CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

Directors Briefing: Board Oversight of Tax Risk

Questions for Directors to Ask

by Brian J. Wilson

Library and Archives Canada Cataloguing in Publication

Wilson, Brian J., (date)
Board oversight of tax risk [electronic resource] / Brian J. Wilson.

(Directors briefing)
Electronic monograph in PDF format.
Issued also in print format.
ISBN 978-1-55385-744-0

1. Corporations--Taxation--Law and legislation--Canada. 2. Tax planning--Canada. 3. Boards of directors. I. Chartered Professional Accountants of Canada II. Title. III. Series: Directors briefing (Chartered Professional Accountants of Canada : Online)

KE5884.W44 2013 343.7106'8 C2013-900468-8
KF6499.ZA2W44 2013

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Preface

The Risk Oversight and Governance Board (ROGB) of the Canadian Institute of Chartered Accountants (CICA) has developed this briefing to assist boards in understanding taxation issues and the risks posed by taxation.

Risks can arise as a result of both ongoing tax planning processes and extraordinary transactions. Directors, as part of their oversight role, are responsible for overseeing these risks. While much of the work involved in oversight of these risks is often delegated to audit committees, the entire board is ultimately responsible and each director needs to satisfy himself that the materials risks have been identified and addressed. This document is intended to assist directors by suggesting questions that they might ask to aid them in discharging their oversight responsibilities regarding taxation.

The Risk Oversight and Governance Board acknowledges and thanks the CICA staff who provided support to the project and the members of the Directors Advisory Group for their invaluable advice. The Board also acknowledges the author Brian J. Wilson, the editor Joseph Petrie, and Douglas Hayhurst for sharing his observations and insights on this important topic.

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Executive Summary

Taxation is an enormously complex area that poses significant financial and reputational risk. Taxes are among most companies' largest cash costs, corporate tax obligations are complex and varied, and governments in Canada and worldwide are becoming more aggressive and sophisticated in their tax collection techniques. Directors have personal liability for unremitted payroll source deductions and certain sales and other taxes, plus interest and penalties.

As part of their overall stewardship function, directors should consider how the tax planning process—from planning and implementation through tax filing, audits and appeals—can create risks for the organization. Whether a tax plan involves an extraordinary transaction or an ongoing structure, directors should seek assurance that management has identified material or significant risks and taken adequate steps to avoid, manage or mitigate them.

Oversight of tax planning risks

Tax planning involves the design of transactions, processes, business structures or programs that produce a favourable tax result. The tax consequences of most activities and transactions will be clear. In other cases, the interpretation of certain tax laws may be less certain, and taxpayers can take positions on filing their tax returns that differ from those of the revenue authorities.

Depending on the aggressiveness of the tax filing position taken and the expected tax benefit, closer oversight by directors may be needed. Among other situations, directors should consider whether appropriate specialized external tax advice should be sought where the tax plan involves risks related to:

- specific complex areas of taxation law (e.g., corporate reorganizations)
- the involvement of one or more foreign taxing jurisdictions (e.g., cross-border financing)
- proposals developed in-house by tax personnel without the requisite tax knowledge or by third-party tax plan promoters who may be likely to attract tax authority scrutiny
- transfers of assets requiring independent valuations at the time of transfer
- intercompany charges among related parties in multiple jurisdictions (i.e., transfer prices).

Because revenue authorities have broad powers to request working papers and other documents that may help them plan the scope of their audits, directors should inquire about management's procedures for protecting the company's confidential tax planning information.

Directors should seek assurance that management has considered the effect of tax planning transactions on financial disclosure. External auditors can play an important role in determining the disclosure of a specific tax planning transaction in financial statements and its implications, and management should involve them early in the development of a new tax plan.

Oversight of tax plan implementation risks

Once a decision has been made to proceed with a tax planning proposal, processes and resources will be needed to ensure it is implemented as planned, including the preparation of related tax filings and supporting documents. Directors should be satisfied that the company has adequate resources and systems in place to meet these compliance needs, including appropriately skilled tax managers and specialists, external advisers and technologies.

On implementing the tax planning proposal, documentation needs to be in place to effect the required legal entities and relationships and support the plan's legal substance. Once the tax planning arrangement is in place, processes should be established to ensure that the arrangement continues to operate as intended in light of potential business, tax law or other changes.

Due to new accounting standards affecting taxation and new requirements for certification and public disclosure over internal controls and their weaknesses, directors should examine the effectiveness of the company's internal tax controls and obtain certification from management.

Oversight of tax disclosure risks

Once a tax planning proposal has been implemented, risks arise related to the associated disclosures in the company's tax filings. Before implementation, management should satisfy directors that it has considered the position that the revenue authorities are likely to take. When the revenue authorities are likely to differ from the proposed tax filing position, directors must judge whether implementing the plan is worth the higher likelihood that it will be challenged on audit.

In some cases, assurance can be achieved by asking revenue authorities to provide a binding ruling or non-binding technical interpretation on the tax consequences of proposed transactions before they are implemented.

Oversight of tax compliance risks

Putting the appropriate tax filing, remittance and other compliance processes in place for all of a company's activities can be a management challenge.

In addition to the annual income tax return, many returns must be filed at various times in the year, such as GST/HST returns and T4 reporting slips. Certain amounts must be withheld at source and remitted, and tax instalments must be remitted periodically to avoid interest charges. Directors may be personally liable for some payments if the company does not make them, including Goods and Services Tax (GST), CPP and EI payments.

Directors need to seek assurance that management has sufficient resources and processes in place to ensure effective compliance with all applicable taxation laws and to monitor the potential impact of tax law, policy and administrative changes.

Oversight of tax reassessment risks

No matter what tax filing positions are taken, it is always possible that the revenue authority could challenge it. Decisions about whether to defend an original position can entail the actual costs of pursuing the dispute and opportunity costs in terms of time spent on dealing with the dispute at the expense of other business activities.

Where the company has decided to object to a tax reassessment, achieving a satisfactory result may require going beyond the revenue authority's internal appeals process and pursuing the matter through the courts. The costs and risks of defending a tax position would rise the further the appeal is pursued, as would potential reputational costs. Directors should ask management whether these costs could outweigh the benefits of a resolution in the company's favour.

Questions for directors to consider

To help directors ensure that processes and controls are in place to guide decisions about the extent and nature of the company's tax planning and to manage the company's tax compliance obligations and risk, this Briefing offers the following questions for directors to consider asking themselves or management, as appropriate.

Tax planning risks

Has management acknowledged and mitigated risks inherent in more complex tax planning arrangements (for example, international financing arrangements, mergers and acquisitions) by:

- involving specialist tax advice, including location-specific tax advice and written tax opinions where appropriate?
- evaluating the source of the proposal and related fee structure?
- involving valuation expertise?
- considering transfer pricing implications?
- considering commodity and other taxes?
- protecting the confidentiality of tax planning analyses?
- the impact of the relevant tax reporting on the company's financial reporting, including disclosure requirements in financial statements and in MD&A reports?
- weighing the actual costs of implementing and monitoring the proposed arrangement against the expected tax benefits and the risk that they will not be realized?

Tax plan implementation risks

In implementing tax planning proposals, has management displayed sufficient focus on:

- adequacy of human resources to implement the plan?
- adequacy and extent of documentation?
- post-implementation monitoring?

Tax disclosure risks

Has management provided sufficient information and analysis to the board in, for example:

- annual reconciliations of the company's effective tax rate with statutory tax rates and with competitors' effective rates, which can provide information on the tax structure and risks adopted by the company?
- existing administrative interpretations, practices and trends of tax authorities in the jurisdictions in which the corporation operates?

Tax compliance risks

Has management involved the internal and/or external resources commensurate with the level of complexity of the company's tax affairs to:

- prepare and file all required tax returns?
- withhold and remit taxes within deadlines?
- keep up with changing tax requirements?
- deal with compliance errors?
- provide certification for the remittance of taxes and withholdings for which directors have personal liability?
- manage and report on the status of assessments and reassessments?
- manage interactions with revenue authorities?

Tax reassessment risks

In responding to a proposed reassessment by a revenue authority, has management provided the board with:

- sufficient information?
- supporting opinion?
- analysis of potential consequences, including reputation risk, of pursuing an objection or tax court appeal?
- analysis of alternatives courses of action?

Introduction

According to the *TSX Company Manual's* corporate governance guidelines, a key aspect of a board's overall stewardship function includes "the identification of the principal risks of the corporation's business and ensuring the implementation of appropriate systems to manage these risks."[1]

Taxation creates material risks for corporations, in terms of potential costs and missed opportunities, for a number of reasons:

- Taxes are among most companies' largest cash costs.
- Corporate tax obligations are complex and varied, encompassing income tax, sales and excise taxes, Employment Insurance (EI) and Canada Pension Plan (CPP) premiums, capital taxes, municipal taxes and health taxes. By one estimate, Canada has close to three hundred taxation points that can affect a company, and that number multiplies exponentially when a company sources or sells goods or services across international borders.
- As fiscally challenged governments at all levels search for more sources of revenue, revenue authorities are becoming more aggressive and sophisticated in their approaches to collecting taxes. New regimes are being introduced that require companies to increase the transparency of their tax planning practices. Canada Revenue Agency now assesses the quality of large corporations' tax compliance processes and controls in determining the extent of its corporate income tax audits.
- Reporting of taxes in financial statements has historically been one of the most common sources of failures in financial reporting.
- Last but not least, directors have personal liability for unremitted payroll source deductions and certain sales and other taxes, plus interest and penalties.

This *Directors Briefing* is intended to advise directors who are not tax specialists on how the life cycle of the tax planning process can create business risks for the organization, whether the plan involves an extraordinary business transaction or an ongoing tax planning structure. It also suggests specific areas where directors might pose questions to assure themselves that the material or significant risks have been identified and appropriately avoided, managed or mitigated.

Clearly, directors will be involved in tax matters only in cases of material risk, whether downside or upside. It is acknowledged that most tax risk oversight duties are often delegated to audit committees, whose members have some degree of general tax knowledge but not the equivalent insight and experience as a tax specialist.

This briefing generally follows the typical chronology of tax planning arrangements and transactions within a company, as follows:

1. Oversight of tax planning risks
2. Oversight of tax plan implementation risks
3. Oversight of tax disclosure risks
4. Oversight of tax compliance risks
5. Oversight of tax reassessment risks.

1 TSX Group Inc., *Toronto Stock Exchange Company Manual*, at section 474.

1. Oversight of tax planning risks

Tax planning involves the design of transactions, processes, business structures or programs with the goal of producing a particular future tax result, such as accumulation of data, reduction or deferral of tax owing, or acceleration of a tax refund. In most cases, the tax consequences of most activities and transactions will be clear.

In other cases, the interpretation of certain tax laws may be uncertain, and revenue authorities, taxpayers and the courts may have different views on how the tax laws should apply. In these cases, taxpayers can take positions on filing their tax returns that differ from those of the revenue authorities. In doing so, taxpayers run a risk that the revenue authorities could challenge the position on audit. The risk rises with the aggressiveness of the position taken. Also, Canada's tax laws contain a general anti-avoidance rule that can apply to strike down abusive tax planning arrangements that are technically within the law but contrary to its object and spirit.

Tax practices and strategies that are too aggressive may lead to an increased focus from the revenue authorities and potential significant reputational risk. On the other hand, if a company's tax practices are too conservative, the company may miss out on tax saving opportunities.

Depending on the aggressiveness of a specific tax planning proposal and the expected tax benefit, closer oversight by directors may be needed, especially in the following areas.

Specialist tax advice

Tax has become so complicated that tax professionals now tend to specialize in certain areas. For example, a person who is an expert in the complexities of GST/HST may not have the knowledge needed to design a tax-effective cross-border financing deal. In evaluating a specific tax planning proposal, directors should consider whether management has sought appropriate specialized tax expertise. Access to outside expertise is essential in more complicated transactions, particularly for international ones.

Location-specific tax advice

Every jurisdiction has its own unique domestic tax legislation. Legal and tax concepts that apply in Canada do not necessarily apply elsewhere. If a tax planning proposal involves one or more other jurisdictions, directors should ask whether management has sought tax advice to determine the tax risks of locating in those jurisdictions.

To complicate matters further, the most effective tax strategies often involve more than one jurisdiction. In these cases, management needs advice from professionals who are familiar with the laws of each jurisdiction and how these laws interact.

Directors should also inquire about the mindset of the company's management in the foreign jurisdiction to ensure the foreign management team's priorities and objectives are aligned with those of the global company.

Ask about whether management has sought tax advice specific to the tax risks of foreign tax jurisdictions.

Source of proposal

The origin of a particular tax planning proposal can help guide directors in evaluating its merits:

- If the proposal was developed internally, directors should ask whether the people who developed it have the right skills and specialized tax knowledge. For example, an in-house tax person who specializes in compensation arrangements may not have the expertise to undertake a cross-border financing deal.
- If the proposal involves a generic tax plan that is presented by a promoter whose compensation is based on a success fee, the proposal is more likely to be aggressive in nature and come under tax authority scrutiny. In these cases, specific tax reporting requirements related to “aggressive tax planning” may also apply.
- If the company’s external auditor recommended the proposal based on its knowledge of the company and in line with the company’s objectives, directors may be able to take a greater degree of comfort that the related risks have been identified and considered.

Directors should also ask management whether a complementary third-party opinion is advisable in the circumstance and, if so, whether one has been obtained.

Ask about whether a second opinion on the tax proposal’s merits should be obtained from a third-party advisor.

Valuations

In the case of tax-motivated asset transfers, directors should be satisfied that management has considered whether valuations are necessary. For example, if assets are to be transferred to a related entity in another jurisdiction, arm’s-length valuations may be needed to support the conclusion that the assets were transferred at fair market value prices.

Directors also should ask whether valuations were done at the time of the transfer, as tax authorities are less likely to accept valuations that are prepared after-the-fact (for example, in response to a tax audit query).

Ask about whether a valuation should be obtained where assets are transferred to related parties in the course of a tax planning arrangement.

Transfer pricing

For taxpayers that are part of a multinational group, transfer pricing is extremely important. Canadian and foreign revenue authorities worldwide are focused on how profits are allocated within international companies. These allocations affect the profits subject to tax within each jurisdiction, and companies have an incentive to shift their profits to locations where they will pay less tax.

Most countries impose transfer pricing rules designed to prevent such profit-shifting by ensuring reasonable efforts are made to determine appropriate intercompany charges. Transfer prices are usually based on what an unrelated third party would pay for the same product or service. This includes charges for day-to-day cross-border transactions and for internal allocations of functions, assets and risks.

Transfer pricing compliance is an extensive undertaking that requires specialized skills. Directors should ensure that management has taken appropriate steps to comply with transfer pricing rules.

Protecting confidentiality of tax planning analyses

Corporations and their advisors keep an abundance of records documenting their analyses of proposed tax planning arrangements. These documents include audit working papers, emails and laptop hard drives.

Ask about the steps management has taken to comply with transfer pricing rules.

Management needs to take care that the documentation does not go beyond what is needed to support the position taken. In the event of legal proceedings, planning notes, analysis and other correspondence can all be brought into evidence and are producible in discovery. Directors should understand the implications of this and discuss the issue with management regularly as part of their tax oversight role.

Revenue authorities around the world are increasingly seeking access to that information to help them plan the scope of their tax audits, and they have broad powers to request that information in the course of a tax audit.

Revenue authorities are not entitled to information that is protected by solicitor-client privilege. This privilege applies to documents that:

- communicate between solicitor and client
- entail the seeking or giving of legal advice
- are intended to be confidential.

When a company provides a privileged document to a third party, privilege may be waived and the revenue authorities then have a right to that information. Extra care is needed to preserve the confidentiality of privileged documents because privilege can be waived easily in unexpected ways. For example, the Canadian Bar Association has advised lawyers not store confidential information on computers when entering the United States: if the U.S. authorities exercise their right to review the computer's contents, solicitor-client privilege may be undermined.[2]

Ask about the steps management has taken to protect confidential tax planning information.

Directors should inquire about steps that have been taken to protect the company's confidential tax planning information.

Financial reporting of tax planning transactions

Directors should seek assurance that management has considered the effect of tax planning transactions on financial disclosure. A proposed tax planning transaction that meets the technical requirements of the tax law may not be feasible to implement because of the resulting disclosures required in the company's financial statements.

External auditors can play an important role in determining the disclosure of a specific tax planning transaction in financial statements and its implications. Management should involve external auditors early in the development of a new tax planning proposal.

2 Conrad McCallum, "Laptop Searches at the Border: What the Revised U.S. Guidelines Say", Canadian Bar Association, CBA Practice Link at: http://www.cba.org/CBA/PracticeLink/TAYP/laptopborderupdate.aspx

For example, assume a company decides to undertake an aggressive tax plan that may allow the company to claim certain tax deductions against its income but did not consult its external auditor before implementing the plan. The company then issues management prepared statements without disclosing a tax charge. At the time of its year-end financial reporting, the company learns from the external auditors that it should adjust its tax expense to record a tax charge to accord with applicable accounting standards. Shareholders, bankers, potential investors and other stakeholders may not view such a restatement favourably.

Another reason to involve the external auditors in tax planning at an early stage is that, as noted, financial reporting and notes under International Financial Reporting Standards (IFRS) in the future may highlight areas of concern over the judgment applied in reaching a particular tax conclusion.

Oversight of tax planning risks — questions for directors

Has management acknowledged and mitigated risks inherent in more complex tax planning arrangements (for example, international financing arrangements, mergers and acquisitions) by:

- *involving specialist tax advice, including location-specific tax advice and written tax opinions where appropriate?*
- *evaluating the source of the proposal and related fee structure?*
- *involving valuation expertise?*
- *considering transfer pricing implications?*
- *considering commodity and other taxes?*
- *protecting the confidentiality of tax planning analyses?*
- *considering the impact of the relevant tax reporting on the company's financial reporting, including disclosure requirements in financial statements and in MD&A reports?*
- *weighing the actual costs of implementing and monitoring the proposed arrangement against the expected tax benefits and the risk that they will not be realized?*

2. Oversight of tax plan implementation risks

Once a decision has been made to proceed with a tax planning proposal, processes and resources need to be set in place to ensure the proposal is implemented as planned, including the preparation of related tax filings and supporting documents. The implemented plan also needs ongoing monitoring to ensure the arrangement continues to operate as intended in light of business, legislative or other changes.

Directors should be satisfied that management has weighed the actual costs of implementing and monitoring the specific tax strategy against the tax benefits to be achieved and the risks that they will not be realized.

For example, a structure that is complicated and costly to implement and monitor may not be worthwhile if the tax benefit is one or two percentage points. Alternatively, a specific tax planning proposal may promise potential future tax savings if a costly and complicated structure is put in place now. Directors should ensure the proposed tax benefit is weighed against the possibility that the plan or structure will not generate the anticipated benefits.

Adequacy of resources

A system for filing returns and remitting tax that looks appropriate on paper will not function properly unless there are adequate resources to maintain the system. Directors should be satisfied that the company has adequate resources to maintain its compliance systems. These resources will generally include:

- in-house tax management with responsibility to supervise the entire system
- external tax specialists who may complete and/or review tax returns
- technology to make the process efficient
- a hierarchy of tax specialists with knowledge in each of the taxation points that affect the company such as income tax, GST/HST, EI, CPP, capital taxes, municipal taxes and health taxes.

If the company operates in a sector subject to special tax rules and taxable income calculations, such as the financial services industry, directors should be satisfied that management has effective processes and systems in place to comply with these rules.

Ask about whether the right levels of resources and appropriately skilled professionals have been allocated to meet the company's tax obligations.

Adequacy of documentation

On implementing the tax planning proposal, appropriate documentation needs to be in place to effect the required legal entities and relationships. There is a risk that the legal rights and obligations created by the documents may not properly reflect the tax arrangement. The implementation of any tax planning arrangement requires meticulous attention to the documents' preparation and execution.

If the revenue authorities challenge a tax planning arrangement and the dispute ends up in court, the courts will apply the doctrine that the legal substance prevails over the legal form; and the legal substance of a transaction is the legal rights and obligations created by the parties. If the implementation is not meticulous, then the legal substance may not support the specific tax strategy, and it will fail.

Given the length of time it can take to resolve a tax dispute and the possibility of staff or advisor turnover, directors should be satisfied that established documentation standards have been followed. This will ensure that, in the future, a person who was not involved with the file can gain knowledge on material issues without the input of people who were originally involved.

Post-implementation monitoring

Once the tax planning arrangement is in place, processes should be established to ensure that the arrangement continues to operate as intended. Many things can disrupt the specific plan over time including changes to the business, changes in the legislation, changes in tax policy or administration, and changes brought about by case law.

For example, if business is to be carried on by a Canadian company in a foreign jurisdiction without a permanent establishment, thereby making it non-taxable in that jurisdiction, procedures need to be established to ensure that the Canadian company or its employees do not undertake activities in the future that may inadvertently create a permanent establishment and resulting tax liability in that jurisdiction.

Directors should ensure management has an effective plan in place to monitor potential business, tax law or other changes and review their impact on specific tax planning arrangements.

Ask about management's processes for monitoring and responding to developments that may affect tax planning arrangements.

Interaction with financial reporting

The increasing complexity of financial statements and the introduction of new accounting standards affecting taxation are increasing the potential for issues to occur in either accounting for tax or tax reporting.

Effectiveness of internal tax controls

In Canada, the move to IFRS has changed the starting point for taxable income calculations for most public companies. Under IFRS, companies may be required to recognize and measure taxes at the probability-weighted average of all possible outcomes—from having the tax position accepted as filed to having it completely overturned—based on assumptions that the revenue authority would examine the reporting and has full knowledge of all relevant information. For U.S. GAAP reporters, FIN 48 has presented similar reporting challenges for tax.

Further, under the U.S. Sarbanes-Oxley Act section 404 reporting requirements, hundreds of companies over the past several years have reported tax-related material weaknesses to the Securities and Exchange Commission. Similar legislation[3] in Canada requires certification and public disclosure over internal controls and their weaknesses. These rules require Canadian listed companies to explain their process for testing their internal financial controls in their published Management Discussion and Analysis (MD&A) reports.

Ask about the effectiveness of the company's internal controls and obtain certification from management.

3 Ontario Bill 198, enacted in 2003, applies all companies listed on the Toronto Stock Exchange, and therefore applies to virtually publicly listed companies in Canada.

For these reasons, directors should have management provide certification as to the effectiveness of the company's internal tax controls.

Adequacy of documentation

To support the position taken on the financial statements and tax returns, documentation is important. For example, a tax planning proposal may involve the use of reserves to affect the timing for the reporting of income, resulting in tax deferral.

Directors should be satisfied that the methodology used by the company to determine reserves would withstand a revenue authority challenge and that documentation is in place to support this determination.

Ask about the methodology used to determine tax reserves and the supporting documentation.

Tax plan implementation risks — questions for directors

In implementing tax planning proposals, has management displayed sufficient focus on:

- *adequacy of human resources to implement the plan?*
- *adequacy and extent of documentation?*
- *post-implementation monitoring?*

3. Oversight of tax disclosure risks

Once a tax planning proposal has been implemented, risks arise related to the associated disclosures in the company's tax filings. Directors can intuitively gauge the company's overall tax risk exposure from its tax planning activities through an annual reconciliation of the company's effective tax rate paid by the company and the statutory rate. If the reconciliation changes significantly compared to previous years, directors may wish to ask management to explain the underlying reasons.

Directors may also compare the effective tax rate with that of its competitors. If the company's effective tax rate is significantly lower than its competitors, this could signal that the company's tax planning carries relatively more risk.

Determining risk of reassessment

Management should satisfy directors that it has considered the position that the revenue authorities are likely to take regarding a proposed tax filing position. How the revenue authorities interpret the law and its policies should help determine the level of tax risk a company accepts. Most interpretations by revenue authorities are consistent with the interpretations of the members of the tax community, which makes assessing the risk somewhat easier for directors.

When the interpretation likely to be taken by the revenue authorities diverges from the views of the tax community, the added uncertainty makes the decision more difficult. In such circumstances, directors must judge whether the proposed tax planning arrangement is worth the higher likelihood that it will be challenged on audit. In making this evaluation, directors should ask about the relative strength of the revenue authority's interpretation and whether the courts would be likely to support it.

When a plan involves other jurisdictions, directors need to understand the likely assessing positions of the other revenue authorities. In some cases, certainty can be achieved by asking revenue authorities to rule in advance on the tax consequences of proposed transactions before they are implemented. Advance tax rulings are binding on the revenue authorities in most jurisdictions. In other cases, a technical interpretation can be obtained from the revenue authorities, which, while not binding, may provide some comfort as to how the revenue authorities will view certain transactions.

Ask about **the assessing practices of tax authorities in other relevant jurisdictions and whether certainty over tax treatment can be obtained through rulings or other means.**

Tax disclosure risks — questions for directors

Has management provided sufficient information and analysis to the board in, for example:

- *annual reconciliations of the company's effective tax rate with statutory tax rates and with competitors' effective rates, which can provide information on the tax structure and risks adopted by the company?*
- *existing administrative interpretations, practices and trends of tax authorities in the jurisdictions in which the corporation operates?*

4. Oversight of tax compliance risks

Given the significant number of potential taxation points in Canada alone, putting the appropriate filing, remittance and other processes in place for all business activities, including tax planning activities, can be a management challenge. Directors need to consider whether sufficient resources and processes are in place to ensure effective compliance with all applicable taxation laws, in light of the complexity of the company's tax affairs.

Preparing and filing tax returns

Appropriate tax compliance is essential to ensure that all taxation points are covered. In addition to the annual income tax return, many returns must be filed with revenue authorities at various times in the year, such as GST/HST returns and T4 reporting slips.

Ask about the adequacy of the company's system for ensuring all tax returns, withholdings and remittances are submitted on time.

Directors should obtain assurances from management that an appropriate system for filing tax and other information returns is in place. A good system will have several attributes including:

- regular communication among those involved in tax compliance and financial reporting
- a plan for the preparation and review of tax and other information returns
- a deadline control system to ensure that tax and other information returns are filed on time.

Withholding and remitting taxes

Directors should be satisfied that there is an appropriate system in place to withhold certain amounts at source and remit them to the revenue authorities. Tax instalments must be remitted periodically throughout the year to avoid interest charges. Directors may be personally liable for some payments if the company does not make them, including Goods and Services Tax (GST), CPP and EI payments—see "Certification regarding tax payments" below.

Keeping up with changing tax requirements

Many things can affect tax compliance over time, including changes in the legislation, changes in tax policy, changes brought about by case law, and even revisions to the tax forms that must be used. Companies should have an effective process in place to monitor these potential changes and review their impact on the company's compliance obligations. Whether the company relies on in-house or external parties to monitor tax developments, the company should clearly identify accountabilities in this area to ensure that nothing is overlooked.

Compliance errors

Ensuring the company's tax function has effective processes and sufficient human and technological resources in place can significantly reduce the possibility of tax computation or filing errors. But in the event that a compliance error is detected internally after a return has been filed, the company should set appropriate monetary and reputational risk thresholds, depending on the context, for elevating the error for directors' consideration.

If penalties may be assessed because of the error, management may want to consider whether a voluntary disclosure should be made. Taxpayers who make a valid voluntary disclosure will have to pay the taxes and interest, without further penalties or consequences.

Certification regarding tax payments

Many of Canada's tax laws hold corporate directors personally liable for taxes owing by corporations. Most of these provisions concern liabilities that the corporation is required to withhold and remit to the revenue authorities.

Beyond simple failure to pay an outstanding amount, such liabilities can arise from strategic decisions taken by management. For example, a company could decide to change the status of its workers from employees to independent contractors. While such a plan could save administrative costs, it carries the risk that the revenue authorities could challenge the workers' change in status and assess the company for EI and CPP premiums that should have been withheld.

Directors may be personally liable, and so they should ask management to certify that all required tax withholdings and remittances have been made on time.

Tax compliance risks — questions for directors

Has management involved the internal and/or external resources commensurate with the level of complexity of the company's tax affairs to:

- *prepare and file all required tax returns?*
- *withhold and remit taxes within deadlines?*
- *keep up with changing tax requirements?*
- *deal with compliance errors?*
- *provide certification for the remittance of taxes and withholdings for which directors have personal liability?*
- *manage and report on the status of assessments and reassessments?*
- *manage interactions with revenue authorities?*

5. Oversight of tax reassessment risks

No matter what tax filing positions are taken, there is always a possibility that the revenue authority could challenge it. Decisions about whether to defend an original position and how much effort to spend on the defense can entail both actual and opportunity costs. These costs may include:

- retaining tax advisors to carry an objection through the appeals process
- staff time spent gathering information for the revenue authorities throughout the appeal process
- time spent by other people within the organization on the appeal rather than on other aspects of the business.

Directors should also take an interest where the company's taxes are assessed as filed. This may indicate that management is not being aggressive enough in its tax filing positions and that the company may be missing tax saving opportunities as a result.

Pursuing objections and appeals

Where the company has decided to object to a tax reassessment, achieving a satisfactory result through the revenue authority's internal appeals process may not be possible. The costs and risks of defending a tax position would rise the further the appeal is pursued. Resolving a tax case through the courts can take years and even longer if the case is appealed to higher levels. Even if the company wins, its costs may not be fully recovered.

Reputational risks also rise when a tax dispute reaches the courts. The file is a matter of public record and a high-profile case could attract unwanted media exposure. The potential reputational costs should factor into decisions on whether and how far to pursue a tax dispute.

Ask about the potential monetary and reputational risks of pursuing a tax dispute and whether they outweigh the benefits of a resolution in the company's favour.

Paying taxes in dispute

Directors should be satisfied that management has assessed the implications of paying or deferring taxes and interest arising from a reassessment that is in dispute. Some companies opt to pay the tax and interest in dispute as soon as it is assessed, even though the law does not require payment until the appeal is resolved. Other taxpayers choose to wait until the matter is resolved before payment; if they do, interest will continue to accumulate during the appeal process.

Directors also should be satisfied that management has adequately planned its cash flow to account for the risk of reassessment.

Settlement

There may be the opportunity to settle with the revenue authorities at any point in the objection and appeal process. Directors should ensure that management has assessed the relative cost benefit of negotiating a possible settlement. Directors may also become involved in using their judgment to weigh the settlement's pros and cons.

Risks on tax reassessments — questions for directors

In responding to a proposed reassessment by a revenue authority, has management provided the board with:

- *sufficient information?*
- *supporting opinion?*
- *analysis of potential consequences, including reputation risk, of pursuing an objection or tax court appeal?*
- *analysis of alternative courses of action?*

Conclusion

Taxation is an enormously complex area that poses significant financial and reputational risk in the absence of effective management and oversight. Directors should not expect to fully understand the intricacies of their organization's tax obligations and planning arrangements. Rather, they should ensure that processes and controls are in place to guide decisions about the extent and nature of the company's tax planning and to manage the company's tax compliance obligations.

Summary of Tax Oversight Risks

With effective tax oversight, directors can help companies mitigate or avoid the significant risks that can arise due to ineffective tax planning or noncompliance with the tax law.

Financial risks

- Penalties and interest on unfiled or late-filed tax returns and tax payments
- Double taxation of amounts assessed in both home and foreign tax jurisdictions
- Directors' personal liability for unremitted GST and certain source deductions (e.g., EI and CPP premiums)
- Cash flow impact of paying or not paying taxes in dispute

Reputational risks

- Harm to the company's brand and its perception among shareholders, regulators and other third parties
- Material misstatement of tax accounts in financial reports
- Increased tax audit scrutiny based on historical tax filing deficiencies

Opportunity costs

- Missed tax saving opportunities through lack of tax planning or lack of tax-efficient business structures

List of Questions for Directors to Ask

Oversight of tax planning risks

Has management acknowledged and mitigated risks inherent in more complex tax planning arrangements (for example, international financing arrangements, mergers and acquisitions) by:

- involving specialist tax advice, including location-specific tax advice and written tax opinions where appropriate?
- evaluating the source of the proposal and related fee structure?
- involving valuation expertise?
- considering transfer pricing implications?
- considering commodity and other taxes?
- protecting the confidentiality of tax planning analyses?
- the impact of the relevant tax reporting on the company's financial reporting, including disclosure requirements in financial statements and in MD&A reports?
- weighing the actual costs of implementing and monitoring the proposed arrangement against the expected tax benefits and the risk that they will not be realized?

Oversight of tax plan implementation risks

In implementing tax planning proposals, has management displayed sufficient focus on:

- adequacy of human resources to implement the plan?
- adequacy and extent of documentation?
- post-implementation monitoring?

Oversight of tax disclosure risks

Has management provided sufficient information and analysis to the board in, for example:

- annual reconciliations of the company's effective tax rate with statutory tax rates and with competitors' effective rates, which can provide information on the tax structure and risks adopted by the company?
- existing administrative interpretations, practices and trends of tax authorities in the jurisdictions in which the corporation operates?

Oversight of tax compliance risks

Has management involved the internal and/or external resources commensurate with the level of complexity of the company's tax affairs to:

- prepare and file all required tax returns?
- withhold and remit taxes within deadlines?
- keep up with changing tax requirements?
- deal with compliance errors?
- provide certification for the remittance of taxes and withholdings for which directors have personal liability?
- manage and report on the status of assessments and reassessments?
- manage interactions with revenue authorities?

Oversight of tax reassessment risks

In responding to a proposed reassessment by a revenue authority, has management provided the board with:

- sufficient information?
- supporting opinion?
- analysis of potential consequences, including reputation risk, of pursuing an objection or tax court appeal?
- analysis of alternatives courses of action?

The author acknowledges the contribution of Douglas Hayhurst in reviewing this Director Briefing and thanks him for sharing his observations and insights on this important topic. Acknowledgement is also offered to Joseph Petrie for his editorial assistance in developing this publication.

Where to find more information

CICA Publications on Governance*

The Director Series

The 20 Questions Series

20 Questions Directors and Audit Committees Should Ask about IFRS Conversions (Revised)

20 Questions Directors Should Ask about Building a Board

20 Questions Directors Should Ask about CEO Succession

20 Questions Directors Should Ask about Codes of Conduct (2nd ed)

20 Questions Directors Should Ask about Crisis Management

20 Questions Directors Should Ask about Crown Corporation Governance

20 Questions Directors Should Ask about Director Compensation

20 Questions Directors Should Ask about Directors’ and Officers’ Liability Indemnification and Insurance

20 Questions Directors Should Ask about Executive Compensation (2nd ed)

20 Questions Directors Should Ask about Governance Assessments

20 Questions Directors Should Ask about Governance Committees

20 Questions Directors Should Ask about Insolvency

20 Questions Directors Should Ask about Internal Audit (2nd ed)

20 Questions Directors Should Ask about IT (2nd ed)

20 Questions Directors Should Ask about Management’s Discussion and Analysis (2nd ed)

20 Questions Directors Should Ask about Responding to Allegations of Corporate Wrongdoing

20 Questions Directors Should Ask about Risk (2nd ed)

20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee

20 Questions Directors Should Ask about their Role in Pension Governance

20 Questions Directors Should Ask about Special Committees (2nd ed)

20 Questions Directors Should Ask about Strategy (3rd ed)

*Available at cica.ca/governance.

Director Briefings

A Framework for Board Oversight of Enterprise Risk

Climate Change Briefing — Questions for Directors to Ask

Controlled Companies Briefing — Questions for Directors to Ask

Diversity Briefing — Questions for Directors to Ask

Long-term Performance Briefing — Questions for Directors to Ask

Shareholder Engagement — Questions for Directors to Ask

Sustainability: Environmental and Social Issues Briefing — Questions for Directors to Ask

Director Alerts

The ABCP Liquidity Crunch — questions directors should ask

Executive Compensation Disclosure — questions directors should ask

Fraud Risk in Difficult Economic Times — questions for directors to ask

The Global Financial Meltdown — questions for directors to ask

Human Resource and Compensation Issues during the Financial Crisis — questions for directors to ask

New Canadian Auditing Standards — questions directors should ask

Social Media — questions for directors to ask

The Not-for-Profit Director Series

NPO 20 Questions Series

20 Questions Directors of Not-for-Profit Organizations Should Ask about Board Recruitment, Development and Assessment

20 Questions Directors of Not-for-Profit Organizations Should Ask about Fiduciary Duty

20 Questions Directors of Not-for-Profit Organizations Should Ask about Governance

20 Questions Directors of Not-for-Profit Organizations Should Ask about Human Resources

20 Questions Directors of Not-for-Profit Organizations Should Ask about Risk

20 Questions Directors of Not-for-Profit Organizations Should Ask about Strategy and Planning

Liability Indemnification and Insurance for Directors of Not-for-Profit Organizations

NPO Director Alerts

Pandemic Preparation and Response — questions for directors to ask

Increasing Public Scrutiny of Not-for-Profit Organizations — questions for directors to ask

New rules for charities' fundraising expenses and program spending — questions for directors to ask

New Accounting Standards for Not-for-Profit Organizations — questions for directors to ask

The New Canada Not-For-Profit Corporations Act — questions for directors to ask

Other Publications

A Guide to Financial Statements of Not-For-Profit Organizations — questions for directors to ask

Accountants on Board — A guide to becoming a director of a not-for-profit organization

The CFO Series

Deciding to Go Public: What CFOs Need to Know

Financial Aspects of Governance: What Boards Should Expect from CFOs

How CFOs are Adapting to Today's Realities

IFRS Conversions: What CFOs Need to Know and Do

Risk Management: What Boards Should Expect from CFOs

Strategic Planning: What Boards Should Expect from CFOs