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Director Briefing: Strengthening Tax Governance

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Preface

The Corporate Oversight and Governance Board (COGB) of the Chartered Professional Accountants of Canada (CPA Canada) has commissioned this Briefing, *Strengthening Tax Governance*, to help boards understand their role in overseeing the risks that can stem from taxation.

Because the proactive management of tax risk is a critical component of maintaining a successful and sustainable organization, boards should take notice of these risks and enhance their understanding of this complex area.

The COGB and the author would like to thank the many board members and tax experts who provided valuable input during the drafting of this Briefing.

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Table of Contents

Introduction 1

Framework for Identifying and Assessing Tax Risks 1

Tax Risk Management: Is There a Tax Policy and Is It Being Followed? 2

Tax Compliance Risk: Are Effective Controls in Place and Working? 3

Tax Planning Risk: Is the plan or filing position likely to be challenged? 6

Tax Reassessment Risk: Has the Organization Been Tagged as High Risk? 7

Tax Reputational Risk: Is the Organization Perceived as a Responsible Taxpayer? 9

Concluding Observations 9

Introduction

Tax governance is a complex area that can have significant ramifications for the sustainability of an organization. The failure to meet tax obligations may impair operations, trigger substantial financial penalties, cause material reputational harm and even create personal liability for directors.

Tax governance may not be a comfortable topic for most boards. The nuances of tax law are often complex and considerable uncertainties can arise from tax disputes. However, the proactive management of tax risk is critical to operating profitably in the current environment.

This publication provides board members with a basic framework within which to identify and assess modern tax risks, while encouraging them to leverage expertise from management and others to strengthen the tax governance structure of the organization.

Framework for Identifying and Assessing Tax Risks

To meet their oversight duty effectively, directors must be sufficiently fluent in tax matters and be aware of material tax risks. While much of the work involved in the oversight of such risks is often delegated to audit and risk committees, the entire board is ultimately responsible and must be satisfied that the risks are being appropriately managed.

All directors, and especially those responsible for tax oversight, should focus on the following main sources of tax risk: (1) risk management; (2) compliance risk; (3) planning risk; (4) reassessment risk; and (5) reputational risk.

This publication addresses these concepts and reminds board members that each risk can stem from any form of taxation.

1. **Tax Risk Management:** Risks are not limited to unanticipated assessments by domestic or international tax authorities; they can also include reputational impacts, cash flow strains and more. For governance to be effective in managing tax risk, the board must form a clear understanding of what key stakeholders would consider an acceptable level of tax risk for the organization. This can, and should, be achieved through a written tax policy developed by management and approved by the board.
2. **Tax Compliance Risk:** Sufficient controls should be in place in all relevant jurisdictions to ensure that tax compliance obligations are being met. The board should ensure that management is deploying such controls effectively.

3. **Tax Planning Risk:** Legacy tax plans should be periodically reviewed to confirm that they fit within the organization's current tax policy and the board's view of acceptable tax risk. Before implementing any tax plans that could have a material financial or reputational impact on the organization, all related risks should be assessed critically, both internally and with the benefit of external advice where appropriate.
4. **Tax Reassessment Risk:** The profile of tax has become increasingly visible, not only from the perspective of investors and boards, but also from the public's perspective. Attention should be paid to all aspects of the organization's tax profile that could attract scrutiny or challenge.
5. **Tax Reputational Risk:** In today's climate of swift moral judgment through media coverage, an organization must often do more than merely ensure compliance; it must also mitigate reputational risks by ensuring that it is perceived by the tax authorities and the investing public as a responsible corporate citizen. The board should ensure that the prospect of capitalizing on any material tax benefit is weighed against the possibility that it could be front page news if challenged.

TAX RISK MANAGEMENT

Is There a Tax Policy and Is It Being Followed?

To properly discharge its oversight responsibility, the board must clearly understand what key stakeholders regard as an acceptable level of risk both in tax planning and in the selection of tax filing positions.

Tax planning involves the design of transactions, processes, business structures or programs that produce an optimal tax result. In addition, for significant or complex transactions where tax planning has not taken place, there may still be more than one possible filing position where the risk levels vary.

Although the tax consequences of most transactions will be clear, in other cases, the interpretation of tax laws may be less certain. If a filing position is taken that differs from the position of the relevant tax authority, it may result in an audit or reassessment. In such cases, it is advisable to have research and analysis on file to justify taking a different position.

In addition, Canada's tax laws contain a general anti-avoidance rule (GAAR) which can negate any tax benefits arising from "abusive" transactions that are technically within the law but contrary to its purpose. The Canada Revenue Agency (CRA) has been relying increasingly on the GAAR to support assessments, and its efforts have met with some success.

Depending on the nature of the organization's tax filing positions and the expected tax benefit of each, closer oversight by the board may be appropriate. A documented tax policy provides the board with a baseline to exercise this oversight and assess whether the organization is meeting its stated tax objectives.

To assist in the review and approval of such a policy, boards are encouraged to participate in some form of tax training session, led by either senior tax management or external tax advisors, to ensure they are fully informed of the main risks posed to the organization.

TOP TIPS

Having the board undergo tax orientation can help directors identify risks. Publicly disclosing the tax policy can enhance stakeholder perceptions of the organization as a responsible corporate citizen.

Once the tax policy has been developed and approved, the board can also consider whether to make it public. As corporate social responsibility (CSR) becomes increasingly ingrained in society, stakeholders may perceive public disclosure as enhancing the reputation of the organization as a responsible corporate citizen.

TAX COMPLIANCE RISK
Are Effective Controls in Place and Working?

Tax risks arise from many different sources. Directors should have a basic understanding of the tax obligations imposed on the organization, even if they do not fully appreciate the intricacies of tax law. They should ensure processes and controls are in place to guide decisions about the extent and nature of the organization's tax planning as well as the key tax positions that have been taken and to manage its tax compliance obligations.

DID YOU KNOW?

Simply driving a company truck with inventory through a U.S. state can trigger a tax filing requirement, or even payment of a minimum tax.

With strong internal controls, an organization can reduce the likelihood of avoidable errors or omissions. For effective tax governance, the board must be comfortable that both management and internal auditors have such controls in place to monitor tax compliance and are positioned to warn the board of potential changes in tax filing or payment requirements in existing as well as new jurisdictions.

DID YOU KNOW?

Globally, there is a trend of lower corporate income taxes, but higher indirect or sales taxes. Does your organization understand how this could impact business?

The board should appreciate there are different types of taxes, each with distinct filing and payment requirements. Generally, the most material taxes are income tax, indirect or sales tax, non-resident withholding tax and payroll tax.[1] Basic cash flow risks arising from these various forms of taxes can be easily mitigated through appropriate controls that ensure tax instalments and payments are both accurately projected and timely made.

DID YOU KNOW?

In an income tax case, the CRA is entitled to collect half of the total amount in dispute from a large corporation, without awaiting resolution of the case.

Effective controls can also assist in responding to unanticipated reassessments (e.g., by ensuring deadlines are not missed). Even where such reassessments are challenged, there may be immediate financial consequences, particularly if the organization qualifies as a large corporation.[2]

Large corporations are subject to special income tax rules that entitle the CRA to collect 50% of the disputed amount, even before the dispute is resolved. In the case of GST, the full amount is generally collectible. This could impair even a well-capitalized organization by severely restricting its free cash flow, and potentially make it harder to issue debt if the CRA secures the amount against corporate assets. Moreover, if the large corporation is a public company, financial disclosures may be required.

As a result, the board must stay well informed of any material tax positions that are likely to be challenged, and the resulting financial impact to the organization. The facts giving rise to the tax dispute will influence how it is handled (*i.e.*, accepted, settled, or challenged in court), determine if the organization is operating within its stated acceptable level of tax risk (as documented in its tax policy), and highlight potential strains on cash flow that can be proactively mitigated.

1 Annual Financial Report of the Government of Canada, Fiscal Year 2016-2017, "Composition of Revenues": www.canada.ca/en/department-finance/services/publications/annual-financial-report/2017/report.html

2 "Large corporation" is defined in subsection 225.1(8) of the *Income Tax Act* (Canada).

Questions the board should ask regarding tax-related controls are:

- What controls are in place to ensure tax returns and information returns are filed accurately and on time, and sufficient payment is made to all appropriate government authorities?
- What controls are in place to ensure the organization, if operating internationally, is meeting local tax obligations, including country-by-country reporting requirements?
- How does the organization ensure it responds to all audit or information requests within allowable time limits, and with the benefit of appropriate guidance and advice?
- Are all material transactions subject to written tax analysis[3] supported by external opinions and, if suitable, by Advance Tax Rulings (ATR)? Are the external opinions sufficiently independent and, if deemed appropriate, protected by any applicable privilege?[4]
- What controls are in place to ensure uncertain tax amounts are being properly calculated and disclosed in public filings?

Finally, directors should seek assurance that management has fully considered the effect of tax planning transactions on financial disclosure. A high-risk transaction that meets the technical requirements of tax laws may not be feasible because of the resulting disclosures required in publicly available financial statements. The board should also be satisfied that the methodology and decision-making process used by the organization to determine the amount of tax reserves booked will withstand challenge.

TOP TIP

Ensure management has taken appropriate measures to identify and quantify a tax reserve and meet disclosure requirements.

3 The Federal Court of Appeal's decision in *BP Canada Energy Company v. MNR* (2017 FCA 61) suggests that if such written analysis forms part of a public company's "tax accrual working papers", the CRA may not generally be permitted to obtain disclosure (these are papers created by or for independent auditors to assist in the process leading to the certification of financial statements in accordance with GAAP).

4 For example, opinions from legal counsel are subject to solicitor-client privilege and, as such, afforded protection from disclosure to the CRA. It should be noted that the question of whether such privilege applies is fact specific and varies from jurisdiction to jurisdiction.

TAX PLANNING RISK

Is the plan or filing position likely to be challenged?

Tax is often complex, particularly in significant transactions; the details should be left to the experts. However, the board must appreciate that almost all tax disputes and any resulting publicity stem ultimately from a filing position supported by management.

To achieve effective tax governance, boards should question management at least annually about the types of tax structures currently in place as well as new ones being considered. Also, where significant transactions have been undertaken, it may make sense to ask about the filing positions taken on these transactions. Some key questions that should be asked are:

- Which tax structures or transactions are most likely to be challenged by the CRA? What is the CRA's position and, if different, is there support for taking a different position?
- Which tax structures or transactions could potentially embarrass the organization, impact customer trust, or impair public procurement contracts if they were made public?
- Do historical tax structures continue to be within a tolerable risk range as stated in the organization's tax policy? Also, where the environment has changed, do other structures exist that are more efficient from a tax perspective?
- Should any historical structures be unwound and restructured to comply with the current tax legislation and the prevailing legal, political and social environment?
- Are tax reserves adequate?
- Is there a tax-efficient plan to repatriate needed capital that is currently located offshore?

DID YOU KNOW?

Taxpayers can ask the CRA for an "Advance Tax Ruling" which confirms the CRA's view of how tax legislation would apply to a prospective event. Although this can take time and requires upfront disclosure, it can provide certainty in relation to complex transactions.

There are several ways in which management can provide comfort to the board regarding the legitimacy of proposed structures. For example, if a plan is not yet in place, the organization can approach the CRA and request an ATR if time permits. If provided with the details of a proposed transaction, the CRA may agree to issue such a ruling providing its interpretation of how the legislation would apply in the circumstances. This may help create some tax certainty for the organization. Other methods will often be necessary, depending on the circumstances.

If a ruling is not sought or is not possible to obtain, there are alternative ways to manage risk. At a minimum, an internal memorandum should be prepared for routine tax plans, as well as planning undertaken in the context of significant transactions, which outline the: transaction(s), the commercial objective(s) and specific legislation on which the plan is premised. This memorandum can advise on the differing tax consequences of alternative ways to achieve the commercial objective and provide a recommendation to the board.

If the risks are such that a greater level of certainty is required (e.g., international structures, or when third-party liability is a factor) the organization should obtain a second opinion from an independent external advisor. Such an opinion offers an added level of comfort as it provides an impartial assessment of the chances of success in the event the plan is challenged.

When selecting and collaborating with external advisors, management should assess whether the advisor is qualified and sufficiently independent. Also, management should consider the extent to which communications with the advisor, including any opinions obtained from the advisor, can be accessed by the CRA.

Additionally, the board should consider whether any opinions obtained accurately take into consideration litigation risk (*i.e.*, does the opinion assume away harmful facts or fail to reflect the burden of establishing the facts necessary for the desired legal outcome).

TOP TIP

Boards should ask management if any historical tax structures need to be unwound or restructured due to the organization's current tax policy and the prevailing tax, legal, political and social environment.

The board should always verify the level of diligence undertaken by management before deciding to continue with any existing plan or to proceed with a proposed plan. More importantly, the board should ensure that the level of risk for both existing and proposed plans are consistent with the organization's approved tax policy.

TAX REASSESSMENT RISK

Has the Organization Been Tagged as High Risk?

There is always a possibility that a tax filing position may be challenged. Directors should be assured that the organization is fully compliant with all required filings, payments and information requests. The board itself may otherwise be at risk. Management should also satisfy the board that it has acted responsibly and taken supportable filing positions so as to reduce the likelihood of the organization being perceived or categorized as high risk.

DID YOU KNOW?

Directors have personal liability for unremitted payroll source deductions and certain sales and other taxes, plus interest and penalties.

The CRA currently uses an integrated risk-based approach to large business compliance to identify and address the highest risk cases nationally. As part of the CRA's *Approach to Large Business Compliance* (ALBC) framework, entities that are in the large business audit population segment and are currently under audit can invite the CRA to explain the organization's risk rating and the significant audit issues that have been identified during the audit process. This can highlight any specific structures or transactions that are viewed as contributing to a higher risk rating by the CRA and enable the board to have a more informed discussion with management.[5]

Large corporate taxpayers are inherently more complex and, as a result, inherently higher risk. However, taxpayers that are transparent with the CRA about their tax risks and maintain effective internal controls demonstrate a lower behavioural risk, thereby allowing the CRA to validate the level of compliance and provide earlier tax certainty.

It follows that management should proactively identify for the board any other aspects or features of the organization's tax profile that may attract scrutiny by the tax authorities such as the CRA. For example, the board should look closely at jurisdictions with large variances between the statutory tax rate (tax rate imposed by law) and the effective tax rate (percentage of income actually paid as tax). Variances are normal and can be explained, but large variances may trigger increased audit activity or negative publicity.

Finally, changes in technology and information sharing have fundamentally altered the tax compliance landscape and the ability of tax authorities to gather and analyze taxpayer information. The trend to transparency, including global exchange of information agreements as well as non-traditional sources of information (e.g., leaks through media outlets) have resulted in tax authorities accessing far more corporate data than would previously have been available. Directors should understand the implications of these developments and discuss the issue with management regularly as part of its oversight role.

5 The CRA has also recently expanded a program where tax compliance letters can be obtained by corporations online. These letters can help provide assurance to the board that the corporation has met its basic compliance obligations.

TAX REPUTATIONAL RISK

Is the Organization Perceived as a Responsible Taxpayer?

Reputational damage from either real or perceived tax non-compliance can cause significant damage to an organization's brand and future revenue streams. This is especially the case for consumer industries and those that rely on public procurement contracts or seek to rely on government subsidies during difficult financial times. Today, an organization must go beyond simply meeting its tax obligations; it must also mitigate reputational risk by ensuring it is perceived by the investing public as a socially responsible taxpayer.

Even with strong controls in place and conservative tax planning, audits and CRA requests for information should be expected. To facilitate this normal process, and create a climate of trust, corporate tax policies should direct management to comply with CRA information requests in a timely, respectful manner and to the full extent of the law.

If the organization decides to challenge an assessment, it may be necessary to go beyond the tax authority's internal appeals process and seek recourse in the courts. The further an appeal is pursued, the greater the costs and potential reputational risk, as court proceedings are public. Directors should ask management whether these costs outweigh the benefits of a resolution and ensure there is a public relations plan in place to respond to the press should the need arise.

Concluding Observations

Tax is complex and it can materially impact cash flow as well as reputation. By following the above framework and having regular discussions with management about mitigating these risks, the board will be well-equipped to strengthen its tax governance.

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