

Commissioner Shulman also suggested that boards question corporate tax executives and external auditors on the following points:

- What was the process for identifying uncertain tax positions and how does the company know all material issues have been identified?
- How did the company go about determining the maximum tax exposure relating to each uncertain tax position? What makes the company comfortable that it accurately reflects the company's maximum exposure?
- How did the company go about quantifying the likelihood of sustaining its uncertain tax positions?

Does the company plan to litigate the issue if the IRS challenges the position? Does the external auditor or tax advisor agree with the tax director's assessment?

- Could the company be subject to potential penalties, such as for underpayment of tax, negligence or worse? If so, are they appropriately recorded, and, perhaps more important, what does this say about how aggressive the company's position is regarding those issues?

Commissioner Shulman is not alone in stating that corporate taxpayers "that employ sound management and governance practices on tax matters are more likely to be compliant." OECD nations are trending toward greater board oversight of tax issues. Given these trends, CFOs and their finance organizations increasingly will be asked to engage in substantive conversations with their boards on taxes. CFOs will want to work together with their tax executives in fulfilling the important role of communicating the company's process for identifying, assessing, and accounting for uncertain tax positions to boards.

Late breaking developments – On January 26, 2010, in a speech to the New York State Bar Association, IRS Commissioner Douglas Shulman announced the release of a proposal (IRS Announcement 2010-9), which contemplates changes to the reporting of uncertain tax positions by large business taxpayers as part of their annual income tax filing. Comments are being requested on a proposal for a new schedule to be filed as part of the annual income tax filings to require 1) disclosure of uncertain tax positions in the form of a "concise description" of each uncertain tax position and 2) the maximum amount of potential federal tax liability attributable to each.



A framework that has been effective for CFOs and tax executives in shaping discussions on tax matters with boards revolves around four specific issues:

- **Rate** – impact on effective tax rate
- **Risk** – integration with overall risk management
- **Resources** – internal and external requirements for execution, maintenance and defense
- **Reward** – timing and amount of cash flow impact

While different boards and CFOs will prioritize each of these areas and the order of relative importance to their company, we believe these four areas of focus are important to framing an effective board dialogue on taxes. Summarized below are certain considerations within each of the four areas.

Rate

Boards should understand the major drivers of the company's effective tax rate. This information is already disclosed by companies in their financial statements, and is becoming increasingly relevant to discerning analysts, shareholders, and regulators. Understanding the company's effective tax rate relative to its peers, and how different areas of a company's business impact the effective tax rate is important. An understanding of these drivers is critical to assessing the impact of changes in the company's business on the effective tax rate. For example, if a company earns a significant portion of its revenues outside the U.S., its effective tax rate may be lower than the U.S. statutory tax rate. However, those earnings may be vulnerable to currency risk and/or the inability to repatriate without significant incremental tax cost. With knowledge of these drivers, boards and management can then consider the tax rate impact that arises from both planned and unexpected changes to their foreign versus domestic revenues.

Risk

As tax positions are integrated with business strategy, tax risk needs to be managed along with operating risk. How can CFOs collaborate effectively with tax executives to communicate tax risk issues to the board? Questions to consider would include the following:

- What impact does the tax issue have on the company's overall tax risk position?
- Does the issue impact the company's examination risk?
- Is there a potential for penalties to be assessed?
- Does the risk arise from interpreting the law, demonstrating the relevant facts, or both?
- Have foreign, state and local, and non-income taxes been considered in addition to federal taxes?
- Is there any reputational risk for the company?
- What processes are in place to manage tax risk within the confines of the broader risk management structure of the company?
- Is the company taking an appropriate level of risk in pursuing potential tax planning opportunities?

As tax ramifications are considered within the context of operational strategy, it becomes difficult to segregate risks into discrete functional domains. Some CFOs are asking tax executives the following questions as they evaluate the potential considerations:

- Would our organization be significantly worse off if the tax position were not sustained than if it had potentially never been implemented?
- Is there the potential for impairing our relationship with taxing authorities?
- Does the transaction create the risk of negative publicity?

Beyond a discussion of the risks associated with existing tax issues, the broader board discussion should establish a consensus for the level of risk the company would tolerate with regard to taxes. For some CFOs and boards, good tax risk management is viewed as bad things not happening. However, this posture can lead to excessive risk aversion and an avoidance of legitimate tax planning that could result in potential tax savings. Good tax risk management is not necessarily equivalent to no tax examinations or adjustments. An effective tax risk discussion should center on what risks the company should be taking as well as how to effectively manage those risks. For an in-depth discussion of tax risk management, refer to "Effective Integration, Enhanced Decision Making: The Risk Intelligent Tax Executive."¹



Resources

Effectively managing tax risk requires specific experience and resources. The sourcing and deployment of resources and the trade-offs between investments in tax resources and benefits derived should be included in a board discussion on taxes. Some considerations for CFOs and tax executives in preparing for this discussion include:

- The direct cost of evaluating a specific tax issue
- The full administrative cost of sustaining the position
- The expected cost of defending the position
- The balance between internal and external resources required

Often the ongoing direct and indirect cost of maintaining a tax position is substantial. Thus, accounting for the total cost is necessary.

In addition, the availability of tax experience can be a critical constraint on a company's capacity to plan for and manage tax issues. As tax experience becomes more specialized and scarce, a critical component of the board discussion will center on how tax experience is effectively sourced. Increasingly, specialization might cause parts of the tax function, like other functions, to be more efficiently delivered through outsourced services than by in-house staff.

Thus, the discussion of resources should give the board greater clarity on the benefits and resource costs of managing tax risk.

Reward

The effective management of a company's tax position can potentially generate immediate as well as continuing tax savings, support market capitalization, and support the financing of specific initiatives. It is useful for the board to understand the nature of the return on resources deployed in managing tax issues and the impact on the company's cash flow.

Framing the board discussion in terms of the timing and amount of tax benefits is crucial. Due to the criticality of cash in today's environment, the timing, levels, potential interest on cash generated, and how cash is saved are increasingly important. One of the most important considerations with tax savings is having an effective plan to use and deploy the amount saved. This requires collaboration between various parts of the finance organization such as treasury and tax.

Conclusion

As recent statements by governmental officials and agencies have demonstrated, tax should be elevated on the board agenda. The board will ultimately be held accountable for the company's tax posture and therefore, an understanding of tax risk is crucial. Focusing on the four areas of rate, risk, resources and reward can provide a useful framework for tax executives and CFOs to organize discussions around tax matters with the board. As boards increasingly ask more focused questions on tax issues, CFOs will need to effectively team with their tax executives, who will play an important role in these discussions.

Endnote

¹"Effective Integration, Enhanced Decision Making: The Risk Intelligent Tax Executive," Deloitte, <http://www.deloitte.com/us/RI TaxExec>.



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